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Only original papers will be published and a copy of the Publishing Agreement will be sent to the authors of papers accepted for publication. Manuscripts will be processed only after receiving the signed copy of the agreement.

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EDITORIAL

There are occasions when the editor of this journal takes up the pen to write rather than edit, yet such occasions have been few and far in between—and that is how it should be. However, now that thirty years have passed since the first volume of *Acta Oeconomica* had been published, it seems to be fitting to open the thirty-first year with an editorial. Although anniversaries when journals turn thirty usually go unnoticed, we made it a point to carry in this issue articles by authors who have made special contributions to this journal in previous decades.

Acta Oeconomica turned thirty six years after the sweeping political and economic changes of 1990. Therefore, it seems to be justified to consider the accomplishments of Hungarian economics and economic policy over the past thirty years, and whether the journal has managed to present a realistic picture of these tendencies. The question is also particularly relevant for this journal because—along with some other institutions—it is the product of a remarkable stage in economic reforms, which started in the second third of the 1960s.

The late György *Cukor*, who was active in encouraging the international cooperation of economists, raised the idea of launching a Hungarian economic journal in a foreign language years before *Acta Oeconomica* first came out. Initially his recommendation was ignored.

In 1965 the Class of Economics and Legal Science was set up at the Hungarian Academy of Sciences and this made it possible to start *Acta Oeconomica*. It would be false modesty not to add that the author of this editorial wrote the recommendation, acting at the request of the Economics Committee of the Academy.

Economics gained in prestige in Hungarian academic circles because the preparation of reforms had got underway in the second third of the 1960s. Launching an economics journal in a foreign language and making a cautious opening towards the external economy were organic components of this process. This opening was inevitable for the Kádár regime because the preparations of the reform were only permitted after it was realised how serious the disequilibrium of the external economic balance was.

It goes without saying that Hungary was not the only country to experience such developments. The need to improve the efficiency of economic management applying economic means appeared on the agenda of several countries of the region, including the Soviet Union. Economists of these countries badly needed closer research ties. Moreover, the drive towards reform attracted the attention of Western economists who specialised in Eastern European affairs. A plethora of research papers—which were normative in nature but included critical observations and thereby broke fresh ground—were offered for publication. Consequently, demand and supply were both there to justify the starting of a new journal.

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In Hungary, just as elsewhere in the region, economics was under political control. There were several levels of this control, the highest one being the Agitation and Propaganda Committee of the Hungarian Socialist Worker's Party (HSWP).

That Committee, and the staff of a department subordinated to it, checked on the work of newspapers and periodicals. Fortunately, *Acta Oeconomica* was not categorised as a periodical because it was not sold by street vendors. It was available either on subscription or in the bookshop of the Academy. As a consequence, the ebb and flow of daily politics had no direct influence on our work. The limits of the room for manoeuvre were fixed "merely" by the self-censorship of the authors and the editor.

There were, in addition, administrative limitations. Initially Kultúra, the only export/import house that was authorised to trade in periodicals, succeeded in having *Acta Oeconomica* included on the list of periodicals that could be distributed in the socialist countries. Later on it was struck off the list, apparently at a Soviet initiative (because the journal also carried articles in Russian). The agitprop department of the HSWP rejected the idea that the journal be distributed as a present by Hungarian diplomats and trade mission staff abroad. That was the price the journal had to pay for not being under direct political control.

This peculiar situation made it possible, for instance, to publish an article by Ferenc *Jánossy* on what he called the "quasi developed" nature of the Hungarian economy. Prior to its publication in *Acta Oeconomica*, the paper was harshly criticised at a public conference by the Prime Minister himself. There were other instances when politics interfered with our work. At a time when the Sino-Soviet relations were at a low ebb, we could afford to publish a critical analysis of the Chinese economy. (It had for a long time been forbidden to openly criticise the economic performance or economic policy of other socialist countries.) That article on China attracted so much attention that it was translated from English into German and published in its entirety by *Neue Zürcher Zeitung*.

It was another sign of Hungary's external economic opening that in 1970 the Council for World Economy was set up to act as an advisory body to the Secretariat for International Economic Relations. We agreed with the Chairman of that Council, Professor József *Bognár*—who died in November 1996—that the Council would not launch a journal of its own but would, instead, grant resources for doubling the size of *Acta Oeconomica* as from 1971.

The spectrum of the journal—which until then focused on Hungarian economic policy and especially issues of the economic reform—broadened. As from the third volume, articles by foreign authors also occasionally appeared (as for instance, that by William *Fellner*, Jan *Tinbergen* and Robert *Triffin*), as well as the results of Hungarian research on the world economy. (The Institute for World Economics was formed in 1973.) *Acta Oeconomica* increasingly showed that international organisations were not the only fora where Hungarian economists met foreign economists. Bilateral committees of economists (for instance, Hungarian–

Austrian, Hungarian–Dutch, Hungarian–British, Hungarian–French, Hungarian–German, Hungarian–Soviet, etc.) were formed, in which economists met regularly. A change of attitude occurred simultaneously with the expansion of the size: the journal announced that it would launch a programme of an *alternative* approach to problems of the socialist economy (József Bognár).

The year 1972 witnessed a change of direction in Hungarian economic and science policy. Regression came first, to be followed by repression. These developments had limited but lasting effects on the journal. The political climate of the time did not tolerate the proposals for carrying on with the 1968 reform (itself the result of hard-won compromises). Many of the articles which economists published between 1963 and 1972 included original ideas and critical views. By contrast, political pressure slowed down the reform drive for some years.

The editorial opening the second decade in the life of the journal did not proclaim a new programme, it only promised to retain the results achieved that far. That was also an accomplishment at that time, as illustrated by the fact that the next issue carried an article by Ferenc *Donáth*, a politician and scholar specialising in agricultural affairs, who served on the 1956 government of Imre Nagy. Articles that expressed fresh ideas were published about the economic relations of the East and the West (András *Köves*) and on sociological traits of state-owned enterprises (Teréz *Laky*). The editor needed a tightrope dancer's sense of equilibrium to get such articles published in those days. An example is Volume 17, which included two articles written by Soviet authors. One of them was insipid and covered some Comecon-related issue. However, the other one discussed East-West economic relations, and it was written by the former son-in-law of Khruschev (who had been ousted by that time). Later on its author (N. *Shmeliov*) became an advisor to Gorbachev.

Volumes that appeared following 1978 once again carried articles of more interest. Examples included an article by László *Szamuely* and Tamás *Bauer* that criticised industrial combines (it had been published in limited circulation a few years before); an article written by a Soviet author (*Lisichkin*) who was barred from publishing in economics journals at home; reviews of books that in the libraries of other Comecon countries were available for "reliable" researchers only. As from that time, *Acta Oeconomica* became a forum for the writings of authors who found it difficult to publish in other Comecon countries and/or of approved authors who could not have published the article concerned in any other journal (e.g. *Balcerowicz*, *Dyba*, *Popov* and others). It must be admitted that the journal also served as a mouthpiece for official Hungarian economic policy.

At the time when the reform drive was slowed down for a few years, empirical economic research gained in importance—which could also be seen in the selection of articles in the journal. Members of a new generation of economists made a novel empirical approach to phenomena of socialist planned economy, though theoretically they were successors of the originators of reform thought (like János *Kornai*).

Although, as a rule, they did not risk drawing sweeping conclusions (which would have contradicted the purposes of empirical research), but they shed new light on how the planned economy actually worked. By the 1980s empirical researchers and reform economists had produced those works (parts of which were published by *Acta Oeconomica*) which put the entire system of planned economy into a new perspective. (Issues discussed included the soft budget constraint (János Kornai), the bargaining over the plan targets (Tamás Bauer), and the function of various campaigns in economic management (Attila K. *Soós*).)

As illustrated by articles in our journal, Hungarian economists—along with the Polish colleagues—excelled in making a comparative analysis of economic systems by offering a critical analysis of the conventional command economy and the so-called "reform planned economy".

In the field of research on the world economy, a new tendency appeared at the time: structural analysis (e.g. Béla *Kádár*). Its main representatives played a leading role in shaping economic policy after 1990 and *Acta Oeconomica* carried several writings of these scholars.

In the early 1980s the journal carried articles of those representatives of the new reform generation who played a decisive role in dismantling the system of planned economy between 1988 and May 1990, e.g. László *Antal*, György *Surányi*, Lajos *Bokros*. Some of them are still active in shaping economic policy.

In the middle of the 1980s the reform tendency was once again pushed to the background temporarily. This could be seen on the debate on how open the Hungarian economy should be. Advocates of the conservative view argued that the Hungarian economy should become less open if it wished to overcome stagnation and indebtedness. Those advocating the conservative stance had the political sensitivity to see that the drive to continue the reforms may endanger the dominance of the public sector, central planning—that is, the pillars of socialist economy. Many of the articles we carried rebuffed the conservative views (among them András *Nagy*).

Many economists had recognised by the last third of the 1980s that the economic system could not be reformed without a reform of the political system. This conclusion was expounded in "Change an reform", an essay prepared by a team of economists most of whom worked in the Financial Research Institute and the Institute of Economics of the Hungarian Academy of Sciences. This essay served later as the economic policy manifesto of the opposition roundtable i.e. in the course of their negotiations with the communist ruling party on the details of the transition to the multi-party parliamentary system and market economy. This was also published in our journal.

We were able to publish "Change and reform" at that time because both central planning and the so-called ideological control had become ever weaker and then collapsed. The covert transition to the post-Kádár era began. As a sign of the deterioration in the country's economic situation and shrinking role of the state, the journal was not able to generate public resources necessary for producing two volumes per year. Just as 16 years before, we could afford to publish only one volume per year.

As mentioned above, until the late 1980s our journal was the mouthpiece of Hungarian economic reform towards the outside world. When assessing this role it is inevitable to put the question: how important were the economic reforms for the future development of the Hungarian economy? On the one hand, the reform endeavours transformed the fears of the political elite—which became ingrained because of the lasting effects of 1956 and the Soviet military presence—into conscious (but contradictory) economic policy actions. Thanks to the reforms, the Hungarian economy became more open than that of any other socialist country. More scope was assured for enterprise autonomy and the unfolding of the private sector (the legitimate second economy). Thereby the reforms change the attitudes of the people in general, and the economic elite in particular. On the other hand, the reform endeavours strengthened the citizens' dependence on the state (even if in a new form). The so-called "second economy" could flourish in the shadow of the public sector and the related trade with the other socialist countries. Although the attempts at reform undermined the egalitarian ideals, they kept alive the population's illusions about a paternalistic state. They also helped legitimise the people's failure to fulfil their obligations towards the state.

As if to finish with its role as the propagator of the reforms, the journal interviewed noted Hungarian and foreign economists on whether they considered the socialist market economy or market socialism a viable model. The majority of the 30 interviewees answered that even the notion was unacceptable for them. In 1992 we put similar questions to economists on issues of the transition to market economy, and the interviewees were eager to expound their ideas.

The sweeping changes that occurred in Hungary in 1989–90 posed a major challenge to our journal. Many of our former authors quit the researcher's career or carried on with their work abroad. The conditions of domestic economic research also deteriorated in other aspects. Due to the financial problems of research institutes and the low pay of research staff, some researchers switched over to deal with consultancy services. Moreover, the former system of collecting statistical data collapsed and this further narrowed the scope for analyses. The administrative barriers to Hungarian scholars publishing their writings abroad disappeared. Therefore, more and more scholars decided to have their papers published in foreign journals. Workshops specialising in questions of transition were set up in Western Europe and under the auspices of international organisations, which swelled the number of publishing opportunities. Eastern Europe attracted the attention of researchers who had never examined this part of the world before. In sum, our journal's position weakened in terms of both demand and supply.

We had to rethink our future role, functions and the content of the journal. It goes without saying that the issues of the transition could not be ignored, even if competition is the hottest factor in that field. Over the past six years we have made it a point to reduce radically the ratio of normative articles. Instead, we have provided more scope for the results of empirical research, and diversified the content of the journal by covering new fields, like economic sociology, housing, education and the pension system, as well as new issues of transition. These were not covered by the journal before.

From the late 1950s the application of mathematical methods gained increasing scope in Hungarian economics and found its way to mainstream economics. Macroeconomics is their principal field of application, though microeconomics is also more and more affected. *Acta Oeconomica* has so far failed to pay sufficient attention to this development. True, one of its issues was devoted to *Szigma*, the journal of the Hungarian mathematical economics school. It is part of our future programme to put our readers in the picture in this field.

Now and then we ask whether or not it is worthwhile publishing an English-language economic journal in Hungary under such severe financial conditions. We are deeply convinced that it *is* worthwhile. Why? The Hungarian language is accessible to a limited circle of readers only and authors unable to publish their writings in a foreign language would be left out from the international circulation of ideas. Young researchers find it difficult to place their writings in foreign journals (where supply exceeds demand). As Hungary is not the only transition country in Eastern Europe, the international fora offer only limited scope for analyses dealing with Hungarian issues. Last but not least, *Acta Oeconomica* has won international recognition, as illustrated by our presence in numerous bibliographical survey databases.

We have to acknowledge the past and present contribution of colleagues without whose dedication this journal could not have lived to see this anniversary. Credit must be given, for launching the journal, to the late Professor István *Friss*, who was first chairman of the Academy's Class of Economics and Legal Science and director of the Institute of Economics. The first chairman of the editorial board was the late Professor Imre *Vajda* an eminent personality who participated in strengthening ties among Hungarian economists and those between them and foreign economics. After his untimely death he was temporarily substituted by the late György Cukor. In the period when the late József Bognár was chairman of the editorial board the intellectual character of the journal was renewed and its size grew. The next chairman of the editorial board was Professor Mihály *Simai*. Both he and his successor, Professor Tibor *Erdős* played an important role in assuring the intellectual and financial conditions for the publication of the journal. The journal enjoyed the support of the past and present members of the editorial board, who are always elected by the Academy's Class of Economics and Legal Science.

The editorial office of the journal had quarters at the Academy's Institute of Economics and later, for a few years, the Economic Information Unit. Today the office and the equipment are once again assured by the Institute of Economics, whose director is now Jenő *Koltai*.

Scholarly journals always need sponsors. Our principal source of support is the Hungarian Economist Foundation under the chairmanship of Béla *Csikós-Nagy* and the Hungarian Economic Association. After support from the Council for World Economy discontinued, the journal received considerable support from the Academy, the Hungarian Soros Foundation, the Institute for Economic and Market Research and the Hungarian Mineral Oil and Gas Industry Co. Ltd. (MOL). The Publishing House of the Academy maintained this journal even in the period when most journals of the Acta-series had to vanish.

For two decades László *Szamuely* helped me in editing the journal. Today Mihály *Laki* has a lion's share in the editing. They have made an important contribution to earning international recognition for the journal. As for the day-to-day management of the affairs of the journal, credit should go to Katalin *Lorschy*. Thanks to her conscientious work over two decades, the journal has been published—even if not always at regular intervals—mostly in time. Her predecessors were Erzsébet *Juhász*, Judit *Vári*, Emánuel *Szmikun* and the late Miklós *Bródy*. In copy-editing and translating the texts into English credit must go to György *Hajdú*, the late G. F. *Ray*, Rudolf *Fischer*, Philip *Rawlinson*, Ilona *Lukács*, Péter *Fiers*, Iván *Sellei*, Anna *Neimann* and many others.

Last, but not least, we have to thank the contribution of those domestic and foreign authors who have helped us to develop the internationally acknowledged character and quality of this journal.

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SOME THEORETICAL PROBLEMS RELATED TO OVERCOMING THE DEPRESSION IN HUNGARY

T. ERDŐS

The author examines the factors which make the overcoming of the transformation crisis difficult. He points out that the budget deficit has a moderate demand increasing effect only because of the double digit inflation. Owing to the obsolate production structure also the current balance is in the red despite the depression which diminishes the level of aggregate demand. Business investment shows a very moderately increasing trend at the end of the depression as well because the level of the rate of return is depressed and the real rate of interest is extremely high. In the author's opinion the drop of real wages together with the real devaluation of the HUF may contribute to the increase of exports and business investment and by this way to overcoming the depression related to transformation.

The process of transformation to market economy has been accompanied by a deep and lasting depression in all the former socialist countries. In Hungary, for instance, GDP fell by slightly more than 20 percent between its peak level in 1989 and its lowest point in 1993. The drop of industrial activity was even more—in 1992 the extent of the fall was 30 percent in the case of gross industrial production. Registered unemployment had risen to 12.6 percent by 1992, and in 1993 its real level was even higher. A more reliable picture about the labour market can be obtained by looking at the changes in the level of employment. It had plummeted by 25 percent by 1993, indicating that a considerable proportion of the population who were of working age were out of the registered labour force at that time. The depression which has accompained the systemic transition can be regarded as the deepest in the history of the Hungarian economy; moreover, it appears to lasting longer than any of the recessions which have taken place in the past.

The depression, however, is not only significant for its extreme deepness and severity. In fact, by the end of 1993 signs of recovery could be observed in industrial activity; however, the dynamic of this recovery was conspicuously weak. Despite the rise of GDP in 1994 and 1995, its level still lagged far behind the previous peak; the shortfall amounted to 17 percent even at the end of 1995. In other words, the yearly growth rate of GDP was not more than 1–2 percent, which is quite unusual during a recovery period. Furthermore, the depression was accompanied by double digit inflation and the rate of inflation was highest just at the time when the fall in production was at its greatest. In contrast with the experience of usual business cycles, the trade and current balance showed a sharply worsening trend; also, while exports were essentially stagnating, imports were growing fast as a result of opening the economy. Although the behaviour of the budget balance was normal, the depression itself was marked by a rising budget deficit. The share

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of deficit relative to GDP was high, amounting to around 8 percent. Moreover, this share showed a rising trend even by the time the GDP started to increase again. Another peculiar feature of the budget deficit is that it is the interest payments which account for the deficit's rising trend, and most of these interest payments are a result of double digit inflation. The features mentioned here are closely connected to the problem that the recovery, which started at the end of 1993 and/or at the beginning of 1994, has proved to be noticeably fragile despite the considerable drop in production (i.e. relative to its previous peak).

Factors influencing the overcoming of the depression in the business cycle

Most cyclical depressions soon come to an end as a result of the factors which affect changes in aggregate demand and in the amount and share of profits gained by enterprises. On the demand side, the changes in exports and imports, the appearance and/or increase of the budget deficit, the development of investments, and the changes of private savings all cause aggregate demand to become larger than aggregate supply over time. This results in a new recovery process. Even if the existence of the state budget and external trade are disregarded, the reversal in the proportion between aggregate demand and aggregate supply can easily be pointed out. Consumption declines at a slower rate than production as a consequence of the falling savings ratio of the population and the rising trend of real wages received by those in employment. Furthermore, investments also tend to decline at a decelerating pace due to the fact that certain investments aimed at maintaining fixed capital are unavoidable during the period of crisis. Looking at the role of the budget deficit and that of the current balance makes the process even clearer. Both can considerably raise the level of aggregate demand for goods produced in the country.

The entire process can be examined from the aspect of profits realized by the enterprise sector as well. The budget deficit and the surplus of the current balance both raise the profits realized by the totality of enterprises. This is because both increase the total revenue over the total amount of costs by an amount that is exactly equal to the sum of the budget deficit and the surplus of the current balance. Moreover, any *worsening* in the budget and *improvement* in the current balance lead to an increase in the profits realized on the macroeconomic level—i.e. profitability may show signs of improvement even if the budget balance shows a surplus and the current balance is in the red. Since, during the crisis, the budget balance tends to become worse, and the current balance tends to improve, taking their role into account makes the beginning of a new recovery much more understandable.[1]

[1] The argumentation relies on the theory about the determinants of profits realized on the macro level. The point is that, in a closed economy, costs—i.e. wages, energy, material, etc.—are

The problem is, however, that the depression taking place in Hungary in the course of the current economic transformation is very different from the usual nature of depressions. It is precisely this problem which explains the deepness and persistency of the depression which has dogged the progress of the Hungarian economic transformation.

Factors which make the overcoming of the transformation crisis difficult

Budget deficit and inflationary interest payments

Like any depression, the one taking place together with the systemic change in Hungary has been accompanied by an increase in the budget deficit. The deficit, counted according to the SNA system, had been increasing year after year and its peak level occurred in nominal terms in 1994 and 1995. Nevertheless, the aggregate demand-enhancing effect of the rising budget deficit cannot be easily proved. The entire process was, namely, affected by the high inflation rate. Altogether, budget receipts and expenditures were not increasing in real terms. Calculating on the basis of 1990 prices, the outlays of the central budget had slightly fallen by 1994 and the percentage drop of expenditures has come to 2.5 percent. Considering the budget receipts their fall in real terms was enormous, amounting to 23 percent. Since the budget was almost nearly balanced in 1990, the different movements of budget receipts and expenditures resulted in the large level of deficit both in real and nominal terms by 1994.

The effect of the deficit on the aggregate demand is, however, sharply debated in Hungary. Financial authorities, the Ministry of Finance and the National Bank of Hungary consider this deficit to be a factor which enhances the aggregate demand considerably. Yet many experts dealing with financial interrelationships from theoretical aspects as well lay stress upon the composition of budget expenditures. (*Tanzi, Bleijer and Teijero* 1993)[2] They emphasize that the deficit is mainly made

at the same time receipts for the enterprise sector if employees' savings are zero and the state budget is in equilibrium. Expenditures on capitalist consumption and business investments raise the receipts of the enterprise sector over its total costs. The difference—i.e. between the amount of business investments and capitalist consumption—equals the profits achieved on the macro level. The latter may significantly differ from the sum of business investment and capitalist consumption if employees save a part of their incomes, the state budget is not balanced and/or its balance is changing. Furthermore, this is also the case if the current balance shows a positive or negative sign and/or this balance is changing. The theory of macroprofit, relying on the Keynesian system, was elaborated by *Kalecki* (1954).

[2] Among Hungarian authors *Dedák* (1994), *Oblath* (1995), *Pete* (1994), *Erdős* (1995) lay stress upon the importance of the composition of budget expenditures and the role of inflationary interest payments.

up of interest payments and the level of the latter is fairly large because of the great internal and external indebtedness of the state, and the high level of nominal interest rates. In short, when looking at the effect of the budget deficit on the aggregate demand we also have to allow for the share of inflationary interest payments in the total budget expenditures. The experts mentioned above assert that savers do not spend their interest incomes if the latter compensate mainly for the loss in the savers' financial capital (i.e. bank deposits, bonds, etc.); the latter supposes that savers are exempt from the "money illusion". In this case they simply add their interest incomes to the nominal amount of savings instead of raising the level of their spending on goods and services. Taking into account the fact that, under the present conditions, savers in Hungary constitute the richest group of people, the ones whose spending does not necessarily depend on their nominal interest incomes means that an outcome in which budget deficit does not perceptibly have the effect of increasing the aggregate demand has a fairly large probability. This is of great importance when examining the chances of overcoming the depression.

Suppose that budget deficit is entirely made up of inflationary interest payments and it does not enhance the aggregate demand at all. In this case, the depression is not alleviated by the budget deficit and, for this reason, the fall in production must be deeper and the duration of the recession must be longer, other things being equal. Furthermore, the effect of the budget deficit on the profits of enterprises cannot be reckoned with either. If aggregate demand remains unaffected, the revenues of enterprises also do not have an influence on the deficit. Consequently, the differential between prices and costs are not enhanced. As a result, the profits of enterprises show a downward trend, as if the state budget had been balanced. Moreover, while the total budget deficit may show a powerfully increasing trend, aggregate demand could still drop dramatically if the *primary balance* of the budget is greatly improving in the meantime. Namely, the interest burdens of the state budget can increase by a larger extent than the total of the budget deficit if the inflation rate is high, the level of the indebtedness of the state is large, and nominal interest rates are flexibly adjusted to inflation. In short, it is not at all certain that a rising trend in the budget deficit is necessarily beneficial to the changes of aggregate demand and profitability. Much depends on the changes of the primary balance of the state budget and on the problem of whether inflationary interest payments lead to an increase in spending on the part of savers or not.[3]

Of course, the linkages connected to the impact of the budget deficit are not entirely unambiguous.[4] Even if inflationary interest incomes are saved by the population, the budget deficit may have a certain aggregate demand-increasing effect. Namely, not all the interest payments accrue to the savers. There are financial in-

[3] The different impact of the primary balance relative to the total budget balance was powerfully emphasized by Oblath (1995).

[4] The problem is examined in detail by Erdős (1995).

termediaries between them and the state budget—for instance, commercial banks. Consequently, a certain proportion of the interest payments raises the revenue of banking institutions. This part of the interest payments is already being spent. Furthermore, some savers may suffer from money illusion; thus they are probably spending at least a share of their inflationary interest revenue rather than adding it to their accumulated money savings. Finally, not all the interest payments are connected to savings. There have been cases, for instance, in which the state budget has provided interest-bearing state securities to banks in a bad financial position in order to consolidate the banking system. The interest paid on these securities is, of course, adjusted to the inflation rate. However, such interest payments are used up by the banks, and are continuously pumped into the economy.

Considering all that has been said, the following statement can be formulated: As a consequence of inflation and the great indebtedness of the state, a large proportion of interest payments has been provided from the state budget year after year. Since a considerable part of these payments is not spent, the budget deficit gives only a moderate stimulus to aggregate demand.

The impact of the trade and current balance

Examining the impact of the trade and current balances in Hungary, the striking problem is their definite *depression-deepening* effect. It is fairly conspicuous that the trade balance in Hungary radically worsened up until 1994; this was so despite the grave depression and the fact that during this time there was no deep crisis in Western Europe and the world market. When a depression occurs the trade balance should show a strongly improving trend under normal conditions because of the shrinkage of the internal market. The latter involves a sharp fall in imports and a rising trend in exports. In Hungary, however, all has happened differently. Since the depression has come about as a consequence of the systemic change, and a significant feature of the latter has been the collapse of the intra-Comecon trade, Hungary has had to encounter sharp competition in the world market. While, in 1990, the trade balance showed a surplus of almost 1 billion dollars, from 1992 it registered a deficit and by 1993 and 1994 this deficit was fluctuating between 3.2 and 3.7 billion USD; such figures represented 7–8 percent of the GDP. The movement of the current balance showed a somewhat more complicated picture because it was improving slightly in 1991 and 1992. In 1993, however, the current balance also deteriorated suddenly.[5] It is also worth mentioning that at the beginning of the systemic change, the trade balance showed hardly any signs of deterioration. The

[5] Source: *National Bank...* (1995) The development of the trade balance was, with the exception of the Czech Republic and Slovakia, fairly similar in the other East European countries. (*United Nations* 1995)

sudden change took place only in 1993 when the trade deficit grew dramatically. Immediately after the systemic change the firms made efforts to compensate for the fall of sales in the former Comecon market, and this led to a sudden increase in the West-related exports. However, exports could not be increased for any length of time because a majority of firms were exporting at a loss. The firms were trying to maintain the level of production and employment achieved formerly, and also attempting to cover at least a part of their fixed costs. Yet this involved a situation in which the high level of imports could not be balanced by exports for any prolonged period.

The exchange rate policy has also played a role in the changes experienced by the trade and current balances. Real devaluation was considerable in 1991 and this, in all probability, contributed to the fast increase of exports. Later, however, the exchange rate policy became one of revaluation rather than devaluation (considered in real terms). This must have had some role in the sharply deteriorating movement of the trade and current balances in 1993 and 1994.

If the level of imports tends to exceed the level of the exports, and private savings do not show a declining trend—moreover, if the budget deficit is not rising either—the market position of domestic firms worsens. Under these conditions foreign firms "compete away" purchasing power from domestic enterprises; this implies that, due to foreign competition, domestic firms can only reckon with less revenue and profit.

Of course, the worsening of the market position and of the profitability of domestic firms due to the import surplus is not inevitable. If private savings are declining and the budget deficit is rising along with the growing imbalance of external trade, then the market position of the domestic firms may even improve and they could move from deficit to rising profits. In Hungary, however, when the amount of import surplus was sharply rising (in 1993 and 1994) the sum of the net private savings in real terms showed only a moderate fall in 1993, and it had already increased by 1994. The budget deficit was increasing throughout the depression period but most of this deficit can be accounted for by the rapidly increasing inflationary interest payments.

Summarizing the problems examined thus far, it can be established: in Hungary, as in many countries, market conditions were worsening and the level of profits was declining in the course of the depression. The striking feature of the depression was, however, that the worsening trend of market positions and the level of profitability were not alleviated by the summarized effect of the state budget and the current balance. This result was essentially unavoidable. Owing to the obsolete structure of production, even an equilibrium state of the trade balance could not be maintained. Moreover, the fall of total output was in part brought about by the deterioration of the trade balance. This was because of the way in which domestic firms sudden had to face sharp competition in the world market. In order to bring the trade balance and the current balance in a state of equilibrium powerful investment activity, reshuffling of the structure of production, and privatization need to be carried out; yet there are also several other crucial tasks such as the development of a capital market, the banking system, raising the share of small- and middle-sized enterprises, and developing the management of firms. Over a relatively longer period equilibrium can only be unstable. It is worth drawing attention to the fact that not only in Hungary but in most of the Eastern European countries, the deficit of the trade balance showed a sharply rising trend from 1990 to 1993.

The whole process is of crucial importance from the viewpoint of the development of investments carried out by enterprises. Investment activity tends to decline in every depression, in particular due to difficulties in selling the goods produced and the increasing extent of excess capacities. The declining trend of investments can strongly be enforced by the growing deficit of the trade and current balances. One of the determinants of profit expectation is the change in the actual amount and share of profits. If they are declining, firms are inclined to reckon with a further fall in profits. Expectations become optimistic usually when the amount and share of profits stop declining and begin rising. Business investment, in turn, greatly depends on profit expectations. Accordingly, the peculiar changes of the trade and current balances, and the problem that the budget deficit in Hungary did not necessarily raise aggregate demand, had much to do with the changes in the pattern of investments. The investment ratio was not high in 1989, and business investments plummeted at least as fast as GDP fell—it is more than likely that this was in part due to pessimistic profit expectations.

Although it is precisely investment activity that can lay the foundation for a sound recovery process, the conditions for reversing the trend of investments were not favourable in Hungary for long. This was not only because the forces driving down the volume and rate of profits were powerful but also because of the factors determining the level and movement of nominal and real interest rates.

The problem of the nominal and real rate of interest

Investments carried out by enterprises are determined by the expectable rate of profit and the real rate of interest in particular. Albeit, it is the real rate of interest that has to be related to the rate of profit. Nevertheless, we have to start with an examination of the change of nominal interest rates in Hungary.

The level of nominal interest rates has been fairly high since the beginning of the systemic change. This can mainly be traced back to the high inflation rate. The increase in consumer prices reached 35 percent in 1991 and, since then, prices have been growing by more than 20 percent on a yearly average. Of course, nominal deposit interest rates paid on the savings of the population had to be adjusted in order to be more or less in line with the increase in consumer prices. As a matter of course, credit interest rates were higher than the interest rates paid on deposits. Considering only the credits raised by firms, the high nominal interest rates to be paid by them would not have caused too grave a problem if the sales prices the firms had to reckon with had grown at least at as high a rate as the percentage rate of the interest to be paid on credits. In reality, however, the situation was the opposite during the time of depression. Firms had to calculate with the (expectable) increase of producer prices because these were the prices at which their sales were executed. In addition, due to the transformation to market economy, consumer prices usually increase at a considerably higher rate than producer prices.

The faster increase of consumer prices is an unavoidable result of the growing share of the private sector in the area of retail trade; this entails an increasing retail trade margin. Of course the latter causes consumer prices to increase faster relative to producer prices. Some other factors have similar effects. For instance, with the beginning of the transition, a reshaping of the tax system was started. Concomitant with this was a sharp increase in the share of sales and excise taxes, while the proportion of direct taxes—primarily those imposed on the enterprises' profits—declined radically. A special case regarding the formation of prices concerns the changes in the price of services. Technical progress is usually slower here than in the area of the production of tangible goods, and this entails slower growth of the productivity of services. Furthermore, since the central control of wages and salaries was abolished after systemic change, the growth rate of nominal wages has accelerated; this has led to a fast increase in prices, especially in the area of services, where the growth rate of productivity is only moderate. Considering the fact that most services (the so-called "consumer services") are taken into account when calculating the consumer price index, the latter had to increase remarkably faster than producer prices.

All in all, due to the peculiar changes of consumer and producer prices, firms have had to face an extremely difficult situation when trying to carry out investments. Their own investment funds have been only moderate owing to the low level of production and the low rate of profit. At the same time, the real rate of credit interest has been too high for the firms. It moved between 10–15 percent for most of the period of transformation up until 1994, with the exception of 1991. The discrepancy between the real rate of profit and the real rate of interest was so powerful that investment activity for most of the domestic firms seemed hazardous. It is instructive to note that lively investment activity was being implemented mainly by enterprises which were in foreign or mixed ownership; investment activity was also powerful in enterprises which were able to get credits from abroad and which were able to sell abroad in particular. Another detail worth pointing out is the fact that the expansion of investments—which extended to a considerable part of domestic enterprises—was first experienced in 1995, when the increase in producer prices had caught up with the increase in consumer prices. Thus in 1995 real credit interest rates for firms fell significantly. Experience proves that the relative level of the rate of return realized by enterprises, along with the real rate of interest, have noticeably affected the actual changes of investments. Their approach to one another is conducive to investments, just as their moving away from one another has an adverse effect. Because the real rate of interest exceeded the real rate of return by a considerable extent in nearly every year of the depression, the discrepancy between them must have played a fairly determinant role in the sluggish investment activity.

The crowding out effect

The former problem raises the question of the "crowding out effect" of the budget deficit. It is a widely held opinion in Hungary that the large share of the state deficit, relative to the GDP and to the volume of private savings, has played and continues to play a significant role in the high level of real interest rates; in this way, the budget deficit "crowds out" private investment.[6] The problem of the "crowding out effect", however, raises peculiar theoretical and practical problems under the condition of transition.

To begin with, it needs to be noted that the budget deficit, however large it may be, does not inevitably lead to "crowding out". A typical case of this is the state of depression when there are free capacities. Under such conditions, economic performance is inside the "production possibility frontier" and, accordingly, this has an effect on the budget deficit, the GDP produced, and private savings also increase. Because, in this case, the level of savings is not given, the demand for credit respectively from the state budget and firms can easily be met without the level of the real rate of interest rising. The firms' investment activity can thus be unchanged or it can even increase. Of course, a "crowding out" effect may appear in the case of the existence of free capacities as well if the monetary authorities pursue a conservative monetary policy which does not allow the money supply to increase. In this case it is not the budget deficit that is to blame for the increase of the real rate of interest but the insufficient money supply—in other words, the blame lies with a faulty monetary policy.

Let us suppose, however, that the monetary policy is correct, and that the budget deficit does have an aggregate demand-increasing effect.

Although, in Hungary, the depression itself suggests that a large level of free capacity exists, both in the labour and production facilities, we have to deal with the problem of crowding out cautiously. First, it can be asked where the production possibility frontier is to be located. On the effect of the systemic change, the proportion of western-related exports is suddenly enhanced, and this means

[6] The problem is examined with reference to Hungary, with theoretical approach, by Erdős (1993) and Dedák (1994).

that the quality requirements raised towards the production capacities and labour must be evaluated under the new external trade conditions. What were real and marketable production facilities under the conditions of Comecon trade are hardly usable and competitive once they are exposed to the conditions of competition in the world market. Since the Hungarian economy depends greatly on external trade and the degree of its openness is significantly above the international average, the production possibility frontier must have shifted inwards as a consequence of western related exports becoming the determining factor in the total volume of exports.[7] It follows that the mere fact of the depression in Hungary does not necessarily imply that there is a large volume of competitive free capacities in the country. If external competitiveness is also taken into consideration, not only one but two production possibility lines can be drawn: the first one concerns *physical* capacities, the second one external competitiveness. The second one has shifted inwards considerably, as a result of the change in the composition of foreign trade partners, and it leaves a part of the production facilities out of account. The first one is located outside and refers to the possible level of GDP, in physical terms. If the actual level of production is between the two lines, the trade balance must be in deficit, for the value of imports cannot be met by the value of exports. This situation may not last for long. The country in question has to raise either the capacity of its marketable production facilities and its competitive exports so as to balance its external trade, or it has to restrict its production in order to reduce the amount of imports and the deficit of the trade balance. Over time, the distance between the two curves diminishes. Noncompetitive production capacities are successively eliminated, which means that the outer line will shift inwards. It is only the line which takes into account the competitiveness that tends to shift outwards as a result of the continuing investment activity. It can be supposed that the level of production in Hungary is between the two lines.

Concerning the problem of the budget deficit's crowding out effect, the following needs to be taken into consideration. If the deficit leads to a rise in aggregate demand, production could fall out of the production possibility line (representing competitiveness), and thus be located nearer the origo. This causes a trade deficit, or the deficit may increase. Unless the deficit is abolished—for example, by a devaluation of the national currency—a restriction has to be implemented which results

[7]The probability that the production possibility frontier is shifted inwards is also raised by *Bárta* (1994, pp. 20–42): "Economic potential output adjusts the technical potential output to the conditions on the market in the medium-run... The main criterion here is the medium- and long-term competitiveness of production of a given firm, industry or the whole economy: as an economic potential of the country only those production capacities could be regarded which produce the output which is effectively demanded not only in the short-term but also in the medium- and long term... If we, 'guesstimate' the decline of potential output ... we may arrive at the decrease of potential output for the whole economy by about 16–20 percent on June 1993/June 1990 basis".

in the rise of the real rate of interest. The higher real interest rate crowds out investment. In Hungary, the high average level of real credit interest rates and the insufficient level and dynamic of investment activity can, at least in part, be accounted for by the large share of the deficit in the central budget. If this is true, the budget deficit is a serious problem because sound recovery in Hungary, where the structure of production is obsolete, cannot be imagined without rapidly rising investments.

However, the expasive effect of the budget deficit in Hungary can be questioned despite the above considerations. It is not clear that the budget deficit in Hungary is mainly to be blamed for the high real level of credit interest rates and the relatively depressed level of investments. The controversies around this question are closely connected to the problem of inflation and, as a consequence, the large volume of inflationary interest payments. The latter raises doubt as to whether the budget deficit has a considerable increasing effect on aggregate demand. If not, the deficit of the trade balance can hardly be explained by the budget deficit. Consequently, the latter is not directly related to the restrictive measures applied by the financial authorities, and it cannot explain the high level of real credit interest rates.

Nevertheless, the budget deficit may have a certain crowding out effect even if it is made up of inflationary interest payments. The problem is that, with regard to its effect, the budget deficit can attain a very high share relative to GDP, involving difficulties in its financing. In other words, the budget deficit raises the demand for additional financial means. Yet during a period of high inflation, the monetary authorities are reluctant to increase money supply. The thesis is essentially denied that recipients of interest payments add most of their interest revenue to the cumulative amount of savings—i.e. they do not intend to spend the interest revenue received. Of course, risks are important. A proportion of the additional money supply may result in an increase in money spending; some savers may suffer from money illusion, inducing them to spend more. The whole problem becomes more intricate if it is also taken into account that the required additional "dose" of the base money from the central bank which should be put into circulation is not easy to determine. All in all, difficulties in financing the budget deficit frequently emerge and this often results in a rise of nominal and real interest rates.

Naturally, in an open economy, events are usually more complicated. If the current and capital balances are in surplus, money supply can increase essentially faster than money demand; thus in spite of the budget deficit interest rates may show a declining trend. What is generally true, however, is that the monetary authorities are usually cautious in monetizing the budget deficit. This usually tends to raise nominal and real interest rates, even when the deficit should not otherwise cause interest rates to increase (i.e. in the case of a resilient money supply).

The crowding out effect of the budget deficit in Hungary definitely exists. A final explanation for its occurrence is the high level of risk in lending credits. This is observable in the course of transition because of the large number of bankruptcies and widespread insolvency among firms. To lend credits to a great number of firms is risky, and the risk cannot always be compensated for by the high level of credit interest rates. With regard to the degree of risk, interest rates are highly differentiated in Hungary due to the respectively better or worse situations of the firms that are demanding credits. (Interest rates for credit are often two times higher for bad firms than for reliable ones in Hungary.) As a result of the riskiness, commercial banks often prefer buying state securities, which bring in relatively moderate yields, rather than giving credits to firms which appear to be unreliable. Accordingly, the budget deficit must also have a considerable crowding out effect if the interest rates paid on state securities are not high enough. Consequently, the budget deficit in Hungary has an unequivocally adverse effect on the development of business investment; this is true in spite of the deep depression and the questionable role of the deficit in affecting the changes of aggregate demand.

Deficit spending and anti-crisis economic policy measures

The reduction of the budget deficit

As has been pointed out, the budget deficit has a crowding out effect in Hungary. For this very reason the announcement of the aim to reduce the budget deficit was raised precisely under the conditions of the crisis.[8] Those who are convinced that radical improvement in the budget balance is absolutely necessary are of the opinion that the most important barrier to the increase of business investment in Hungary is the budget deficit. They also refer to the problem that when the size of external indebtedness is already high and only a relatively low amount of direct capital inflow can be reckoned with, the import of capital may not provide enough impetus to investments in the country. Since private savings cannot be increased significantly by the interest rate policy—because the real rate of interest for firms is already high and the average level of personal income is on a depressed level—the reduction of the budget deficit is an unavoidable necessity.[9]

In fact, budget expenditures in real terms have substantially decreased despite the depression; this is because the inflation rate has been higher than the growth

[8] "Fiscal policy... did not take note of the warnings that the budget deficit, showing so high a level, bid up the rates of interest and exerted a crowding out effect in relation to the credits to be given to enterprises, and thus it could hardly be financed for long by relying on internal savings only." *Balassa* (1995, p. 71)

[9] The opinion is spreading, in reaction to the high share of budget deficit in many countries, that a balanced budget should be achieved and the budget deficit has harmful effects on the economy. (*Buchanan, Rowley and Tollison* 1986)

rate of expenditures in nominal terms. Furthermore, when the depression seemed to be coming to an end and the recovery process became obvious, restrictive measures were actually applied so as to decrease the level of interest rates and drive back the crowding out effect. In order to reduce the budget deficit a tariff surcharge of 8 percent was one of the measures imposed to raise the budget revenue. Certain social outlays were also decreased and/or abolished.[10] Furthermore, many of the budget outlays were nominally fixed or held back in order to reduce expenditures in real terms. In 1995, as a consequence of the measures applied, the share of the budget deficit was sharply reduced relative to GDP. Along with it, nominal and real interest rates showed a declining trend; alongside this the trade and current balances indicated that they were improving strongly.

As regards the problem of whether the reduction of the budget deficit is a proper solution under the condition of transformation crisis or not, there are still outstanding controversies in Hungary. The Keynesian thesis, however, that the reduction of the deficit diminishes aggregate demand significantly is not doubted. Of course, it is not only the decrease in the deficit but also the multiplier effect of its fall which has to be taken into account. Since, at present, the marginal propensity to consume in Hungary is relatively high, the numerical value of the multiplier must be relatively large. The high share of taxes, in turn, has a reducing effect on the multiplier. The problem is complicated by the fact that Hungary is an open economy because imports and exports amount to around 30 percent of GDP. This means that if a fall in the budget deficit leads to a drop in aggregate demand, the latter makes its effect felt also in the reduction of imports, and not only in the decline in demand for goods and services produced domestically. All in all, however, the contractive effect of the diminished budget deficit on domestic production is marked. It causes serious problems if the level of GDP and that of aggregate demand are already depressed as a result of the crisis. Among other things, it is exactly the prospective development of business investment that may suffer from the contractive effect of a reduction of the budget deficit. The crux of the matter is that the latter is suggested in order to weaken the crowding out effect. Yet one of the main determining factors of the investment activity of enterprises is the present and prospective development of aggregate demand and GDP. This implies, that a reduction of the budget deficit, with the aim of giving stimulus to business investment, is advisable only if a fall in aggregate demand and GDP can be avoided. This may occur if it can be guaranteed that there will be a rapid increase in exports and/or spectacular improvement of the trade- and current balances can be expected in line with certain economic policy measures. What is more, there may even be rising aggregate demand due to the favourable conditions prevailing in the external markets, traceable to the fast economic growth taking place abroad.

[10] Restrictive measures aimed at driving down social outlays are criticized by *Kõves* (1995).

In Hungary, from 1995 on, when economic performance was still much lower than it was in 1989, the government did apply serious measures for reducing the budget deficit. However, these were accompanied by other measures aimed at stimulating exports, and also by an import-contracting economic policy. At the same time, the recovery process in the world economy, which started in 1994, continued in 1995, and this has provided favourable conditions for Hungarian exports. Thus it must be kept in mind that exports in Hungary react extremely elastically to the changes of the market conditions in partner countries.

Devaluation and the fall of real wages

With regard to the measures aimed at giving a stimulus to exports, it is the real devaluation of the national currency which needs to be emphasized. The effect of the real devaluation is commonly known. What deserves special attention is the degree of devaluation parallel with changes in the rate of inflation and the development of the nominal and real wages. The development of exports, apart from considering changes in economic conditions in foreign countries, can only be understood by looking at both the effect of devaluation and changes in nominal and real wages.

The devaluation of the forint amounted to nearly 30 percent in 1995. Until March 1995 the so-called "adjustable peg" was applied under conditions in which the national currency was devalued by 3.4 percent in two steps in 1995. From 13 March the "crawling peg" system was applied, and it was introduced with a massive devaluation, running to 9 percent.[11] In the framework of the "crawling peg" devaluation amounted to 14.9 percent. This, together with the former steps applied, resulted in a devaluation of 29.6 percent for 1995. It is worth emphasizing, however, that the rate of inflation also reached a high level. The annual average for the consumer price index amounted to 128.2 in 1995 (1994 = 100), while the wholesale price index in industry ran to 127.3 (1994 = 100). Calculating on the

[11] The application of the "crawling peg" has advantages and disadvantages. If the "crawling peg" is applied and the appropriate economic policy measures make it credible for actual changes in the price level and the formation of the trade- and current balances to be in harmony with the exchange rate, enterprises can reckon with a more reliable calculation basis *vis à vis* external trade. Together with a concomitant antiinflationary policy, inflationary expectations can also be favourably affected on the basis of the "crawling peg" system. Notwithstanding the above, the "crawling peg" nevertheless implies severe constraints for monetary policy. Real devaluation, for instance, can only be applied to a moderate degree because, otherwise, either the inflow of speculative capital would enormously increase (involving undesirable consequences), or in the case of an inadequate interest rate policy the conditions of private saving would spectacularly be worsened. Some disadvantageous consequences of the use of the "crawling peg" are already being experienced in Hungary in connection with the inflow of speculative money capital, and the sterilization which needs to be applied by the central bank.

basis price indices only, it can be concluded that competitiveness has not essentially improved as a result of the devaluation implemented in 1995.[12] Calculations based on unit labour costs, however, show very strong improvement. While over the first three quarters of 1995 unit labour costs rose by 8 percent in the area of industry, the wholesale price index increased by 27.3 percent. In other words, the improvement of competitiveness on the basis of unit labour costs came to nearly 18 percent. Also, if we take into account the fact that export prices rose faster in 1995 than domestic consumer and wholesale prices, the final result is clearcut enough: despite the fast increase of prices in the domestic economy, devaluation in 1995 could have led to a strong increase of exports due to the considerable improvement in profitability. This assertion draws attention to the role of the fall in nominal and real wages in the changes of economic growth, employment and the trade and current balances.

In the Keynesian system, under the conditions of a closed economy, the fall of nominal and real wages is unsuited to the raising of the level of employment because it causes aggregate demand to fall. In this case reduced real wages can lead to an increase in employment on the microeconomic level only. In an open economy, however, interrelationships are already different and Keynes also put emphasis on the importance of the decrease of real wages when taking external economic interrelations into consideration.

In Hungary, exports absorb a considerable part of GDP. Exports of course, depend on price competitiveness. If real wages decline, profits realized can be increased if aggregate demand does not fall appropriately. In Hungary, despite the enormous fall in real wages, (it amounted to 12 percent in 1995) aggregate demand perceptibly increased owing to the improving external market conditions. This can be accounted for by the continuing economic growth in Western Europe and in other developed market economies, and also by the increased price competitiveness of Hungarian exports. Due to the strong fall in real wages the internal market has narrowed considerably. At the same time, prices achievable abroad were growing steeply in forint terms and, because of sharply falling real wages, costs were growing in forint terms only moderately. As a result, exports could be increased at a high rate in nominal and also in real terms. Imports showed a declining trend in real terms owing to the narrowing internal market, the increased costs of imports and the tariff surcharge imposed in March 1995. The final result is, that while the internal market narrowed, the trade and current balances significantly improved and the

[12] This approach is sharply critized by *Tarafás* (1995). The author writes: "The reduction of inflation has for years been driven back to the umpteenth place among the priorities of economic policy. The restoration of the double equilibrium (that of the budget and trade balance—E.,T.), economic growth and employment not only always come before antiinflationary objectives but divert attention and efforts away from searching for antiinflationary policy measures. The latter would not, in the short run, endanger the realization of the aims preferred by the policy but would definitely lay the foundation for the accomplishment of the aims regarded as being more important." (p. 122.)

total aggregate demand for domestic goods did not fall but actually rose. All this happened despite the fact that not only the market-contracting effect of decreasing real wages has to be taken into account, but also the effect of the reduction of the budget deficit. The point is that a sharp reversal took place in the relative growth rate of exports and imports. As a result of the drastic measures applied, both the volume and the value of exports began rising significantly faster (relative to those of imports) by 1995.

Referring back to the problem of the budget deficit it must be noted that the reduction of the deficit is conducive to business investment if total aggregate demand remains at least unchanged. There is only one way to avoid a further drop in aggregate demand: exports must be stimulated, imports must be restricted, and the trade- and current balances must radically be improved. The major tools for realising this aim are real devaluation and reduction of real wages. Both the revitalization of business investment and the improvement of the trade- and current balances entail a fall in real wages. The latter can only be avoided if economic growth is accelerated considerably. This, however, is virtually impossible to achieve because of the delicate position of the trade balance and, in the background, the weakness of the structure of production. For this reason, only moderate economic growth rate can be expected. Given this fact, both the improving trade balance and the rising investment ratio go together with the absolute fall of consumption and the fall in real wages. The thesis can be formulated that, during the time of depression brought about by the transformation, the fall in real wages per employee has been unavoidable; moreover, this fall represents an indispensable precondition for the start of the new recovery process.

Inflation and real wages

Recently, the question among experts over whether the recovery can or cannot be continued without decreasing the real wages has not been a controversial theme. However, there is intensive discussion concerning the way in which the fall in real wages should take place, as well as the degree of this fall. It is commonly agreed that, in 1995, the decrease in real wages was too intensive. A much lower decline had been expected, even at the beginning of 1995. The way in which the decrease in real wages should be implemented is even more controversial. The discussion focuses on the role of inflation. Of course, no one doubts that the bringing down of real wages cannot be carried out by reducing them in nominal terms. In fulfilling this aim the inflationary process has to be relied on. However, one open problem concerns how the desired drop in real wages should be accomplished, particularly with regard to the level of the nominal wage increase and the inflation rate. Experts who are averse to inflation stress that the growth rate of nominal wages should be as low as possible and, at the same time, they lay emphasis on an antiinflationary policy. Others, who do not attribute a high role to inflation, are inclined to accept a higher inflation rate in order to evaporate the excess purchasing power of the population and enforce a fall in real wages.[13] They usually require powerful devaluation of the national currency, advocate the elimination of the producer and consumer price subsidies in a short time, and are sceptical when the question concerns the possibility of bringing about a general wage-price agreement between employers and employees with the assistance of the government. Up until 1995 the group of economists and policymakers whose views tended to predominate could not be blamed for holding an anti-inflation attitude. This makes the fact understandable that, although Hungary did not suffer from hyperinflation, the double digit inflation proved to be stubborn and in 1995 inflation accelerated noticeably.

By the beginning of 1996 the influence of the anti-inflation group of experts had increased considerably. By 1996 inflation, together with the fall of real wages, had led to a strengthening of social tensions. Although the primary balance of the state budget improved conspicuously—moreover, it attained a significant surplus—the inflationary interest payments of the budget increased enormously because the inflation rate rose from 18 percent in 1994 to more than 28 percent in 1995. As a result, the total deficit of the state budget (according to the SNA system) rose from 286 billion to 293 billion forints, while the primary balance showed a surplus of 171 billion forints. This contrasted with 1994 when the primary balance was in deficit by 37 billion forints. The contradiction of an inflationary economic policy arises in the problem that, although it contributes to driving down real wages (and in this way strengthens competitiveness abroad and, by holding down the rise in the nominal amount of budget expenditures, it leads to the improvement of the primary balance) the more rapid inflation raises the internal burdens of the state budget.[14] Accordingly, the difficulties in financing the deficit of the state budget persist, as does the crowding out effect of the deficit. It is becoming increasingly obvious that, over a longer period, the costs of inflation are larger than its benefits and the radical reduction of the inflation rate is one of the fundamental conditions of overcoming the depression and of initiating sustainable economic growth. The level of real wages at present is low enough—relative to productivity—to be able to ensure competitiveness with respect to the cost and price of exportable goods. The key tasks, such as ensuring the dynamic increase of exports and a favourable

[13] "The rise of the rate of inflation entails extremely large additional nominal expenditures because of the increasing interest burdens of the indebtedness of the state, while it makes it possible for the state to be able to reduce the real value of its primary expenditures (calculated by leaving out the sum of interest payments) to an extent that would be unimaginable without the high inflation rate". (*Kopint-Datorg* 1996)

[14] The factors of inflation and the measures to be applied in the framework of an antiinflationary policy are thoroughly examined by *Cinkotai* (1995).

climate for investments over a longer period, are to be fulfilled with an inflation rate which approaches the inflationary price rise in the major trading partners in Western Europe. It also means that the devaluation of the forint should gradually play a diminishing role in keeping the trade and current balances in equilibrium.

Prospects and factors for attaining sustained economic growth

Examination of the peculiarities of the transformation crisis shows that there are very strong indications that it can be overcome because there are several factors which will only detain the start of recovery for a temporary period. Moreover, these factors cause the growth rate of production to remain relatively low during the time of recovery. (For instance the lack of marketable productive capacities despite the powerful relapse of production.) Notwithstanding these drawbacks, like any other crisis, the depression related to transformation is also transitory.

After a temporary upsurge of inflation its radical drop can be expected on condition that the government pursues a consistent antiinflationary policy. The gradual accomplishment of the transformation will make the reduction of the rate of inflation possible. After private ownership has gained predominance, the share of capitalist consumption in GDP does not necessarily increase; in other words, on average, the excess of prices over costs remains relatively stable. Over time the price subsidies will also be eliminated. Consequently, the rate of inflation becomes lower, since that part of the firms' losses which is caused by the lessening or abolition of price subsidies need not be compensated by raising prices. Furthermore, if employers and employees do enter into an overall price-wages agreement inflation can be radically moderated (of course, this goes together with the adaptation of other antiinflationary measures). In this case, the inflationary interest payments of the state budget could fall significantly as a result of the strong decline of the budget deficit. The latter is beneficial to changes in the nominal and real interest rates and, in this way, also to the development of business investment. The possibility is not precluded that one digit inflation can be achieved in three or four years or so as against the inflation rate of 20–30 percent which Hungary has experienced in recent years. If the antiinflationary policy is consistent, the credibility of the government will grow and favourable inflationary expectations may also be relied on.

Besides the real rate of interest, profit expectations play a further crucial role in the development of business investment. The improvement taking place in the trade and current balances should result in an increase in the profits realized by the totality of enterprises. With a favourable change in the volume and rate of profits, profit expectations will also improve, and will obviously have a significant effect on the behaviour of enterprises: i.e. their propensity to invest will also become favourable. In short, investments will tend to increase not only because of the fall in real interest rates, but also as a consequence of the rise in profits and auspicious profit expectations.

Profit expectations will also improve due to the increase in business investment itself. Any increase in business investment raises the difference between the total revenue and total cost on the macroeconomic level. This differential reacts elastically to the changes in investments since the latter can be regarded as an outlay for the totality of enterprises, without involving any rise in costs. In a closed economy all the outlays of enterprises are at the same time revenues for them, unless the volume of private savings is increasing. Of course, a certain proportion of the investment expenditures raises the demand for investment goods from foreign countries. Yet, since the larger part of business outlays—and within it the investment expenditures—is directed toward the domestic market, and private savings do not increase significantly from one year to another, the rise in investment outlays has a profit-increasing effect even if the respective increments of investment and profits are not equal. If profits and profit expectations start increasing—for example, because of the improving trade balance—the process becomes self-strengthening through several transmissions over a longer period. This process is observable in Hungary: since 1994 and more noticeably since 1995, business investment, profits realized, and the trade balance have all been showing an improving and/or rising trend.

The development of aggregate demand is also of importance. The reduction of real wages in itself diminishes aggregate demand. However, its effect on the development of exports and imports, and the effect of the latter on the rise of profits and business investment (furthermore, the role of the increasing investments in the development of total profits achieved as well as in that of aggregate demand) all cause the total market to expand. Statistical data prove that aggregate demand increased in 1995, although the consumption of the population fell significantly in Hungary; the extent of the improvement of the trade balance and the increase in business investment was larger than the extent of the fall in private consumption.

When looking at the development of aggregate demand the changes in the state budget also deserve attention. As has already been mentioned, the budget deficit rose somewhat in nominal terms in 1995. In the same year, however, the primary balance of the state budget improved significantly. Taking into consideration the point that the demand effect of inflationary interest payments can at least be disputed, the state budget could have had a further decreasing effect on aggregate demand. This latter impact, however, must not be added to the effect of the fall in personal consumption, because much of the impact of the improving primary balance within the state budget manifests itself in the fall of private consumption. That is, double counting has to be avoided. It is, however, true that the improvement of the primary balance must have had some additional reductive effect on aggregate demand. Consequently, the growth of exports and the restriction on imports, as well as the growth of business investment, also had to overcompensate for the adverse effect of the changes in the state budget in 1995.

This latter problem calls attention to an important viewpoint concerning economic policy. The deficit of the state budget should really be reduced through an antiinflationary policy and, in this way, through the curtailment of inflationary interest payments. To begin with, it should be kept in mind that the ratio of the budget deficit in Hungary is greatly determined by the depressed level of GDP and the fact that both the inflation rate and the level of internal indebtedness of the state budget are high. As a consequence, making mechanical comparisons between the deficits of the Hungarian state budget and the ones observable in the developed market economies is highly misleading. In this connection, the problem of a full employment deficit can be referred to; furthermore, it should be noticed that wherever the inflation rate and the internal indebtedness are high, the ratio of the budget deficit must be large. Considering these interrelationships it must be established that the ratio of the Hungarian budget deficit is not as high as seems, relative to several developed market economies.

Nevertheless, the importance of the reduction of the budget deficit should not be underestimated, even though this reduction should not be pursued by improving the primary balance of the state budget. Instead, the antiinflationary policy should be strengthened and in this way the inflationary interest payments and, along with them, the total deficit should be reduced. If the primary outlays of the budget are to be decreased in the framework of the reform of the state household, tax burdens should also be reduced in order to give a stimulus to private initiatives. The advantage of this policy is that the reduction of the budget deficit can be brought about by exerting as moderate a contracting impact on aggregate demand as possible.

In order to stimulate a rise in investments and exports the application of discrete economic policy measures is also necessary. Concerning stimuli to be given to investments, the widespread use of accelerated depreciation, the adjustment of depreciation rates to the expectable inflation, credits given to investments at favourable terms, and support to the extension of export capacities can be mentioned. Ensuring favourable conditions for direct capital imports is also of crucial importance. Concerning the stimuli to be given to exports the risk factors relating to exports have to be reduced perceptibly. The financial conditions of export credit insurance must be improved radically. Emphasis must be given to financing exports. Most exports can only be successful if they are linked to the provision of long term credits. Financing these, however, is too costly to exporters given the conditions of current credit interest rates. For this reason, export credentials should be discounted at favourable interest rates; of course, this is only possible with the use of state funds. The taking of diplomatic steps is also needed in order to improve the conditions for gaining access to foreign markets.

The conclusion can be drawn that the depression, which is traceable to the transformation to market economy, is not an everlasting phenomenon. The factors leading towards a sustained growth process are clearly recognizable. The new growth path is, however, not easy to enter. For instance, although it is true that, under present conditions in Hungary, the reduction of real wages is unavoidable the latter has to be seen, from a certain point of view, as one of the impediments confronting the investment activities of firms. The fall in real wages may cause technical progress to slow down through the substitution effect. In other words, capital goods become relatively more expensive than labour; accordingly, the business investment underlying technical progress could be driven back, with preference being given to the hiring of new workers. If this happens, both investment activities and structural changes would become more sluggish. This calls our attention to the fact that the reduction of real wages is not omnipotent and must not be applied for long. The problem of inflation is another example which illustrates the impediments facing entry to a new growth path. The radical reduction of the inflation rate is not easy to achieve, especially in a short time.[15] Inflationary expectations are strong in Hungary, and the credibility of the government with regard to its determination in following a consistent antiinflationary policy is, at the time of writing, highly doubted. The attempts of the trade unions to achieve acceptance of the indexation of nominal wages is strong enough to render a reduction of the inflation rate as more unlikely. If the high inflation rate continues, it will worsen the respective chances of reducing the budget deficit and the level of real interest rates. Of course, these are impeding factors but not ones that cannot be eliminated and/or surmounted. Both recovery and sustained economic growth are attainable in the coming years although the rate of growth will not be conspicuously high until the end of this decade.

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[15] The difficulties of the reduction of inflation, especially in the developing countries, are thoroughly examined in the economic literature. (*Bruno, Di Tella, Dornbusch and Fischer* 1988)

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THE STRUGGLE FOR FISCAL CONSOLIDATION DURING THE ECONOMIC TRANSITION

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Fiscal policy is one of the most difficult components of transition, serving as an excellent litmus test of the progress achieved in other areas of systemic changes. A typical scenario of events starts with the initial fiscal crisis connected with decomposition of the previously existing political and economic system. A radical stabilization and liberalization associated with the removal of subsidies should provide a way out from the aforementioned crisis. However, the initial stabilization success is usually not sustainable and it is followed by a secondary fiscal crisis, rooted in the output decline, inefficiency of tax system, the excessive social obligations of the state, and sometimes in a lack of consistency in conducting a tough policy. It is much more difficult to respond to the secondary crisis than to the primary one. What is badly needed is a comprehensive reform of the tax system and social policy. Post-transformation growth helps to alleviate the secondary crisis leading to the fiscal consolidation stage.

Introduction

In practice the transition process in post-communist countries covers all aspects of economic and social life, as well as economic policy. By its nature, it must also affect public finance and fiscal policy, and when the transition process is initiated, the crisis in this latter sphere reflects—often in a drastic manner—the economic problems inherited from the previous economic system. These problems include: macroeconomic imbalance, structural and price distortions, redundancy and ineffectiveness of social policy instruments and institutions (as well as public social services), over-regulation, paralysis of market adjustment mechanisms, and the dominance of state ownership. The crisis of public finance also frequently serves indirectly as an indicator of the extent to which the former political regime lost control over public finances and incomes policy (extreme cases of such loss of control include Poland in 1987–1989 and the USSR in 1990–1991).

In the transition to a market economy, the state of public finances usually serves as an excellent litmus test of the progress achieved and the degree of internal consistency and far-sightedness of the transformation policy. Simplifying somewhat, one can state that the share of public spending in gross domestic product (GDP), the degree of stability of public finances (including the budgets of territorial units and off-budget institutions), and the size of public debt constitute synthetic indicators of the quality of the transition process and development perspectives in a given economy.

The purpose of this study is to describe the subsequent stages of the transition in light of the basic accompanying fiscal difficulties, and to formulate general conclusions regarding the factors which substantially affect the state of public finances and the quality of fiscal policy in post-communist countries.

The structure of the study is as follows: the next section contains a proposed scheme for distinguishing successive stages of fiscal policy during the transformation period. In the following four sections, four such stages of fiscal policy are discussed. These are: initial destabilization, initial stabilization, secondary fiscal crisis, and finally, fiscal consolidation. The last section presents a summary and concluding remarks.

This paper was written on the basis of statistical data and information collected in the course of the research project "The Fiscal Crisis in Central and Eastern Europe under Transition", carried out in 1994–1995 by CASE (Center for Social and Economic Research) under the author's supervision. It was sponsored by the Ford Foundation, and other information was acquired from the database of the World Bank EC 2 Department (Central Europe). The author was able to use the World Bank database during his time at the World Bank as a visiting research fellow from October 1994 to May 1995. Generally available IMF and World Bank publications were used as supplementary sources of information. However, it is important to remember that the incompleteness and incomparability of statistical data is a major methodological difficulty in examining fiscal policies of the transition period, and thus this has also been a drawback for the preparation of the present study.

The fiscal scenarios of the transition process

Both the fiscal situation of post-communist countries and the nature of their fiscal problems have changed during the course of the transition process. One can "stylize" the following four-stage fiscal policy scenario which most of the countries that succeeded in completing the first transformation stage went through:

1. Macroeconomic destabilization (including fiscal destabilization) in the period directly preceding the launching of political and systemic transformation;
2. Initial macroeconomic stabilization connected with economic liberalization;
3. Secondary, post-stabilization fiscal crisis;
4. Restoration of fiscal potential connected with economic revival and advancement in the reforms of the public finance system.

This "stylized" scenario is based mainly on the experience of the Polish economy, though a similar "route" of events can be also noticed in other countries which conducted the transformation process in a comprehensive and quick way. Such a scenario, however, is less observable in the case of the remaining categories, since the countries that initiated a programme of radical reforms relatively late, at best can find themselves only reaching the second stage. In the countries that were gradually and inconsistently carrying out reforms, an overlapping of the separate stages (mainly of first and third ones) ensued. At the same time the first stage turned out to be a long and very painful one in an economic and social sense.

There are also countries that do not fall within the scope of the "stylized" scenario, or in which some scenario stages are only vaguely outlined. For example, Czechoslovakia and to some extent Hungary "by-passed" the initial fiscal crisis, although the latter country suffers seriously from the secondary crisis (i.e. that of post-stabilization and post-liberalization). The third stage, however, appeared to be relatively mild in the Czech Republic and Estonia. These and other exceptions will be discussed more extensively later.

Initial destabilization stage

The post-communist countries inherited from the command system a number of serious economic problems. These are the most serious ones:

1. Full or almost full nationalization, which "squeezed" individual savings and—directly or indirectly—limited private economic activity. The natural consequence was the practice of financing investment mainly from budgetary and quasi-budgetary resources (e.g. off-budget funds, funds collected by bodies such as associations of enterprises, targeted central bank credits); only in a secondary way did investments come from profits of enterprises and private savings collected by the state savings bank and redistributed through the banking system for development processes steered by the state.

2. The existence of huge structural distortions resulting from the creation of strong monopolistic structures, autarkic trade policy, administrative regulation of prices, and centralized investment decisions. Under the CMEA regime, Central and East European economies as well as the USSR were strongly oriented toward domestic and regional markets. The currency inconvertibility, state price control, trade restriction and state monopoly in foreign trade—all these factors led, more or less, to the isolation of those economies from the international market.

3. Substantial social obligations of the state in comparison with the economic development level reached by those countries (*Sachs* 1995a).

4. Permanent domestic and external macroeconomic disequilibrium, severely felt mainly in the last phase of the former system's existence.

With regard to the subject-matter of the present study, the most important is the last of the problems listed above, in particular fiscal disequilibrium. The latter constituted one of the main reasons for monetary imbalance (since the fiscal or quasi-fiscal deficit was financed by monetary emission). This led, in turn, to inflationary pressure, either in a hidden (shortage of goods) or open form (price increase). Foreign credits appeared to be an alternative method of financing the actual deficit of the public sector. In the case of most East European countries (Poland, Bulgaria, Hungary, Yugoslavia, and at the end of the 1980s, the USSR), this led to enormous external indebtedness.

Passing on to the analysis of the sources of fiscal disequilibrium, two groups of factors can be theoretically distinguished. The first group consists of those which were permanently effective through the whole period of the planned economy, and the second includes those which emerged during the last phase of that system—i.e. during its accelerated collapse. In practice, however, an attempt to draw a distinctive boundary-line between both kinds of reasons may raise some doubts.

If we look at the list of major economic problems inherited from the centrally planned economy, we can without any hesitation point to items 2 and 3 as the sources of permanent fiscal tensions. More detailed historical analysis reveals, however, some differences. Whereas structural distortions were rooted in the early stages of socialist industrialization programmes due to the central allocation of resources and administrative prices and state monopoly in foreign trade, the social part of the heritage of the previous system is of more recent origin.

A restrictive welfare spending policy was characteristic during the first decades of the communist regimes. The situation gradually started to change only after Stalin's death, along with growing social dissatisfaction (bloody events in the German Democratic Republic in 1953, in Poland in 1956 and 1970, in Hungary in 1956, and the Prague Spring in 1968). Post-Stalinist communist leaders (Khrushchev and Brezhnev in the USSR, Kádár in Hungary, Ulbricht and Honecker in GDR, Husak in Czechoslovakia, Gierek and Jaruzelski in Poland) began to try to attract social support for their governments. However, the biggest jump in social welfare spending was recorded towards the close of the existence of the communist regimes, when the process of seeking social approval became more intense. It was often connected with partial democratization of the system, and with the efforts of the then governing elites to gain the electorate's approval. The most spectacular explosion of welfare spending and wages occurred in Poland in 1987–1989 and in the USSR.

The scale of state social spending has always been a feature differentiating Eastern Europe and the former USSR from communist countries in East Asia. The latter countries have provided much more modest social nets than those in Central and East European countries and the former USSR (Sachs 1995a). Thanks to this they were able to maintain macroeconomic discipline at a fairly high level (although Vietnam was forced to conduct a radical stabilization operation in early 1989).

The explosion of social spending towards the close of the communist regimes was not the only reason for fiscal crisis and growing inflationary tensions. The state *de facto* lost control over state enterprises and their finances (especially wages).

The first historical reason for this loss of control, and consequently for the emergence of fiscal tensions, was the incompleteness of economic reforms. The latter dismantled, to some extent, the traditional system of central planning but offered no alternative solution in exchange. Several decades of experience with attempts to reform the socialist economy (beginning with the early stages of self-government reform in Yugoslavia in 1950) have clearly shown that "market socialism" or other variants of the "third way" are difficult to reach, and at the same time lead to serious macroeconomic disequilibrium problems. It is no accident that Yugoslavia and Poland were the leaders in macroeconomic instability among the socialist countries, and that the first destabilization phase in the USSR (under Gorbachev's "perestroika") was connected with partial enlargement of state enterprise autonomy. Of all the reforming countries, only Hungary succeeded in avoiding serious crisis, although this economy also could not be considered as a model of stability (especially if the scale of external indebtedness is taken into account).

The problem related to the detailed mechanisms which lead to fiscal destabilization under partial liberalization of the command economy is discussed in economic literature. Generally, emphasis is placed upon the loss of traditional budgetary or quasi-budgetary revenues which, in classic socialist economies, were obtained primarily through the state's confiscation of almost all enterprise profits. As the financial autonomy of enterprises increases, the budget loses part of these revenues. If, in the meantime, the state does not create alternative ways of collecting money from enterprises and citizens (through an obligatory system of direct and indirect taxes) or reduce its expenditures, then the budget deficit grows (*McKinnon* 1992). This is not, however, the only mechanism. The description of the adverse influence of incomplete reforms on fiscal equilibrium can be extended by incorporating a few additional factors and phenomena in the analysis.

The growth of state enterprise autonomy in wage determination (indispensable for the creation of a more aggressive system of financial incentives for employees and management), coupled with a lack of adequate interest in profit, leads to a decline in profit, and thus to a drop in budgetary revenues. Additionally, the level of wages paid in the enterprises indirectly affects—through informal and formal "indexation" systems—the level of wages in the government sector, pensions, and other social contributions financed out of the budget or from off-budget funds.

Even more harmful is a gradual and selective price liberalization, which leads to growing gaps between market prices and administratively determined or regulated prices. This creates a situation where subsidies, tax concessions, or other forms of financial compensation for producers are necessary. Since the goods and services sold at controlled prices—due to their great political sensitivity—cover a large group of products with a large share in the overall market turnover, the final consequence of gradual price liberalization is an increase in budgetary subsidies and a decline in budgetary revenues. The latter are due to the application of tax concessions or a general fall in profitability.

In the light of existing empirical experience, gradual and poorly coordinated price liberalization—which is subject to public political bargaining—constitutes the major threat to macroeconomic stability at the end of the command system. In addition to the earlier discussed negative influence on budget equilibrium, one should also focus on the increase in money velocity. This is caused by the inflationary expectations resulting from slow price deregulation. This problem was severely felt in Poland in 1987–1989 and in the USSR in 1989–1991, where the problem of price liberalization was a subject of public discussion, and the final political decisions in that matter were delayed for many months. To a lesser extent this process could also be observed in other countries such as Bulgaria, Czechoslovakia (in the second half of 1990 before price liberalization became effective on 1 January 1991), and the former GDR (just before the introduction of the Monetary, Economic and Social Union 1 July 1990).

The destabilizing influence of gradual and inconsistent reforms in the late stage of socialism was additionally strengthened due to the weakness, and sometimes disintegration, of the socialist state (e.g. the Soviet Union and Yugoslavia in 1990–1991). This mechanism has been described in more detail above with regard to the explosion of welfare spending and wages.

Only Czechoslovakia, Hungary and the GDR avoided serious fiscal crisis at the beginning of the transformation period; however, in these countries the macroeconomic stabilization level was far from Western standards. In the cases of Czechoslovakia and the former GDR, the maintenance of an unreformed command system, and then its quick replacement with market regulation mechanisms, proved to be of the greatest importance. Both countries were characterized by a high level of political and economic discipline during the central planning era, and state authority and control over the economy did not undergo spontaneous disintegration, as was more or less the case in the other countries.

Hungary's success in avoiding political and economic disintegration occurred despite the completely different initial situation of this country from that in Czechoslovakia and the GDR respectively. In the 1980s, Hungary was the leader in political and economic freedom in the communist camp. The decentralized version of the planned economy which existed in Hungary, although not free of some of the weak points observed in Yugoslavia and Poland, remained capable of disciplining economic agents. The last communist government of Károly Németh, with a clear pro-reform attitude, was also able to avoid those blatantly populist decisions which destabilize public finances.

Table 1 presents basic indicators reflecting the fiscal situations of six former members of the CMEA in the year preceding the launching of the fundamental transformation process. It should be emphasized, however, that this data is only approximate, due to the aforementioned incomparability of statistical data between these countries. A quasi-fiscal deficit (usually connected with central bank oper-

Table 1

General government revenues, expenditure and deficit in the year preceding the beginning of transition (in percent of GDP)

Country	Year	Revenues	Expenditures	Deficit
Poland	1989	34.65	39.86	5.21
Hungary	1989	61.16	62.30	1.14
Czecho-Slovakia	1990	61.86	62.60	0.74
USSR	1991	38.00	53.00	15.00
Bulgaria	1989	77.92	79.46	1.54
Romania	1989	50.79	44.07	−6.72

Source: IMF and Central Bank data; CASE database.

ations or foreign credits), not included in official budgetary statistics, constitutes another factor distorting the picture.

Data presented in *Table 1* confirm the dramatic state of public finances in the USSR before its breakup (1991), and also the relatively high government deficit in Poland in 1989. In the case of Poland, the general indicator for 1989 "hides" substantially deeper crises of public finances in the second and third quarter of 1989 (in the fourth quarter of 1989 the process of withdrawing subsidies was started, and the budget was almost balanced for the quarter). In all countries there were also quasi-fiscal expenditures of the central bank.

Some comments on Romania are necessary as this country showed a significant budget surplus. In the second half of the 1980s, Romania implemented a restrictive programme aimed at external debt repayment (i.e. debts accumulated in the 1970s). This policy, accompanied by economic and political restrictions, was one of the factors that led to the uprising against Ceauşescu's regime in December 1989.

The stage of initial stabilization

The experience of approximately 30 countries undergoing the transition process from plan to market reveals that macroeconomic stabilization is a necessary (although insufficient) condition for achieving progress in other areas of transformation (*Balcerowicz and Gelb* 1994; *Balcerowicz* 1994; *de Melo, Denizer and Gelb* 1995). Since a considerable fiscal and quasi-fiscal deficit constitutes a main source of macroeconomic instability at the very beginning of transition, an anti-inflation programme must aim to eliminate or reduce this deficit. The "standard" set of measures for doing so includes:

1. the elimination or a substantial cut in consumer and producer subsidies,

2. a cutback of other government expenditures (mainly investment expenditures and defence spending),

3. reduction of tax concessions and an increase in tax rates, or the introduction of additional emergency taxes if necessary,

4. elimination of central bank quasi-fiscal spending (mainly in the form of negative real interest rates, differentiated exchange rates and credits directed at particular sectors of the economy).

The measures listed in items 1, 3 and 4 are impossible without price liberalization. In turn price liberalization (under the conditions of extensive monopolization which prevailed in most of the post-communist economies at the beginning of transition) requires external liberalization of the economy.

As the criterion for the success of the initial stabilization stage, I suggest using an indicator which shows a sustained (i.e. a minimum of two successive years) fall in inflation below the level of 50 percent per annum and which is concurrent with the free formation of most prices. This would eliminate the so-called "monetary overhang" which is a characteristic of Kornai's economics of shortage (*Kornai* 1980). Obviously, the level of 50 percent inflation is purely arbitrary, but it seems to be a reasonable threshold for the elementary stability of prices following their general liberalization.[1]

Table 2 presents results of macroeconomic stabilization.[2] The criterion of macroeconomic stability defined above was met, before the end of 1995, by the following eight countries: the Czech Republic, Slovakia, Hungary, Slovenia, Albania, Poland, Estonia, and Latvia. If we take into consideration a December to December inflation index, we should also include Croatia, Macedonia and Lithuania. The aforementioned criterion seems to be almost satisfied by Moldova, Kirgizstan and Romania.

Table 3 shows budgetary revenues, expenditures and balance (in percent of GDP) in 29 post-communist countries in 1989–1994. However, for many countries (mainly the former USSR and Yugoslavia respectively) a full time-set of data is not in my possession. In spite of this incompleteness, it is obvious that most countries that succeeded in achieving fundamental macroeconomic stability (i.e. inflation below 50 percent per annum) enjoy relatively low budget deficits. Only 3 out of 11 countries included in this group have deficits exceeding 3 percent of GDP. These were Albania, Hungary and Lithuania. In 1994 Lithuania was only beginning the stabilization process, and according to prognoses its fiscal balance

[1] A similar criterion has been adopted by Anders *Åslund* (1994).

[2] These results are approximately mirrored by the average yearly data, which with some lag respond to current (December-to-December) inflation rates. A certain complication results from the fact that in some cases the anti-inflation policy is applied in the second half of the calendar year. The statistical effect—in the form of a drop in the average annual inflation rate—is visible only in the following year or even two years later.

Table 2

Inflation in selected post-communist economies (CPI—increase in the average yearly indicator in percent)

Country	1989	1990	1991	1992	1993	1994	1995[a]
Poland	251.0	586.0	70.3	43.0	35.3	32.2	29.0
Czech Republic	2.3	10.8	56.7	11.1	20.8	10.2	9.0
Slovakia	0.0	10.8	61.2	10.1	23.0	14.0	10.0
Albania	0.0	0.0	35.5	225.9	85.0	28.0	9.0
Estonia	6.1	23.1	210.6	1069.0	89.0	48.0	26.0
Latvia	4.7	10.5	124.4	951.2	109.0	36.0	25.0
Hungary	17.0	29.0	34.2	22.9	22.5	19.0	29.0
Slovenia	1306.0	549.7	117.7	201.2	32.0	19.8	13.0
Lithuania	2.1	8.4	224.7	1020.3	390.2	72.0	36.0
Kirgizstan	0.0	3.0	85.0	854.6	1208.7	280.0	44.0
Moldova	0.0	4.2	98.0	1276.0	789.0	327.0	20.0
Romania	1.1	5.1	174.5	210.9	256.0	131.0	34.0
Russia	2.2	5.6	92.7	1353.0	896.0	220.0	181.0
Bulgaria	6.0	22.0	333.5	82.0	72.8	89.0	62.0
Belarus	1.7	4.5	83.5	969.0	1188.0	2200.0	737.0
Kazakhstan	0.0	4.2	91.0	1610.0	1760.0	1980.0	165.0
Turkmenistan	2.1	4.6	102.5	492.9	3102.0	2400.0	226.0
Ukraine	2.0	4.0	91.2	1210.0	4735.0	842.0	321.0
Uzbekistan	0.7	3.1	82.2	645.0	534.0	746.0	273.0
Armenia	0.0	10.3	100.0	825.0	3732.0	5458.0	185.0
Azerbaijan	0.0	7.8	105.6	616.0	833.0	1500.0	464.0
Mongolia	0.0	0.0	208.6	321.0	183.0	145.0	25.0
Macedonia	1246.0	120.5	229.7	1925.2	248.0	65.0	18.0
Croatia	2520.5	135.6	249.5	938.2	1516.0	98.0	2.0
Georgia	0.0	3.3	78.5	913.0	3126.0	18000.0	163.0
Tajikistan	0.0	4.0	111.6	1157.0	2195.0	452.0	389.0

[a]IMF forecast

Source: de Melo, Denizer and Gelb (1995), table 3; IMF data

for 1995 should be much better. Albania has received considerable non-repayable foreign assistance and concessionary loans have been granted by the IMF and the World Bank. Hungary, as mentioned earlier, did not go through pre-transformation destabilization, and thus it did not have to introduce strict stabilization measures. All adjustment activities related to budgetary expenditures in 1991–1993 turned out, however, to be insufficient. This is why Hungary is the country which suffers most severely from the so-called secondary fiscal crisis (see the following section). Moreover, Hungary is also the only country that will register an increase in inflation in 1995.

Table 3

General government revenues, expenditures and budget balance in transition countries (in percent of GDP)

Country	Indicator	1989	1990	1991	1992	1993	1994[b]
Albania	revenues	48.0[c]	47.0[c]	31.0[c]	25.5[c]	28.0[c]	27.7[b]
	expenditures	57.0[c]	62.0[c]	62.0[c]	48.0[c]	44.0[c]	41.0[b]
	balance	−9.0[c]	−15.0[c]	−31.0[c]	−22.5[c]	−16.0[c]	−13.3[b]
Armenia	revenues	52.2[c]	42.7[c]	29.1[c]	21.5[c]	17.6[c]	37.0[b]
	expenditures	49.8[c]	36.9[c]	36.4[c]	61.5[c]	66.4[c]	61.0[b]
	balance	+2.4[c]	+5.8[c]	−7.3[c]	−40.0[c]	−48.8[c]	−24.0[b]
Azerbaijan	revenues	22.3[c]	26.4[c]	25.5[c]	23.4[c]	36.0[b]	
	expenditures	24.3[c]	31.9[c]	30.5[c]	27.5[c]	49.0[b]	
	balance	−2.0[c]	−5.5[c]	−5.0[c]	−4.1[c]	−13.0[b]	
Belarus	revenues			47,5[e]	43,3[e]	43,6[e]	36,6[b]
	expenditures			43,9[e]	46,8[e]	51,9[e]	38,1[b]
	balance			3,6[e]	−3,5[e]	−8,3[e]	−1,5[b]
Bulgaria	revenues	59.6[a]	51.6[a]	42.3[a]	38.3[a]	37.4[a]	38.0[b]
	expenditures	61.0[a]	60.4[a]	50.9[a]	45.3[a]	51.2[a]	44.1[b]
	balance	−1.4[a]	−8.8[a]	−8.6[a]	−5.0[a]	−10.9[a]	−6.1[b]
Croatia	revenues			14.9[d]	20.4[d]	20.1[d]	27.2[d]
	expenditures			19.5[d]	20.6[d]	20.7[d]	27.6[d]
	balance			−4.5[d]	−0.2[d]	−0.6[d]	−0.4[d]
Czecho-Slovakia	revenues	69.5[a]	61.1[a]	55.0[a]	56.4[a]		
	expenditures	72.3[a]	61.5[a]	57.1[a]	60.1[a]		
	balance	−2.8[a]	−0.4[a]	−2.1[a]	−3.7[a]		
The Czech Republic	revenues	42.8[c]	42.4[c]	35.3[c]	49.5[a]	48.5[a]	51.2[b]
	expenditures	42.4[c]	41.2[c]	37.0[c]	47.5[a]	47.5[a]	50.7[b]
	balance	+0.4[c]	+1.2[c]	−1.7[c]	+2.0[a]	+1.0[a]	+0.5[b]
Slovakia	revenues				50.9[a]	48.1[a]	50.5[b]
	expenditures				64.0[a]	55.1[a]	53.0[b]
	balance				−13.1[a]	−7.0[a]	−2.5[b]
Estonia	revenues	43.0[c]	35.7[c]	38.5[c]	31.4[a]	32.5[a]	35.0[b]
	expenditures	42.5[c]	33.3[c]	32.5[c]	31.0[a]	33.9[a]	35.0[b]
	balance	+0.5[c]	+2.4[c]	+6.0[c]	+0.4[a]	−1.4[a]	0.0[b]
Georgia	revenues	31.5[c]	33.2[c]	30.0[c]	10.2[c]	2.7[c]	15.0[b]
	expenditures	30.6[c]	32.0[c]	35.9[c]			24.0[b]
	balance	+0.9[c]	1.2[c]	−5.9[c]			−9.0[b]
Kazakhstan	revenues	40.7[c]	41.4[c]	35.1[c]	24.6[c]	22.3[c]	19.0[b]
	expenditures	39.2[c]	38.4[c]	44.1[c]	31.9[c]	23.5[c]	23.5[b]
	balance	+1.5[c]	+3.0[c]	−9.0[c]	−7.3[c]	−1.2[c]	−4.5[b]
Kirgizstan	revenues	38.5[c]	39.5[c]	35.2[c]	15.8[c]	14.2[c]	24.3[b]
	expenditures	36.4[c]	37.9[c]	27.3[c]	33.9[c]	23.0[c]	32.7[b]
	balance	+2.1[c]	+1.6[c]	+7.9[c]	−18.1[c]	−8.9[c]	−8.4[b]
Lithuania	revenues	49.8[c]	45.0[c]	44.0[c]	33.3[a]	25.1[a]	25.1[b]
	expenditures	53.8[c]	48.8[c]	36.7[c]	32.9[a]	30.4[a]	30.4[b]
	balance	−4.0[c]	−3.9[c]	+7.3[c]	−0.4[a]	−5.3[a]	−5.3[b]

Table 3 *(continued)*

General government revenues, expenditures and budget balance in transition countries (in percent of GDP)

Country	Indicator	1989	1990	1991	1992	1993	1994[b]
Latvia	revenues	31.0[c]	36.6[c]	26.5[c]			36.7[b]
	expenditures	29.8[c]	35.8[c]	21.8[c]			38.7[b]
	balance	+1.2[c]	+0.8[c]	+4.7[c]			−2.0[b]
Macedonia	revenues						42.8[b]
	expenditures						45.4[b]
	balance						−2.6[b]
Moldova	revenues	35.3[c]	35.2[c]	26.2[c]	20.3[c]	12.4[c]	17.1[b]
	expenditures	33.7[c]	32.4[c]	26.3[c]	42.4[c]	18.1[c]	25.9[b]
	balance	+1.6[c]	+2.8[c]	−0.1[c]	−22.1[c]	−5.7[c]	−8.8[b]
Mongolia	revenues	48.6[c]	50.6[c]	47.4[c]	29.9[c]	36.2[c]	36.2[b]
	expenditures	65.3[c]	64.1[c]	55.1[c]	42.7[c]	53.2[c]	48.0[b]
	balance	−16.7[c]	−13.5[c]	−9.7[c]	−12.8[c]	−16.9[c]	−11.8[b]
Poland	revenues	41.4[a]	42.8[a]	41.5[a]	43.9[a]	45.5[a]	47.9[b]
	expenditures	48.9[a]	39.8[a]	48.0[a]	50.7[a]	48.4[a]	50.4[b]
	balance	−7.5[a]	+3.0[a]	−6.5[a]	−6.8[a]	−2.9[a]	−2.5[b]
Russia	revenues				37.6[a]	35.9[a]	36.3[b]
	expenditures				44.4[a,f]	41.9[a,f]	45.1[b]
	balance				−6.8[a]	−6.0[a]	−8.8[b]
Romania	revenues	51.0[a]	39.8[a]	39.4[a]	37.6[a]	30.8[a]	32.6[b]
	expenditures	42.8[a]	38.7[a]	38.8[a]	42.2[a]	31.0[a]	35.6[b]
	balance	+8.2[a]	+1.1[a]	+0.6[a]	−4.6[a]	−0.2[a]	−3.0[b]
Slovenia	revenues		48.9[c]	43.7[d]	46.6[d]	49.8[d]	43.1[d]
	expenditures		49.3[c]	41.0[d]	46.4[d]	49.4[d]	44.1[d]
	balance		−0.4[c]	+2.7[d]	+0.2[d]	+0.4[d]	−1.0[d]
Tajikistan	revenues	40.3[c]	46.8[c]	40.7[c]	32.8[c]	27.2[c]	35.4[b]
	expenditures	38.6[c]	43.4[c]	31.9[c]	69.8[c]	52.2[c]	38.1[b]
	balance	+1.7[c]	+3.4[c]	+8.8[c]	−37.0[c]	−25.0[c]	−2.7[b]
Turkmenistan	revenues	32.4[c]	42.7[c]	44.7[c]	22.5[c]	13.4[c]	6.2[b]
	expenditures	31.2[c]	41.1[c]	41.2[c]	32.6[c]	17.0[c]	7.3[b]
	balance	+1.2[c]	+1.6[c]	+3.5[c]	−10.1[c]	−3.6[c]	−1.1[b]
Ukraine	revenues	26.4[c]	27.4[c]	38,3[e]	44,0[e]	42,4[e]	42,3[b]
	expenditures	25.7[c]	26.6[c]	51,9[e]	73,3[e]	52,1[e]	51.4[b]
	balance	+0.7[c]	+0.8[c]	−13,8[e]	−29,3[e]	−9,7[e]	−9.1[b]
Uzbekistan	revenues	35.2[c]	45.0[c]	45.5[c]	31.9[c]	41.0[c]	43.0[b]
	expenditures	35.8[c]	45.9[c]	50.0[c]	42.1[c]	43.4[c]	45.0[b]
	balance	−0.6[c]	−0.9[c]	−4.5[c]	−10.2[c]	−2.4[c]	−2.0[b]
Hungary	revenues	59.6[a]	58.0[a]	56.1[a]	57.8[a]	54.1[a]	52.3[b]
	expenditures	61.0[a]	57.5[a]	58.3[a]	63.4[a]	60.5[a]	58.8[b]
	balance	−1.4[a]	+0.5[a]	−2.2[a]	−5.6[a]	−6.4[a]	−6.5[b]

Source: *WEO* (1994), table 14, and 15 (a); de Melo, Denizer, and Gelb (1995), table 8 (b); PRD WB data base (c); MultiQuery Database (1995) (d); *Dąbrowski and Antczak* (1995) (e).

[f] without hidden import subsidies

The 11 countries mentioned above differ from each other in the scale and in their detailed path of fiscal adjustments. Due to lack of comprehensive data and the peculiar situation of "newly" independent countries of the former USSR and Yugoslavia, *Table 4* contains data regarding only five East and Central European countries. Although Bulgaria initially adopted a very ambitious programme of liberalization and stabilization (which peaked in 1991), the government later suspended this programme; thus, inflation never fell below 50 percent per annum, and what is more, in the winter of 1993–1994 a noticeable macroeconomic destabilization was recorded (see next section). Nevertheless, it seems to be reasonable to include Bulgaria in the analysis due to its typical (that is, typical for strongly centralized economies) path of fiscal adjustment for the first years of the transformation process.

Table 4

Adjustments of revenues and expenditures in selected post-communist countries during stabilization–liberalization stage (in percent of GDP)

Country	Period of time	Expenditures	Revenues
Czecho-Slovakia	1989–1991	−15.2	−14.5
Poland	1989–1990	−9.1	+1.4
Hungary	1989–1990	−3.5	−1.6
Bulgaria	1989–1992	−16.2	−21.5
Albania	1990–1992	−14.0	−26.5

Source: See *Table 3*

Analyzing *Table 4*, there are two paths which can be distinguished for adjustment processes immediately after initiation of the transformation process. The first one is represented by Czechoslovakia, Bulgaria and Albania, whose economies were strongly centralized before the beginning of the transformation process and resembled the model command system. In 1989, these 3 countries registered a high share of budgetary expenditures in GDP (from approximately 58 percent of GDP in Albania, up to 72.3 percent in Czechoslovakia). In addition, a significant decline both in expenditures and revenues was recorded. In Czechoslovakia, however, the fall in expenditures and revenues was very similar, and this resulted in the preservation of a low budget deficit. In Bulgaria and Albania, the decline in revenues significantly exceeded the decrease in expenditures; thus, the budget deficit increased. In both countries falls in real GDP were much stronger than in Czechoslovakia. This implies that there was a more dramatic decrease in real expenditures, and an even more substantial drop in real revenues.

In Czechoslovakia the decline in the share of budgetary expenditures and revenues in GDP was the effect of a conscious and tightly controlled government policy of liberalization and comprehensive restructuring of the economic system. However, in Albania and Bulgaria, in addition to the aforementioned processes, there have also been other contributory factors, such as significant weakening of fiscal administration and loss of government control over the enterprise sector.

With regard to Hungary and Poland, in 1989 the economic systems of both countries were much more decentralized, and the scope of administered prices and subsidies, as well as that of price distortions, was smaller. The Hungarian economy was more market-oriented and better balanced in fiscal and monetary respects than the Polish economy (See section on the initial destabilization stage). In 1988–1989 Poland experienced a substantial drop in the share of revenues in GDP and a slight fall in the share of expenditures in GDP (*Bratkowski* 1993; *Bratkowski et al.* 1995). In 1989, at the starting point, Hungary had a much higher share of government expenditures (61 percent of GDP) than Poland (48.9 percent); this is similar to the situation typical for countries which had a highly centralized version of the planned economy (see above). In 1989 the share of subsidies in the Hungarian GDP (12.1 percent) was, however, lower than the Polish share (12.9 percent), not to mention the Bulgarian and Czechoslovakian shares (15.5 percent and 25 percent respectively). In 1989, in comparison with the Polish budget, the Hungarian budget had a higher share of the following expenditures:

— expenditures on goods and services (20.5 percent of GDP in Hungary and 10.2 percent of GDP in Poland), i.e. financing the budgetary sphere,

— debt service expenditures (2.4 percent and 0 percent, respectively),

— social security benefits expenditures (14.4 percent and 11.2 percent, respectively),

— capital expenditures (6.6 percent and 3.3 percent).

A lower initial share of subsidies in GDP, and in the case of Poland a lower share of budgetary expenditures and revenues in GDP as well, indicate the reason why both countries (i.e. Hungary and Poland) followed a less strict "adjustment path" in the field of fiscal policy than Czechoslovakia, Bulgaria and Albania. In 1989–1990, as far as Hungary is concerned, the adjustment path consisted in relatively slight cuts both in general government expenditures (by 3.5 percent of GDP) and revenues (by 1.6 percent of GDP). Consequently, Hungary went from a slight government deficit (−1.4 percent of GDP in 1989) to a negligible surplus (+0.5 percent of GDP).

Poland—where in 1989 the government deficit amounted to 7.5 percent of GDP—was on the edge of hyperinflation in the second half of 1989. Therefore, Poland had to make deeper and more asymmetric adjustments than Hungary, lowering expenditures by 9.1 percent of GDP in 1990 (at the same time, there was a substantial fall in GDP) and increasing revenues by 1.4 percent of GDP. As a result, in 1990, a general government surplus amounting to 3.0 percent of GDP was achieved.

Table 5

General government subsidies (in percent of GDP) in the countries conducting a radical variant of stabilization

Country	1989	1990	1991	1992	1993	Changes
Czecho-Slovakia	25.0	16.2	7.7	5.0	–	−20.0[a]
Poland	12.9	7.3	5.1	3.3	2.2	−10.7[b]
Hungary	12.1	9.6	8.0	5.8	4.8	−7.3[b]
Bulgaria	15.5	14.9	4.2	1.8	4.8	−13.7[a]
Albania	8.3	15.7	20.3	8.2	2.2	−18.1[c]

Explanation: [a]for 1989–1992; [b]for 1989–1993; [c]for 1991–1993
Source: WEO 1994

The available data allow us to examine only two items on the expenditure side: i.e. subsidies (*Table 5*) and capital expenditures (*Table 6*); these are both important in the standard adjustment package for the first transformation stage.

Table 6

Investment expenditures of general government (in percent of GDP) in the countries conducting a radical variant of stabilization

Country	1989	1990	1991	1992	1993
Czecho-Slovakia	8.5	6.9	8.4	11.3	–
Poland	3.3	2.8	2.2	1.7	1.5
Hungary	6.6	4.7	6.2	8.1	6.2
Bulgaria	5.5	3.1	2.0	2.8	1.9
Albania	29.3	18.8	6.1	4.3	7.7

Source: See *Table 5*

The most significant reduction of subsidies was made by Czechoslovakia (by 20 percent of GDP in 1989–1992); Czechoslovakia was also the country which had the highest starting level (25 percent of GDP). Czechoslovakia was followed by Albania (reduction by 18.1 percent of GDP in 1991–1993, with a starting level of 20.3 percent in 1991), Bulgaria (13.7 percent of GDP in 1989–1992, although in 1993 an increase of 3 percent of GDP was registered), Poland (10.7 percent of GDP in 1989–1993) and Hungary (7.3 percent of GDP within the same period).[3] It is worth repeating that the drop in subsidies was accompanied by a slump in GDP, and thus the decrease in overall real subsidies was even greater than the fall in

[3] It is worth emphasizing that both Hungary and Poland reduced the share of subsidies in GDP in the preceding years due to partial price liberalization. In Poland, a substantial cut in subsidies was indicated in the second half of 1989 after food price liberalization. In 1988–1989, a fall in general government capital expenditures was also registered (Bratkowski *et al.* 1995).

their share in GDP. In 1993, the level of subsidies in Poland and Albania amounted to 2.2 percent of GDP, while in Hungary, the Czech Republic and Slovakia, they amounted to 4–5 percent of GDP.

As far as capital expenditures of the respective countries are concerned there is no uniform trend. Albania, with a record level in 1989 (29.3 percent of GDP),[4] had by 1992 made the greatest relative reduction in these expenditures, which were down to 4.3 percent of GDP. In 1993, however, they increased to 7.7 percent of GDP. Bulgaria and Poland, beginning from a much lower level (5.5 percent and 3.3 percent of GDP respectively, in 1989), recorded a steady decline in capital expenditures (although in Bulgaria, there was a temporary increase in 1992), while adopting a "milder" trajectory than Albania's. In Czechoslovakia and Hungary, after a temporary and slight drop in 1990, the share of capital expenditures in GDP increased over the following years.

The available statistics on budgetary revenues render impossible a detailed evaluation of the fiscal results due to the suspension of tax concessions, the unification of turnover tax rates, the lowering of marginal income tax rates (especially for the private sector), and other reform activities. In the first period of transformation a generally observed fall in the share of budgetary revenues in GDP was brought about by lowering the highest turnover tax rates (effectively, the elimination of price distortions) and income tax rates, as well as by eliminating the so-called "duplication effect" (*Barbone and Marchetti* 1995); i.e., taxation of profits generated by subsidies.

Secondary fiscal crisis stage

The improvement of the fiscal balances, resulting from radical adjustment activities at the very beginning of transition process, has turned out to be unsustainable. A majority of the post-communist countries that succeeded in the second stage experienced a secondary (post-stabilization) fiscal crisis shortly afterwards. Only the Czech Republic, Slovenia and Estonia have managed to avoid serious problems connected with balancing the budget (see below).

The most important concrete reasons for the secondary fiscal crisis are the fall in budgetary revenues (particularly from enterprise income tax) and the increase in welfare spending.

Table 7 presents changes in the ratio of budgetary revenues to GDP in the period 1989–1994. Twenty of the 26 countries included in *Table 7* registered a fall in budgetary revenues, sometime very noticeable. Five of the six countries that recorded an increase in ratio of revenues to GDP have recently become indepen-

[4] In Albania in 1989 all the enterprise investment spendings were financed from the state budget.

Table 7

Changes in ratio of budgetary revenues to GDP (in percent), 1989–1994

Country	Change
Slovenia	+4.6
Poland	+6.5
Hungary	−6.8
The Czech Republic	−10.9
Slovakia	−11.6
Bulgaria	−21.9
Estonia	−8.0
Lithuania	−25.2
Latvia	−15.1
Romania	−18.5
Albania	−20.3
Mongolia	−12.4
Russia	−4.5
Kirgizstan	−14.2
Moldova	−18.2
Kazakhstan	−21.7
Uzbekistan	+7.8
Belarus	−1.6
Ukraine	+15.9
Turkmenistan	−26.2
Croatia	+12.3
Macedonia	+6.6
Armenia	−15.2
Georgia	−16.5
Azerbaijan	+10.2
Tajikistan	−4.9

Source: de Melo, Denizer and Gelb (1995, *Table 8*)

dent. Those countries have taken over rights to certain revenue sources held earlier exclusively at the union level. Additionally, two of them (Azerbaijan, Uzbekistan) have crude oil pools and other raw materials that can be easily exported. In 1989, the level of revenues in Poland was exceptionally low due to the dramatic collapse of the public finance system and the concomitant hyperinflationary effects (the "Oliviera-Tanzi" effect). This was probably also the case for three former Yugoslav republics—Slovenia, Croatia and Macedonia.

The picture conveyed in *Table 7* is incomplete, since the figures referring to an increase in revenues are of aggregated character; thus they relate to the whole five-year period in which different stages of fiscal policy overlap for different countries. It is worth noticing that 1989 was, for most countries (e.g. Czechoslovakia, Bulgaria, Romania, Albania, the USSR), a year of "normal" planned economy (although in many cases it was the last year). In Hungary, the processes of liberalization, the removal of subsidies and reform of the tax system were already advanced. A similar situation existed in Poland, which had entered the initial stage of fiscal crisis. High inflation was also raging in Yugoslavia.

An even less comparable year is 1994, since some of the countries were still in the stage of initial fiscal crisis, others were only at the end of the stabilization phase, still others were at different stages of secondary fiscal crisis, and a small number of countries were emerging from crisis. The aggregation of the data makes it impossible to differentiate falls in revenue resulting from price liberalization and the removal of price distortions, from those resulting from a decrease in the fiscal "effectiveness" of the state apparatus. Therefore, in order to illustrate the symptoms of fiscal crisis more precisely, one should refer to more disaggregated data related both to the revenue and expenditure items, which are of key importance for this stage.

Both the sources and the course of the secondary fiscal crisis can best be identified by look at examples of East and Central European countries, although the crisis symptoms (particularly a fall in revenues derived from enterprise income tax) can also be noted in most countries of the former USSR—even in countries such as Russia—where there is still three-digit annual inflation. This means that they have not brought the initial stabilization process to an end.

Table 8

Proceeds from tax on enterprise profits (in percent of GDP), 1989–1994

Country	1989	1990	1991	1992	1993	1994
Bulgaria	23.2	17.9	17.4	8.3	5.6	
Czecho-Slovakia	11.0	12.2	13.7	11.7		
The Czech Republic				11.1	7.5	
Slovakia				10.3	6.5	
Estonia				5.3	4.0	
Hungary	8.1	7.6	5.7	2.6	2.2	
Lithuania				6.3	4.7	
Poland	9.7	14.0	6.1	4.6	5.3	
Romaniac		7.3	5.1	5.3	3.5	
Armenia				8.2	4.6	
Mongolia	21.3	19.5	13.1	11.7	13.0	
Slovenia			0.6	0.6	0.0	0.8
Croatia			0.1	0.5	0.5	0.7
Albania				0.5	0.7	2.2

Source: WEO 1994, *Table 14*; MultiQuery Database 1995; IMF data

Table 8 shows the revenue from taxes on enterprise profits. In almost all countries a downward trend can be observed. Czechoslovakia constitutes an exception (until 1992, an exceptionally high level of proceeds from the above-mentioned source were maintained[5]), as do Albania and the post-Yugoslav countries, where this tax was always of minor importance. A rapid fall in average enterprise profitability is the basic reason.[6] Some reasons for that fall include:

— withdrawal of direct and indirect subsidies (in the form of real interest rate credits) and elimination of the "duplication effect" related to them,

— increase in domestic and external competition, and thus reduction of monopolistic profits: many enterprises are affected by deep financial crisis due to difficulties in selling current production,

— weakening of state enterprise motivation to gain profits due to a temporary systemic and ownership vacuum,

— tendency to hide profits both in the private and state sectors in order to diminish tax obligations (in a part of the state sector this may be additionally connected with pre-privatization tactics),

— fall in the inflation rate and elimination of so-called "paper profits" resulting from high inflation.

The last element seems to have played a key role in all countries which have been trying to overcome high or very high inflation. The large share of tax proceeds in GDP in Poland in 1990, and then its rapid decrease (in spite of the fact that effective tax rates remained unchanged) can serve as an example.

In most countries, a drop in relative proceeds from enterprise profit taxes was partially compensated by increases in personal income taxes (this includes taxes on profits derived from the economic activities of individuals). This effect was particularly dramatic in Poland where, in 1992, with the introduction of the Personal Income Tax Act, a jump in budgetary proceeds from this tax was registered (from 2.4 percent of GDP in 1991 to 6.3 percent of GDP the next year).

In contrast to corporate income tax, the proceeds from turnover taxes, VAT and excise taxes either did not fall in relation to GDP (except for an initial period of price deregulation in several countries), or decreased on a smaller scale (see *Table 9*). The Central European countries that replaced the traditional turnover tax with VAT (Hungary in 1988, Slovenia and Croatia in the 1990s, the Czech and Slovak Republics at the beginning of 1993, Poland in the second half of 1993) show a higher level of indirect tax proceeds than those countries that did not introduce any reforms; in addition, proceeds began to grow immediately when the reforms were implemented. This proves the higher tax efficiency of VAT in comparison with the traditional turnover tax.

[5] In 1993, both the Czech and Slovak Republics registered a falling tendency, but this may partly be the result of a drop in enterprise income tax rates (*Stepanek et al.* 1995; *Adamec* 1995).

[6] In a few cases, a reduction in tax rates and an increase in the range of tax exemptions have played a certain role. The tax exemptions, however, have a bigger influence on diminishing the effective tax rates in those post-communist countries where financial discipline has been considerably weakened (e.g. Ukraine or Russia), and which are not included in *Table 8*.

Table 9

Turnover tax, VAT and excise proceeds (in percent of GDP), 1989–1994

Country	1989	1990	1991	1992	1993	1994
Bulgaria	11.2	9.0	7.4	6.1	7.6	
Czecho-Slovakia	17.7	18.0	12.6	12.8		
The Czech Republic				11.5	12.0	
Slovakia				13.4	13.8	
Estonia				8.0	9.2	
Hungary	16.1	13.8	13.9	13.6	14.3	
Lithuania				11.3	7.2	
Poland	8.8	6.3	7.4	9.0	10.6	
Romania	18.8	11.8	8.3	7.0	7.4	
Mongolia		7.2	8.4	7.4	5.0	
Slovenia			10.2	10.7	11.7	11.7
Croatia			7.8	11.6	13.5	17.5
Albania				7.5	7.9	5.8

Source: WEO 1994, *Table 14*; MultiQuery Database 1995

The introduction of VAT (NDS—*nalog s dobavlennoi stoimosti*) in the countries of the former USSR (at the beginning of 1992) resulted in a much worse fiscal performance. Apart from the generally lower efficiency of tax administration and the weaker financial discipline of the enterprises, the numerous constructional defects of the post-Soviet NDS seem to have played a substantial role.

So far, we have analyzed the share of various taxes in officially registered GDP. An additional dramatic aspect of the situation has consisted in the slump in GDP in all post-communist countries at the discussed stage of the transition process. In reality, therefore, these countries were faced not only with substantial declines in the share of budgetary revenues in GDP, but also with an even greater decline in overall real revenues.

The proceeds from most sources are correlated with GDP value, while the same cannot be said for expenditures. Most of them are more or less fixed (for example, payments to government employees, public debt servicing or welfare spending), which is why their share in GDP—given a real fall in this aggregate—can be expected to grow. In practice, in the case of social contributions, most of the post-communist countries have not only been unable to reduce their commitments in this area, but they have also had to face new requirements and challenges, connected mainly with the effects of unemployment. Of course, unemployment had not existed officially in Central and East European economies (with the exception of Yugoslavia). A rapid growth of the number of pension recipients was a side-effect of the fall in employment and, in some countries, was also partly due to gradual, adverse demographic changes. The withdrawal of many general subsidies for goods and services, the fall in registered employment and real wages, and the termination of the performance of social functions by state enterprises for their employees have caused an increase in the demand for social welfare payments. Additional needs in this field have appeared in countries with ongoing armed and nationalistic conflicts. Moreover, the ineffectiveness of systemic solutions in the field of social policy inherited from the command system and/or created hastily in the first stage of transformation—often under the pressure of the first democratic election campaigns or misleading ideas as to the real financial capabilities of the state—have been conducive to the expansion of welfare spending. The biggest problems have resulted from overly liberal legislation designed to counteract unemployment and from pensions legislation. In case of the latter, the most significant sources of excessive expenditures are usually linked with:

— overly low retirement age and numerous entitlements to early retirement; in most post-communist countries retirees and pensioners can continue to work without any significant restrictions (this is usually a "relict" of the era of labour deficits),

— other branch and occupational privileges (the use of preferential coefficients in the calculation of entitlements, bonuses, etc.),

— an overly short period of work used in calculating pension entitlements, which may lead to manipulation in order to increase payments,

— non-equivalent (highly subsidized) pension schemes in the agricultural sector,

— liberal definitions of entitlements and liberal rules for granting disability pensions,

— poorly constructed and calculated principles of valuation and re-valuation of payments.

Any attempts to revise the operating principles of pension schemes (such as the elimination of obviously inequitable privileges, inefficient regulations which are conducive to abuses, and entitlements which exceed the financial capabilities of the state) are more than likely to encounter the political resistance of large group of pensioners and persons of pre-retirement age (Sachs 1995b), as well as the objection of constitutional courts that consider the aforementioned steps as an infringement of the citizens' rights (Poland and Hungary can serve as examples of the latter).

Table 10 indicates a rapid growth of the share of welfare spending in GDP in all East and Central European countries (excluding Romania and the former Czechoslovakia).[7] The level of social expenditures is significantly lower in the

[7] The same situation exists in Slovenia, which is not included in *Table 10* due to the lack of a comparable database. According to Boris *Pleskovic*'s data (1995) the pension expenditures amounted to 11 percent of GDP in 1991, 12.7 percent of GDP in 1992, 13 percent of GDP in 1993, and 13.7 percent of GDP in 1994. The expenses of the obligatory Health Insurance Fund accounted for 5 percent, 7.2 percent, 7.5 percent and 7.3 percent of GDP in the respective years.

Table 10

Share of welfare spending in GDP (in percent), 1989–1993

Country	1989	1990	1991	1992	1993
Albania	7.1	8.6	12.0	10.8	12.7
Bulgaria	10.4	12.0	14.2	14.1	15.8
Czecho-Slovakia	13.6	13.6	16.1	16.4	
The Czech Republic				14.0	13.5
Estonia				7.6	8.8
Lithuania				19.2	14.3
Slovakia				18.8	16.7
Hungary	14.4	14.9	18.1	18.9	18.2
Poland	11.2	10.6	17.3	19.9	20.4
Romania	9.5	10.6	10.1	9.1	8.9
Russia				6.1	6.7

Source: WEO 1994;

countries of the former USSR, since most of them experienced strong inflationary depreciation of welfare payments. The latter was not allowed to happen in Central Europe thanks to the well-developed indexation systems. Moreover, the labour market situation still exerts lower pressure on the pension scheme in the post-Soviet countries. Nevertheless, an upward tendency of welfare spending share (including pension benefits) in GDP was observed in those countries in 1994–1995.

Social programmes are not the only reason for secondary fiscal crisis on the expenditure side. In various countries there were also other reasons for increases in budgetary obligations. These were: internal and external debt servicing (Hungary, Bulgaria, Poland), so-called enterprise and bank restructuring (Hungary, Bulgaria), and sometimes various forms of subsidies (Bulgaria).

The problem concerning the extent to which secondary fiscal crisis is inevitable and how it can be avoided was, and to some degree still is, the subject of ongoing disputes. The supporters of gradual transformation ("the gradualists") initially blamed the excessive radicalism of economic stabilization and liberalization programmes (referred to as "overshooting") for the secondary fiscal crisis (*Nuti and Portes* 1993; *Kołodko* 1991). According to them, so-called "shock therapy" led to an excessive fall in output and enterprise efficiency. These factors then led to a fall in budgetary revenues as well as excessive unemployment and the concomitant costs of unemployment insurance benefits.

In Polish discussions, an argument concerning the alleged discrimination against the state sector (see Kolodko 1992) has been put forward many times, though the followers of this idea have never presented any convincing evidence. Another argument has been related to the allegedly negative impact of privatization on economic activity and budgetary revenues (*Kowalik* 1993).

The latter issue has also been a subject of concern to radical reformers. In the beginning the state sector seemed to show greater tax discipline than the private sector (particularly the thousands of small individual and family firms) and privatized sector. Moreover, rapid privatization has been recognized as an unemployment-increasing element that leads to the growth of budgetary obligations. It has thus inspired discussions on the optimum pace of enterprise privatization and restructuring and transformation as a whole (*Roland* 1994; *Aghion and Blanchard* 1993).

The supporters of radical transformation have emphasized the negative influence on public finances of such factors as delays in implementing fiscal reforms, overexpansion of social programmes, the results of the external shock coming from the collapse of the CMEA, and the lack of tight wage control in state enterprises (*Dąbrowski* 1992; *Gomulka* 1993; *Crombrugghe* 1993; Bratkowski 1993).

Now, from the perspective of the experiences of transition which have been accumulated so far, the above controversy does not look as dramatic as it did a few years ago:

First, the examples of the Czech Republic, Slovenia and Estonia reveal that fiscal crises can be avoided. It must be noted that the fiscal policy scenario was different in each of the aforementioned countries. Estonia, having a relatively low level of general government revenues (31–35 percent of GDP in 1992–1994) has been able to impose iron discipline in the field of expenditures, particularly in the area of welfare spending. In contrast, Slovenia's high welfare spending indicator is closer to the Hungarian or Polish one than to that of Estonia. However, Slovenia has not only been able to maintain the earlier ratio of general government revenues to GDP, but even to increase it. To some extent, Slovenia has also benefited from the breakup of the Yugoslav federation, having been in the past an important net donor to other federal republics. All these reasons also apply in case of the Czech Republic (i.e. maintenance of a relatively high level of tax proceeds primarily from enterprises, disciplined welfare spending in comparison with Poland, Hungary and even Slovenia, and termination of earlier fiscal transfers to Slovakia).

Second, there is no correlation between the occurrence of the secondary fiscal crisis and the application of the radical transformation variant. The countries hardest hit by the crisis were Hungary, which in 1990–1992 was the standard example of the gradualist strategy (this is reflected in the data in *Table 5*, which indicate the moderate pace of subsidy elimination), and Bulgaria, where frequently changing governments very quickly detoured from the radical change path and began to "soften" budget constraints for enterprises. Among the countries that avoided the secondary fiscal crisis are two exceptionally radical reformers, namely Estonia and the Czech Republic.

Third, a heavy fall in officially registered GDP turned out to be unavoidable. Generally, however, it was smaller and shorter in the countries that adopted the most radical transformation variant (de Melo, Denizer and Gelb 1995; Dąbrowski

1995; *EBRD* 1994; Balcerowicz and Gelb 1995; Åslund 1994). These were the first countries to return to the path of economic growth.

Fourth, any fears of the negative impact of overly rapid privatization on public finances have not been confirmed. The greater tax discipline of the state sector has turned out to be a transitory feature. State enterprises have quickly learnt from the private sector how to hide turnover and profits (or to transfer them out of the enterprise) and avoid taxes. Such practices have occurred on the greatest scale in the countries where the privatization of medium and large enterprises has been slow and the state sector has not been subject, from the very beginning, to hard budget constraints (Belarus, Ukraine, Bulgaria, Romania).

Fifth, the experiences of some Western countries (Sweden, Italy, Finland, France, and even the USA) show that the problem of social and pension benefits guaranteed by the state is not exclusively typical for the countries undergoing the radical transition from plan to market.

Stage of fiscal consolidation

In the case of radical reformers, there has been a phase of output decline in the transformation process. This lasted no longer than two (Poland) or three years (the Czech Republic, the Slovak Republic, Slovenia, Estonia, Latvia) from the beginning of the fundamental stabilization operation. Economic growth, if it is based on sound principles (i.e. it is not chiefly the result of, for example, the development of branches subsidized from the state budget), is connected with a proportional (or greater) increase in revenues and not necessarily with a fully proportional rise in expenditures (see the role of fixed expenses, discussed above);[8] thus, it should by itself help towards a fiscal recovery. In addition, long-term tax reforms (in particular, introduction of VAT and consolidated tax on personal incomes), improvement of the tax administration, and adjustment of budgetary expenditures (mainly related to social programmes) have delivered some positive results.

Movement from the third stage (secondary fiscal crisis) to the fourth stage (fiscal consolidation) is best exemplified by the Polish case, in which the budget deficit has been falling since the second half of 1993. The effects of economic growth (since 1992) and the aforementioned tax reforms have contributed to an

[8] In practice it is not always possible to hold expenditures down during a period of economic growth and increased budgetary revenues. Two political elements play a significant role. These are: the willingness of different groups, being the beneficiaries of the budget, to participate in the results of economic growth; furthermore, government difficulty in opposing different pressure groups and carrying out unpopular reforms which limit budgetary commitments. The fiscal crisis usually serves as the best argument for breaking the resistance of interest groups when a good situation in the field of revenues softens the power of this argument.

improvement of the budget situation. To a lesser degree, this improvement is also due to cuts in welfare spending and the real salaries of government employees. These reductions were made in the second half of 1991 and in 1992 and 1993, but they were of a partly temporary and mechanical character and have not been linked with deeper systemic reforms in this field. Moreover, under the left-wing coalition (which has been governing since autumn 1993) they were partially reversed. The significant reduction of the budget deficit is mainly the result of an increase in the share of general government revenues in GDP as well as the fast growth of GDP.

Symptoms of the gradual improvement of the budget situation can be observed in other countries which are advanced in the transformation process, such as Slovenia, Croatia, Estonia and the Czech and Slovak Republics. Some of them (as mentioned in the previous section) have been able to avoid the secondary fiscal crisis. Slovenia, like Poland, benefits mainly from the effects of economic growth and tax reforms. Estonia and the Czech Republic, in addition to strengthening their income base, have managed to initiate more ambitious, long-term oriented reforms of, respectively, the pension scheme, social policy and social services. In Poland, Slovenia and the Slovak Republic there have only been debates on these issues.

The prospects for relative fiscal stability in the group of countries that are already at the fourth stage will depend almost entirely on the intensity of the reforms of pension schemes, other segments of social policy, and basic areas of social services (e.g. health service and education). The fiscal situation of the countries that do not conduct these reforms quickly enough will mainly depend on their ability to maintain the hitherto existing pace of growth. An economic slump may easily lead to another serious fiscal crisis.

Summary and conclusions

As the analysis presented here shows, fiscal policy has turned out to be one of the most difficult components of transition policy, reflecting the problems that arise in other areas of systemic change. When countries have not been able to realize a consistent policy of economic liberalization, eliminate open and hidden subsidies, introduce hard budget constraints for state enterprises, inhibit interventionist inclinations, carry out tax reforms and improve the efficiency of tax administration and the entire fiscal apparatus, and launch reforms of social services, etc., they have fallen into a fiscal crisis. This crisis usually leads to high inflation, and in some extreme cases to hyperinflation. The same correlation exists in politics: countries that are politically unstable and have weak, inefficiently operating or simply underdeveloped state structures (as in the case of newly independent states), or are engaged in armed conflicts, experience the greatest financial difficulties.

In general, the fiscal situation changes rapidly as the transformation process unfolds. A typical scenario of events starts with a fiscal crisis (at the beginning of transition) connected with the decomposition of the previously existing political and economic system. Radical stabilization and liberalization associated with the removal of subsidies should provide a way out from the aforementioned crisis. This stage of fiscal adjustment, though difficult from a political point of view,[9] is quite simple from a conceptual and technical point of view and may bring relatively fast results. It is not, however, the end of the complicated process of essential fiscal adjustments. Initial stabilization success is usually not sustainable and it is followed by a secondary fiscal crisis, rooted in the transformational output decline, inefficiency of the tax system, excessive social obligations of the state, and is sometimes due to a lack of consistency in conducting a tough policy. It is much more difficult to respond to the secondary crisis than to the primary one. What is badly needed at the secondary stage is a comprehensive reform of the tax system and social policy. With regard to the technical and conceptual aspects, these ventures are more difficult than the simple removal of subsidies, and are usually carried out in a more difficult political situation than the first package of reforms. Post-transformation growth helps to alleviate the secondary crisis.

This sequence of events is not universal for post-communist economies. A few of them have managed to avoid the primary fiscal crisis, at least in its most extreme form, and a few have managed to avoid the secondary crisis. This was the case in the countries that undertook adjustment activities early or found themselves in an exceptionally favourable initial situation. Yet there is a much larger group of countries in which the second stage (of macroeconomic stabilization and liberalization) took a number of years to complete or was not completed at all, and for which no final result can yet be foreseen.

In spite of the views expressed by some economists and politicians several years ago, a more gradual pace of reform did not lower the social costs of transition or prevent the secondary fiscal crisis; on the contrary, the populations of the countries conducting slow reforms were forced to pay an enormous inflation tax for the benefit of ineffective sectors of the economy, and they also experienced (and are still experiencing) a much deeper and longer-lasting drop in GDP, stronger differentiation of incomes and wealth, and a number of pathologies including "criminalization" of economic life. The typical symptoms of the secondary fiscal crisis have overlapped with the primary fiscal crisis very quickly. The scale of necessary adjustment activities is much greater and more painful, and prospects for economic

[9] Leszek Balcerowicz emphasises the fact that, thanks to the unique political atmosphere after a communist regime's collapse, traditional political barriers are substantially softened for a certain period of time. This period provides reformers with the possibility to conduct a set of difficult and unpopular reforms. Balcerowicz calls this unique political occasion "the period of extraordinary politics", which after a certain period (1–2 years) is replaced by "normal politics" (with the increasing influence of different lobbying groups).

recovery are less bright than in the countries that have decided on a package of radical reforms from the very beginning.

The transformation process has not been completed yet. This is true of fiscal policy as well. Even the countries whose budgets are not in deficit and whose public debt and inflation are low (i.e., the Czech Republic, Estonia, Slovenia or Croatia) have to face the problems of incomplete institutional reforms in the field of social policy and restructuring of the government sector and ineffective sectors of industry. In other countries—even those recording a rapid pace of economic growth, such as Poland and Albania—the list of challenges is longer.

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POST-COMMUNIST PRIVATIZATION: FLAWS IN THE TREUHAND MODEL

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The paper describes the "Treuhand model" and the lessons that may be drawn in the West European context and considers the aspects in which the model differed from other privatizations already undertaken in other transition economies. It concludes that the Eastern Länder "deindustrialization" that resulted from the application of the Treuhand model could have been less severe under alternative possible policies, and that the reattainment of pre-transition GDP likely in 1996 has been heavily dependent on resource inflows from the Western Länder, which will have to persist to avoid retrogression. Equivalent external support cannot be expected for other transitions.

On 30 December 1994 Birgit Breuel wrote to her staff in the Treuhandanstalt that within its specified life-span of four and a half years the crucial mandate had been achieved.[1] The aim was concisely expressed in the Treuhandgesetz, the Trusteeship Act, passed by the first freely-elected Parliament of the GDR on 17 June 1990, seven months after the breaching of the Berlin Wall:

The Treuhand is an independent government agency established for the privatization and use of state-owned assets based on the principles of the social market economy. The Treuhand promotes the structural adjustment of the economy to meet market requirements by developing potentially viable firms into competitive enterprises and then transferring them into private ownership.

The implementing state-enterprise closures and the restructuring of the remainder was to a degree justifying the term "deindustrializtion"[2] and it may be contended that they brought levels of unemployment in excess of what was needed to facilitate greater competitiveness in labour cost. Such costs had already been heightened by currency unification at par with the D-Mark and by the extension of Federal trade-union authority to the Eastern Länder. The attractiveness of higher wages to enterprise "insiders" (who in industry and mining greatly outnumber "outsiders", those made redundant by the operation of the Treuhand) could have been moderated by the application of profit-sharing or equity-participation schemes. Federal unionization and the imposed forms of corporate governance by

[1] This paper is an adaptation of a lecture (on 31 January 1995) initiating the Open Seminar series of the Institute for German Studies, University of Birmingham. The assistance of Johannes *Stephan* is appreciatively acknowledged in compiling GDP and unemployment data. After the completion of that revision *MOCT-MOST*: (1995) devoted an issue to "German unification and its aftermath: integration outcomes". See also *Furstenburg* (1995, pp. 269–98); and *Sinn* (1995, pp. 403–426).

[2] For perhaps the first powerful argument on such consequences, see *Carlin* (1994, pp. 127-153).

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contrast fostered a management-labour relationship which prioritized wage remuneration over corporate saving and hence enhanced neither international competitiveness nor the rate of investment needed to draw the East from a "Mezzogiorno" lag behind the Western Länder. The weight accorded commercial banks (despite the encouragement of "development banking") in decision-making may have constrained both domestic funding and access to international financial markets. Even if market prospects were clouded by general recession and the breakdown of the East's former markets in Comecon and the USSR, enterprise sales prices may have been pitched too low, and the consequential Federal indebtedness left too high. To that debt is added a continuing flow of resources from the Western to the Eastern Länder: the magnitude of such external support differentiates them from its GDR predecessor as the pre-transition output volume (though not the structure) is being regained.

The operation of the Treuhand 1990–94

The responsibility undertaken by the Treuhand towards its enterprises was more extensive than that of any single state agency in the other transition economies. It had first to guarantee bank credit for working capital to maintain an enterprise in operation or until definitive closure: the new Länder did not therefore experience, as elsewhere, the accumulation of inter-enterprise debt and of tax arrears ensuing from the initial post-communist recession in economic activity. Secondly, it was required to assure new owners with unencumbered title, thus protecting them from former owners or from claims for environmental damage. Finally, it had to assume that part of the cost of shedding labour which Federal German law enjoined. (*Lipschitz and McDonald* 1990, pp. 7–9; *Tanzi* 1992, pp. 69; 73–74) It took over four types of state property—around 30,000 small retail and catering outlets, hotels and warehouses, more than 8,000 manufacturing and mining establishments, one-third of all agricultural land and two-thirds of all forests. It also received the property of Party and Party-sponsored mass organizations, public utilities and surplus military and security service assets. To eliminate a possible contention that it was selling the "property of the people" (Volksvermögen), those enterprises and properties were converted into joint-stock companies of which the Treuhand held all the equity. (*Vehse* 1994, p. 64)

It created specialized branches for the retail group, for real estate and for agricultural land and forests: most such assets were quickly disposed of, but agricultural land will need another decade for resolution, partly because of the complexity of restitution claims and the confinement of transfer of tenure to a maximum of 12-year leases. An important clarification was made by a judgement of the Federal Administrative Court in February 1995, stating that industrial and landed property which had passed into state hands very shortly after the establishment of the GDR on 7 October 1949 (valued at some DM 40 bn in the cases reviewed) had nevertheless effectively been ordered by the Soviet occupation authorities. (*Dempsey* 1995) To indicate the Federal Government's recognition of the legitimacy of the Soviet occupation, restitution under the 1990 German Unification Treaty was confined to owners expropriated by the Nazi government, 1933–45, and by the GDR, 1949–90.

This paper concentrates on the second group, which employed almost 4 million at the takeover. When examined by the Treuhand nearly 90 percent, or 7,600 state enterprises, were insolvent (akut Zahlungsunfähigkeit). They were, moreover, mostly within huge Kombinaten—an outcome of the reversal of economic reform in the 1960s: 9 out of ten employees worked in just 270 Kombinaten. The first task was to unbundle some into saleable units and to merge others, as a result of which the Treuhand initial manifest of 13,815 became 12,354 enterprises. By the end of its mandate in December 1994 only 65 firms were still to be privatized—ownership had been transferred in 8,444 and 3,718 had been liquidated (the balance of 127 were in transitional status). That liquidation, or the restructuring of those to be privatized, brought 3 million redundancies in an initial workforce (including small business) of 4.5 million—and that in a total Eastern Länder employment of 8 million. The motto caustically attributed to it was "sell or slaughter". Political protest was muffled by the social safety net federally funded at Western Land levels: as it was, in a survey of July 1994 conducted by the Konrad Adenauer Foundation, 27 percent of Eastern German respondents believed that the "re-establishment of socialism would be better for Germany's future than the existing free-enterprise system in the Federal Republic" (11 percent in the Western Länder), and a majority (54 percent) considered that "socialism makes sense in principle and is also feasible" (20 percent in the West). (*Veen and Zelle* 1995, p. 55)

Within its own terms, the Treuhand was super-efficient. It operated in a devolved manner, transacting 80 percent of its business through 15 regional offices and employing at a peak only 4,800 staff at end-1993. It should be regarded less as a seller of physical assets (it called itself an intermediate owner, Zwischeneigentümer) than as a buyer of invisibles—management expertise, technology, access to markets and above all purchaser obligations. These obligations were of three kinds. Two were embodied in 18,000 contracts, whereby buyers have undertaken to invest DM 207 bn and to maintain 1.45 mn jobs for a specified period. Foreigners undertook such contracts in about the same proportion as their purchases in total sales, 10 percent (DM 21 bn capital and 152,000 jobs); overall less than one in 10 contracts are being renegotiated. The third purchaser obligation is environmental restoration and the Treuhand has paid DM 100 bn to cover such liabilities and indebtedness. All but two of the enterprises remaining unsold (63 firms employing some 200,000 staff) have been reconstituted into four management corporations (Kommanditgesellschaften), and will be dealt with at a slower pace (1995–2000), but at about the same cost—the DM 45 bn earmarked is DM 225,000 per job in the unlikely event of all jobs being saved, against roughly DM 180,000 per job maintained hitherto. That of course was the average, for the cost of saving the shipyards was DM 800,000 per job and in the deal for EkoStahl in the former Stalinstadt, DM 680,000.

In money terms, the cost was great. There was a promise in the Unification Treaty that proceeds from the sale would be "exclusively and only" used for the benefit of the new Länder—stronger words than had figured in the earlier State Treaty, "with priority"—and that citizens would receive personal dividends in proportion to their then savings balance in GDR Marks. (*Schrettl* 1992, p. 147) Theodor Waigel, Finance Minister at the time and a signatory of the State Treaty, spoke of proceeds of "several hundred billion DM", and the first Treuhand chief, Detlev Rohwedder, spoke of DM 600 bn receipts. This order of magnitude was a gross value of GDR state enterprises of 924 bn GDR Marks, or 620 bn GDR Marks after deducting the value of those to be retained by a government (mostly local) authority. In the event, revenue from sales was only DM 73 bn and the Federal Unwelcome Legacy Repayment Fund is shouldering a debt of DM 270 bn; by the end of 1995 DM 644 bn was the aggregate of all West-East transfers.

Economic effects in Germany and the EU

The policy embodied in "sell or slaughter" was in view from the start. Rohwedder wrote: "Privatization is the most effective rescue operation...the closure of enterprises should form the core of new activity".[3] But, as already observed, it was carried to the stage of "deindustrialization": the workforce in industry dropped from 3.2 mn in the GDR to 0.6 mn in the Eastern Länder in 1994. It correspondingly brought mass unemployment—higher than in most transitional economies. In January 1996 it was 14 percent of the labour force, against 8 percent in the Western Länder. For the country as a whole, those figures marked a passage of the "4 million barrier": 4,158,000 or over 9 percent unemployment.[4] Aggregate output fell at its nadir (1991) by one-third, (*Hoffmann* 1994, p. 664) and though now on the upswing—growth in both 1994 and 1995 was 9 percent, against a Western German 2.3 percent—there may be no increment in jobs. A survey of the German Federation of Chambers of Industry and Trade of 25,000 companies showed for 1996 that 27 percent of Eastern Land firms were planning to reduce employment, while just 10 percent forecast new hirings; the Western Land firms were gloomier—38 percent

[3] "Privatsierung ist die wirksamste Sanierung...Stillegungen sollen zum Kristallisationskern neuer Aktivitäten werden", cited (from *Treuhandanstalt, Entschlossen sanieren*, April 1992) by Claus *Köhler* (1996).

[4] *Informationsdienst des Instituts der deutschen Wirtschaft (IWD)*, no. 7, 1996: the commentary points out that the hard winter brought heavy unemployment in building—but that unemployment in those trades was 70 percent in the East and only 30 percent in the West.

shedding staff, with only 7 percent augmenting employment. (*Norman* 1996) The Eastern part in 1995 regained the 11 percent of all-German GDP that it had in the heyday of the GDR, against the 28 percent it generated before the Second World War, and the nadir of 7 percent in the second half of 1990.[5] But whereas the GDR was highly self-sufficient, the regained level is heavily dependent on imports. Imports used only to be less than one-fifth of GDP in the late communist period, but today the Eastern Länder produce only 60 percent of what they consume and invest; exports are some one-third of West GDP, but they are only one-fifth of that in the East. The 1995 net West-East German transfer of resources was some 40 percent of the East's GDP.[6] The net inflow of resources is so large partly because of the East's poor export performance: a mere DM 30 bn of goods and services to Western Länder in 1994 and a share in external exports only one-tenth of its share in the German population. Quite apart from the cost of restructuring the economy for privatization and the budget deficit caused by government social and other spending in the East, the Eastern Länder are not paying their way.

To some extent the causes are to be found in changing demand, but they are more attributable to changes in supply. On the demand side, the planned economy, which was rightly termed a "shortage economy", absorbed whatever was produced: as in all Soviet-type economies, production, not consumption, was the goal. Production cuts and factory closures of goods that simply were not wanted, or of poor quality or performance, were rational once that plan obligation ceased. East Germany lost most of its export markets in Comecon, first as East Europe dispensed with communism and Comecon alike, and then as the Soviet Union broke up. All those former markets went into recession, but by 1995 their aggregate production was slowly recovering again in East Europe (where there had been positive growth since 1993), although in the CIS it was still declining (by 4 percent in 1995). Military demand collapsed—not so much from the departure of Soviet occupation forces, who were highly self-sufficient, but as Warsaw Pact orders disappeared. Russian defence industry in 1994 produced only one fifth of what it had done within the USSR in 1991—night-vision opticals from Jena and Kalashnikovs from Suhl were no longer ordered. Russia is now exporting defence goods ($2.5 bn), not importing as it once did from Warsaw Pact allies. On the demand side also, East Land households simply stopped buying East Land consumer manufactures: with DM in their hands, they spent in the first couple of years almost nothing on East Land manufactures where a Western product was available.

[5] In 1995 "Inlandsprodukt" in Eastern Germany was DM 378 bn and Western was DM 3081 bn. The full year data were obtained direct from the Auskunftsdienst des statistischen Bundesamtes; half-year data for 1995 and data for years back to second half 1990 are in Deutsche Bundesbank, *Monatsbericht*. Estimates for 1936 and 1980 were compiled by Michael Kaser (1987, pp. 123–124 and 138–139) from sources there stated.

[6] *The Economist*, 30 September 1995, p. 21.

The crucial problem was, and remains, on the supply side. Whereas every other transition economy allowed its currency to devalue as it marketized, the Eastern Länder *re*valued. Thus the Russian rouble fell to one quarter of its real value against the US dollar in the first four months after price liberalization, but the unit of East Germany went in precisely the opposite direction: it was at a stroke quadrupled in value against the DM.

The one-for-one currency exchange was disastrous in the longer term, although it was welcomed by GDR citizens, for it protected their savings (above a certain limit at a 2:1 rate); gave political support in the subsequent elections to the government party; and inhibited East-West migration. A possible alternative would have been converting wages paid at a different rate of exchange from wages received—for example the employer would convert wages at DM 0.50 per GDR Mark (not far off the productivity differential) but a 100 percent wage subsidy would yield the employee a rate of 1:1; the subsidy could have been annually diminished (intendedly in line with productivity gains). Such a wage subsidy might have been in aggregate smaller than that of unemployment benefit, and would have afforded weak enterprises a substantial breathing space for restructuring with better sales prospects. (*Haendcke-Hoppe-Arndt et al.* 1992, p. 182) The embedding by the 1:1 rate of Eastern German economic inferiority was not for lack of warning—Eastern productivity was something like one-third of Western and the purchasing power parity of the Mark was a quarter of a DM. In a united Germany the trade unions of the Western Länder soon offset what gains the Treuhand made by shaking out overemployment and uncompetitive plants: they extended their wage negotiations to the Eastern Länder, so that money wages rose irrespective of comparative productivity. One argument they deployed was that raising the Eastern wage would inhibit a feared major influx of Easterners into the Western labour market which would in turn trigger a Western wage decline. (*Bös* 1993, p. 204) Again, there was a short-term benefit—Eastern workers still in employment received substantial pay rises—but long-run disadvantage. In the East GDP per gainfully-occupied person (a measure of labour productivity) was in 1991 a mere 31.0 percent of that in the Western Länder, while labour costs per employee (reflecting the average wage) was 46.7 percent of that in the Western. Arithmetically, the dividend of the latter by the former showed wage costs per unit of product as 1.5 those of the Western Länder (1.506 on those data). The gap has been diminishing: on these measures productivity in the East was 50.7 percent of the West in 1993, 53.0 percent in 1994 and—following the greater investment in the East per employee—in 1995 54.4 percent; wages were 67.5 percent of the West in 1993, 70.4 percent in 1994 and 72.5 percent in 1995. (*IWD* 1996, No. 6) If, however, the longer work-hours, shorter holidays and fewer fringe benefits of the Eastern enterprise are taken into account, the gap is narrower. Volkswagen calculates that the wage cost in its Eastern works is now 40 percent of that in its Western works, rather than the 70 percent implied above as a regionwide average.

Table 1

Average wage and social charges per hour worked in 1994
DM at prevailing exchange rates

Country	Wage per hour (1)	Social charge per hour (2)	Column (2)/(1) (3)
Germany: West	24.21	19.76	81
Germany: East	15.48	11.05	71
Hungary	2.35	2.28	97
Poland	2.06	1.71	83
Czech Republic	2.02	1.35	67
Slovakia	1.70	1.20	71
Russia	0.85	0.59	69
Romania	0.88	0.53	60
Bulgaria	0.76	0.57	75

Source: OECD, Deutsche Bundesbank and Institut der deutschen Wirtschaft, *Informationsdienst des Instituts der deutschen Wirtschaft (IWD)*, no. 6, 1996.

The combination of lower productivity per employed person in the Eastern Länder and a diminishing wage discount with respect to the Western Länder is aggravated in international competitive terms by the strength of the D-Mark. Allowing for the longer hours worked, the Eastern Länder's wage costs are much higher than those of other transition economies (as 1994 estimates in *Table 1* show) at prevailing exchange rates. Restructuring and exchange-rate depreciation has enabled the other European transition economies to achieve highly competitive unit labour costs with respect to Western Europe. Working to an Austrian comparator on purchasing power parities (PPP), the Wiener Institut für Internationale Wirtschaftsvergleiche demonstrates unit labour costs (Austria = 100) in 1995 as 12 in Ukraine, 15 in Bulgaria, 23 in Slovakia, 26 in Romania, 29 in the Czech Republic, 33 in Russia, 34 in Hungary, 36 in Poland and 59 in Slovenia. (*Podkaminer et al.* 1996, pp. 35–39) Showing a PPP estimate for 1993 of GDP per capita ($17,000) very close to the German average ($16,500), Austria may be taken as a surrogate for Germany. *Table 2*, giving East Germany $6,300 per capita GDP against $19,400 for West Germany, might not imply so wide a gap as in *Table 1*, and a further modification is the lower proportion levied of social charges in Eastern than in Western Germany. Even so, as *Table 1* also shows, the Eastern Länder ratio of supplementary social charges per person is 71 percent of the money wage, against 81 percent in West Germany, and lower that in some of its East European competitors.

Table 2

Indicators of aggregate economic activity in 1995

Index numbers, United States dollars and percentages

Country	GDP (1989=100) in 1995	GNP per capita ($) in 1993	Percent unemployed in mid-1995
	(1)	(2)	(3)
Germany: West	118	19,400	8.9
Germany: East	91	6,300	14.3
Hungary	86	6,050	10.6
Poland	97	5,000	15.1
Czech Republic	85	7,550	2.8
Slovakia	84	6,290	13.3
Russia	49	5,050	7.7
Romania	81	2,800	9.9
Bulgaria	75	4,100	10.7

Source: Germany: Col (1) from 1991-1994 data (Bruttoinlandsprodukt at 1991 prices) in Statistische Bundesamt, *Daten Report 1994*, p. 250, extended back to 1989 for the West and forward to 1995 for both from *Wirtschaft und Statistik*, passim, and back to 1989 for the East from DIW estimates in Lutz Hoffmann, in Joint Economic Committee of Congress, *East-Central European Economies in Transition*, US Government Printing Office, Washington DC, 1994, pp. 65-6; Col. (2) 1983 estimates at purchasing power parity for East and West Germany from *World Fact Book 1994*, CIA, Washington DC; Col. (3) from *IWD*, no. 7, 1996 and *Wirtschaft und Statistik*. Other transition countries: col. (1) from EBRD *Transition Report 1995*, p. 15 and col. (2) from ibid., p. 21; col. (3) from ECE *Economic Bulletin for Europe*, vol. 47 (1995), Table 2.2.5.
Note: Country order is the same as in *Table 1* for ease of comparison.

A further disadvantage to Eastern Land firms of the tie to West Land wage rates was the rescaling of skill differentials. As Köhler notes, the structure of wages had been ideologically skewed in favour of physical work, and the first stage of collective wage bargaining with Western union participation demoted that work in favour of the white-collar and intellectual groups which rank high in the West. (Köhler 1996) Rational as this would have been on a level playing field, the Mezzogiorno relationship described below suggests that knowledge-based industrial processes and services in the East would have benefited from the pre-Unification remuneration ratio. As is noted below, such industries have tended to be discounted in finding expansion finance and their potential competitive edge in "high-tech" salaries has been blunted. Maintenance of the skill differential would have added to the attraction of commuters living in an Eastern, but working in a Western, Land and to more permanent migration, each lightening unemployment in the East.

The East-West economic dichotomy

Such relationships and the currency tie which precludes competitive devaluation have endowed Germany with a "Mezzogiorno problem". The reference is to the 50 years since the end of the War during which Southern Italy has lagged behind the North, despite heavy subsidies from the North to the South. A recent political consequence was the rise of the Liga Nord, which, claiming that Northern Italy should cease to subsidise a permanently poorer South, urged the political and economic separation of the halves. A recent econometric study of Germany suggests that the East could converge with the Western economy only on a time-scale as long as 30 to 40 years and that in the interim slow productivity catch-up will require heavy continuing fiscal transfers. Other estimates have, however, put convergence at ten or at most twenty years.[7]

It is almost too obvious to point out that Germany and the European Union have been emerging from recession more slowly due to the German costs of unification. Federal government transfers since Unification ran at DM 152 bn in 1993, DM 155 bn in 1994 and DM 195 bn in 1995. They resulted in both a serious budget deficit (as percentage of GDP 6.2 in 1993, but down to 3.3 in 1995); a "Solidarity" supplement on income tax; and a diversion of 45 percent of GDP into taxes and social security imposts. The familiar consequence has been to keep interest rates high in Germany and throughout the European Union; public sector borrowing and taxation have crowded out private investment. The German fiscal deficit will persist under continuing West-to-East transfers, debt service and the loss of revenue from the extension to 1998 of the 50 percent tax write-off for investment in the East. The tax burden was increased in 1995 by the reintroduction of the Solidarity Tax. In a broader context, the Mezzogiorno problem poses the obstacles to monetary union before adequate convergence has been achieved among the unifying economies. The Maastricht Treaty was of course correct in specifying monetary indicators for convergence before European Monetary Union, targeted for January 1999, but the German unification experience lends weight to the arguments for adding real indicators (some of which are implicit in the Maastricht aims of cohesion), and for postponing the deadline until both sets of indicators match the desiderata.

Immediate factor mobility applied not only to capital but to labour. The Federal Government withdrew the privileges granted to GDR emigrants (such as guaranteed accommodation on arrival and cash allowances for resettlement), but migration in search of employment continued. One flow is of commuters—residents of the East with a workplace in the West—and another, now diminishing in the light of high Western unemployment, is for permanent settlement. In macroeconomic

[7] "Thirty to 40 years" is from *Hallet and Yue Ma* (1994, pp. 1731–61) "20 years" is from *Sinn and Sinn* (1991) "10 years" is from *Mayer* (1992)

terms, such labour flows are part of the solution of the Mezzogiorno dichotomy, reducing overstaffing in the low productivity zone by employment where productivity is higher (by virtue of inherited capital endowment and organizational efficiency).

In the much shorter term there was a beneficial if transient consequence to the fiscal transfers in the West German partial recovery in 1994: neither personal consumption nor net exports contributed to it, but construction in, and Western exports to, the East were (with stockpiling) the significant factors. An Eastern investment multiplier may have persisted in 1995: an IW forecast for that year put construction per capita at DM 9,800 in the East against DM 5,500 in the West, raising its share in the national aggregate from 12.9 percent in 1994 to 24.3 percent. (IWD 1995, No. 4) The maintenance of higher capital formation in the new Länder—to which execution of the Treuhand investment guarantees contributes—would accelerate the closure of the Mezzogiorno-type gap. GDP growth is also likely to remain higher as its composition in the east shifts towards services, neglected in the GDR period and with lower capital-to-output ratios than in the expansion of physical production. Deutsche Telekom's reequipment of the Eastern telecommunications network may have a high such ratio, but its empowerment of Eastern subscribers with a competitive edge is undoubted. The level of infrastructure in the East is estimated at reaching equality with that in the West by about the year 2000.

Comparison with other economic transitions

Capital and current inflows from outside have been massive since Unification: no other transition economy could have had the resources that the West furnished the East in Germany. At the other extreme, the Soviet-type Asian economies of Mongolia and the Central Asian successor states had large inflows abruptly cut off when they began their revolutionary change. (*Pomfret* 1996, pp. 81 (Mongolia) and 96–97 (Central Asia); Kaser 1996) Nor could any transition state other than East Germany have had access to a pool of entrepreneurship and corporate capital which could be drawn on without a barrier of language and cultural comprehension: only China, attracting overseas Chinese, was able to marketize with such an influx. In Germany some of this cultural benefit has been offset by mutual psychological disapprobation: "Wessies" see themselves as paying heavily for Eastern economic adjustment and "Ossies" deprecate the strata of managers and officials who have taken the place of locals. Clashes—arising *inter alia* from a "know-all" attitude on the part of those disparaged by "Ossies" as "Besserwessi"—led the Treuhand to appoint mediators (Vertrauensbevollmächtige) to iron out trouble. (Köhler 1996) More generally, such a takeover of management positions precluded some of the transfers into the private sector of potential entrepreneurs who, under central planning, had staffed administrative organs and who, in other transition economies, were both a plus (by reason of training and talent) and a minus (where the *nomenklatura* captured privatizations).

Restitution to former owners was a means of "reprivatizing" in Germany, as it was also in Czechoslovakia, Hungary and the Baltic States; but it was precluded in the CIS, partly because of the remoteness in time of the original expropriations and the absence of any political lobby of previous proprietors.

Unlike any other transition economy, the German Government was under little pressure to implement a targetted anti-monopoly policy when it abandoned the administrative economy. One reason was unwillingness to inhibit the purchase by West German (or EU) firms of a Treuhand plant—often a regaining of a possession in pre-1945 Germany. Only subsequently have the effects of such purchases been monitored, but the Federal Government does not seek to inhibit by break-up the general drive to greater international competitiveness (which is lower in Germany than among all its main industrial exporters). A second reason was that any enterprise which was in such a monopoly position in the GDR was immediately exposed on Economic and Monetary Unification to competition from business in the Western Länder and the EU as a whole. The switch of West German exports to the Eastern Länder is evident. Its share of total world export markets has dropped two percentage points since the late 1980s and external surpluses then of some 4 percent of GDP have reversed into current account deficits of around 1 percent of GDP. (*Marsch* 1995) No other transition state has been forced into such acute competition from imports from, or gained unrestricted access to, the $1.7 trillion trade market of the EU. Even the four Visegrad powers (the Czech and Slovak Republics, Hungary and Poland), Romania and Bulgaria (and prospectively Slovenia and the Baltic States), which have achieved Association Agreements with the European Commission, face severe constraints on their sales of steel, textiles and agricultural produce.

In addition to external access, there was also a benefit in "internal access", unavailable to other economies in transition, although in its consequences not wholly beneficial. The application of Federal German law to the new Länder was a short cut to the protection of property and contracts and to the prudential and regulatory provisions which cost other states much time and effort, and through the interstices or inadequacies of which crime and fraud penetrated. Corporations from established market economies could enter into ownership or commercial relationships within those Länder with foreknowledge of the protection available. Such predictability—so important for investment—was also assured, for example, of tax regimes and profit convertibility. Against such gains must be set the overmeticulous nature of Federal legislation, created over the years in response to specific problems in business and general activity in the West, and the cost to the Eastern enterprises of consultancy, legal and other services involved in adaptation to the new practices. The almost overnight availability of Western financial services had its advantages—as shown by the chaotic and unruly banking situation in transitions elsewhere—but has been criticized for a dominance which minimised the flexibility that profound economic restructuring required. It also brought "house banking" (Hausbankbeziehung), the long-term value of which is controversial. The Federal Government, however, complemented bank credit for small and medium enterprises through the KfW "development banking" programme.

After the Treuhand

A year after the end of the Treuhand, four characteristics can be subjected to at least a preliminary evaluation: the effects on employment, the beneficiaries of property transfer, valuation and sales procedure, and corporate governance.

Unemployment in the Eastern Länder remained in 1995 not only much higher than in the Western Länder, but high in relation to other Central and Eastern European states, as *Table 2* shows. Indeed in all the transition economies the high unemployment was exceeded only in Poland, Slovakia, Albania and the former Yugoslav states. The trade-off was of course that labour "shake-out" has, together with the heavy resource flow from West Germany, enabled the workplaces that remain to assure the East Land economy as a whole the near-reattainment of pre-transition output. As *Table 2* also shows, among transition states no other save Poland (which began transition a year earlier) had got within 10 percent of that level by 1995.[8] If a 9 percent increment, as experienced in 1995, is achieved in 1996, the pre-transition level will have been regained. Assurance of such high increments and the preclusion of any retrogression continues to depend upon the external resource addition. Moreover, such productivity and wage gains as ensue accrue only to "insiders", widening the differential between those who are in work and those who are on unemployment benefit or who have abandoned gainful employment. It is only a consolation that (due to federal support) the social safety net extended under the Eastern Land worker is higher in real terms than in other transition states. Such better standards are no more than would be expected from the differentials in aggregate per-capita product as measured by purchasing power parity exchange rates (again see *Table 2*).[9]

A linked issue is that high unemployment ratios for long periods (in the Eastern Länder since 1992) inevitably bring a greater proportion of long-term unemployment (which the ILO defines as for one year or more). That share was 24.4

[8] As the further data in the source to *Table 2* show; on average the CIS was 48 percent of 1989 GDP in 1995 and the other European transition states, 88 percent.

[9] The assertion here is merely that both values are well below the East German level: the writer has not compared the ratio of social security benefit to per-capita product country-by-country, valuable as such research would be.

percent in 1992 and 30.7 percent in 1993. (*Daten Report* 1994, p. 100) A UK study of 5,200 unemployed has recently concluded that it is likely that "employers look on potential employees who have had 12 months unemployment as significantly less "employable" than their counterparts who present themselves for interview at a much earlier stage in their employment history". (*Dolton and O'Neill* 1996, p. 397) Long-term unemployment impacts most heavily on the less skilled, and lack of work itself precludes those involved from on-the-job skill enhancement.[10] A study of labour markets in general suggests that beyond a certain point long-term unemployment has little effect in holding down wage pressures (*Layard, Nickell and Jackman* 1991, ch. 9), while another on transition economies observes that "unemployment rates well in excess of 20 percent...go far beyond levels which, on the experience of OECD countries, could be regarded as necessary for the efficient working of a market economy". (*Jackman and Rutkowski* 1994, p. 147) Another survey concludes that the Eastern German rate would have been higher but for "active" labour market measures, which have taken 43 percent of labour-oriented spending: "active" measures have been "schemes for retraining, for promoting occupational mobility, and for directly creating jobs", while passive measures are "early retirement, part-time work, east-west commuting and migration". (*Fretwell and Jackman* 1994, p. 174)

Mention has already been made of the promise of a share in the proceeds of privatization that was proffered, but could not be kept, towards the residents of the former GDR. Nearly all other transition countries have provided "vouchers" gratis, or at a very low price, whereby citizens appropriated some of the equity created by denationalization: the argument was to endow them with a vested interest in the new system and render the political and economic change irreversible. Hungary and Poland have taken a variant path: Hungarian citizens can obtain zero-interest loans to buy privatization shares and Poles are able to invest their vouchers not only in enterprises, but also in holding companies administered by specialized management firms, mostly Western-based. Most CIS states and Mongolia have provided concessions whereby management and workers have preferential access to shares in their own enterprise, which has resulted in a high proportion of the new establishments being dominated by "insider" owners. Insiders control four-fifths of Russian privatized firms and two-thirds of Mongolian; it is large also in Hungary, Poland (both management buyouts) and in Slovenia (worker buyouts). By contrast just under a fifth of East German firms went to management buyouts, but they were on average smaller firms, and the commitments they made on investment and on labour were an even lower share. Although Federal law on Mitbestimmung applies and hence requires consultation on job protection once the enterprise is private, the new owners, being management rather than workers put job security low among

[10]Examined in ECE, *Economic Survey of Europe in 1994–1995*, pp. 45–46, which does not however have recent data for either East or West Germany.

priorities. Unlike in virtually every other transition-state privatization, the German population as producers gained no advantage such as they got as voucher-recipient citizens elsewhere. The case-by-case, non-voucher privatization in Germany, Hungary and the second phase of the Russian procedure strengthens management power in subsequent corporate governance.

It is in the decision-period on enterprise closure and restructuring that the exclusion from consultation and/or equity of the pre-existing workforce is important. As sole and exclusive owner of the assets to be disposed of, the Treuhand was under no constraint of appeal (save of course on points of law or maladministration). Workplace bargains on productivity and labour practices and commitments to forgo current earnings in favour of corporate investment could have formed a first phase, at least experimentally—the "breathing space for restructuring" to which reference was made above. The Czech Republic experienced a mere 8 percent decline in employment between 1989 and 1995 (Podkaminer et al. 1996, p. 38), and has the lowest unemployment rate of any transition state. Yet its capital stock was vintagewise older than, and its technical level about the same as, that of the GDR. In aggregate terms, the closeness of its GDP per capita to the East German suggest a similarity of inherited structure which contrasts with the difference in post-privatization experience.

As already noted, external investment has chiefly come from West Germany: about one in ten Treuhand enterprises went to non-German owners, mostly from Western countries. A little came from Russia and other transition states (including some of the huge capital flight from the CIS—*in toto* estimated for end-1995 at some \$50 to \$60 bn). Foreign capital inflow into Eastern Europe has principally been direct investment until mass privatizations are completed: by mid-1995 over \$23 bn had gone into Central and Eastern Europe (Hungary at \$10 bn the largest recipient, followed by \$4 bn to Poland and \$3 bn to the Czech Republic) and \$3 bn into Russia,[11] but, with the organization of stock exchanges, portfolio investment is increasing. At the upper extreme, foreigners account for 40 percent of the contracted investment after privatization in Estonia.

The Treuhand encountered some obstacles to disposal from restitution and environmental obligations, but the determination of a selling price was the principal problem. As in other transition states, the decontrol of prices and the abandonment of guaranteed payment for production rendered past earnings a poor guide to future worth. At the bottom line is liquidation value—selling assets separately after closure and after payment of redundancy settlements—but in the majority of instances the price was by negotiation. In the case of a single offer, an auditing company was invoked. Hungary, Poland and Estonia have closely followed the Treuhand practice, but in most CIS states the value of the fixed assets when last valued in the planning period was taken. In all countries, the "soft budget

[11] ECE, *East-West Investment News*, Winter 1995, *Table 1* (Albania and Latvia are estimated).

constraint" and the lack of bankruptcy precedures had allowed state enterprises to accumulate considerable debts: these were vast in Russia (the equivalent of $24 bn), but modest in Poland, the Czech Republic and Hungary. Indeed, in Poland nine out of ten enterprises were debt-free. The German Debt Remission Regulation (Entschuldungsverordnung) allowed debt to be remitted if the funds could be applied to restructuring or enhancing its competitiveness. The heavy costs which the Treuhand incurred in disposing of its saleable assets contrasts sharply with the experience of the Estonian Privatization Agency (Erastamisagentuur). The latter took on the Treuhand as consultants (even its prospectuses were exact copies of the Treuhand's) and was the sole transition state also to restructure state enterprises before privatization, exacting from buyers, like the Treuhand, contracts for future investment and employment. By the same date as the Treuhand closed, the Estonian agency had privatized 80 percent of state enterprises outside transport and utilities but secured $65 mn investment guarantees and 24,400 jobs, while still obtaining proceeds of $98 mn. It seems unlikely that the level of Soviet-installed technology in Estonia was better than that of East Germany: the implication is that the Treuhand's valuations and price remissions were rather generous to buyers. It must, nevertheless, be modified by consideration of the strength of demand for the sales: Carlin attributes the weakness of Western investment offers to uncertainty in general—the sell-offs were at a time of world recession[12]—and the loss of East Germany's one preferential and experienced access—the Comecon and Soviet markets. (Carlin 1994, p. 151)

If the debt to be borne by the German taxpayer and the pan-European recession to which it contributed are "water under the bridge", an acute issue for the future is the form of corporate governance. In the eight countries listed in the tables of this paper, all but the Balkan states have well passed the half-way post in share of GDP already in the private sector. (*EBRD* 1995, Table 2.1) In the terms introduced by *Albert* (1991) Germany is in the "solidaristic" mode (or "stakeholder economy" in current British political discourse); the Czech Republic has taken the "individualistic" path; and Russia has created its own style of "collectivistic" operation. (Kaser 1995, pp. 184–193) Much more research is needed to determine the relative influences of "stakeholders" or "social partners" in the typical Eastern Land firm, but a preliminary consideration suggests that neither banks nor employees are undertaking the function they have come to perform in the Western Länder. Despite the fostering of "development banking", there is evidence that medium-sized privatized and newly-established firms are not securing adequate finance. Commercial banks, acting as agents for the development banks, are seen as balking at risky ventures, even if the risk premium is high; especially among knowledge-based firms, a lack of physical assets to serve as collateral deters bank support. More generally, the influence of banks over management, minimizing the role of shareholders,

[12] A point also made, inter alia, by Köhler (1996).

appears to inhibit a firm's access to international equity-finance markets.[13] With respect to labour's influence on decision-making, persistent high unemployment in the Eastern Länder has not rendered wage negotiations more flexible to continued productivity differentials compared both with the West and internationally. This effect of a nationwide maintenance of industry unionization would have been, and could still be, countered by profit-sharing schemes enterprise by enterprise, which, as already noted, could have raised the domestic rate of saving. The Russian "collectivistic" model was intended to bring some such incentives after privatization, but has been vitiated by contrary objectives among *nomenklatura* managers and speculative or dishonest newcomers. The displacement of those who managed enterprises under GDR state operation in favour of imported Western managements precluded significant penetration by either of those groups, but seems to have introduced more of the "individualistic" than the "solidaristic" model. The evolution of corporate governance in the coming years must be one of the most important constituents of the political economy of unified Germany.

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[13] This summary of the OECD's annual report on the German economy is taken from *The Economist*, 2 September 1995.

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ON THE HARD ROAD TO REINTEGRATION: THE TRANSITION ECONOMIES IN THE GLOBAL MARKETS

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The article is searching for answers to a number of questions related to the participation of the former socialist countries in the global economy, including e.g. such as follows. Are the institutional adaptation and adjustment efforts in the transition economies efficient and conducive for their integration with the global markets? What are the implications of the changes, for the global trading system, and for the different groups of the countries? It is also analysing the external policy responses: how the increasingly competitive global market system, the norms of which are set by strong business groups and powerful states is reacting to the changes, and what are the consequences of the responses of the main partners in different functional areas, particularly in those, which are directly influencing the modernization process in the transition economies.

On the concept of reintegration

There are different dimensions related to the participation of any given country in the global economy—e.g. historical, geographical, economic, political, national security, institutional and cultural. These dimensions are interrelated through the interaction of a number of internal and external factors, including geographical location, size, natural endowments, development level, economic structure, political and institutional patterns, and the competitiveness of the respective countries. Among the external factors, some of the most important ones are: the rates and patterns of global growth, the dominant position of global (or regional) regulatory regimes and institutions (which comprise a framework influencing the relationships between the participants in the act of exchange), the patterns of competition in the main markets, the role and interests of transitional corporations wanting to integrate particular countries in their global production and marketing system, and the degree and the influence of the interconnections between the markets for goods, capital, services and labour on the countries concerned. These factors are not constant and their fluctuations reflect, on the one hand, the diversity of the market system, and on the other the transforming place and role of the countries in the global markets as price-takers or price-makers. The integration of any country into the global economy is a dynamic process, influenced by the changing interests and needs of the partner countries. Dynamism implies also such factors as the self-generating character of the cooperation with other countries through positive

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interactions or constraints, and retreat and even disintegration which may be the result of losses suffered by countries due to external factors. This in itself implies the simultaneous presence of favourable and adverse factors and trends, and cooperative and conflicting relations in the global markets for all countries. Those states which are on the margins of the global markets, or are newcomers to the dominant processes of the system face more problems than those "established" participants. For the transition economies in the 1990s the following are especially important: the growth and structure of world trade, the factors determining the attitude of capital markets, the strength and dynamics of competitors, and the policies of those international organisations which may play a crucial role in promoting integration in the broader global and regional cooperation system by enshrining them into their framework (particularly significant is the European Union).

Taken in a narrow sense, the process of integration into the global economy in institutional terms includes the introduction of rules and regulations. These influence the political-institutional framework of cooperation in the world market as well as national legislation. In economic terms integration involves the establishment of different relationships through all the economic ties created by trade, capital flows and migration between the integrating countries. It is also influenced by the policies and practices of the external partners. The changes in the character of relationships between countries and their interpenetrations in economic, political and cultural terms is also a long-term process. In this process the different actors (i.e. civil society, governments, firms and international organisations) react to the needs and changes with various speed and intensity. There are measurable elements of integration but there are also aspects which are less "tangible".

In fact, integration or reintegration are not quite the precise words for characterising the changes in the former socialist countries' participation in the world economy. In a broader understanding every country in the world is part of the global economy.[1] The former socialist countries were part of the global economy but their domestic institutions and the patterns of their international economic relations practically isolated them from the global markets.[2] This was probably

[1] I define the world economy as the totality of global production, consumption and exchange activities undertaken by microactors working within the national economies and/or the world market. They are conditioned and interconnected, both within nations and internationally, by diverse and increasingly globalized markets (in goods, capital, technology, labour and information). They are influenced by the economic policies, international agreements, and other actions of various national macroeconomic and international organizations that manage cooperation regimes. The world economy comprises different sets of relations which are themselves special systems, regulated by the market and by cooperation regimes. Economic relations are the media for interdependence and competition. Spillovers of economic shocks and crises are communicated and transferred by them.

[2] The transition to the socialist system (which took place some decades ago) also played a crucial role in shaping the participation of China and Vietnam in the global economy and resulted, in many ways, in similar institutions and policies to those of the European socialist countries; this

the largest economic group in human history, so far, to "drop out" from the global market system for geo-strategic and systemic reasons. External economic relations were largely subordinated to national and bloc security interests. The institutions of the centrally planned economic system developed a strong bias against external economic relations; furthermore, the economic policies of the countries reinforced the inward-looking character of the development process. In fact, the new economic foundations of nationalism were established or strengthened during those years in all the countries of the bloc. While their economic interactions with the rest of the world reached a "nadir" in the 1950s, they were for the most part isolated from the integrating forces of global capital and technology flows. The latter has restructured the global economy during the past 40 years. The strategic considerations of the Western countries also contributed to the isolation of the East from new technologies and favourable trading conditions and institutions. The emergence of the "Third World" and the détente process in the 1960s introduced forces and mechanisms which gave rise to stronger economic interactions between the former socialist countries and the rest of the world. Economic relations between the Central and Eastern European countries and the Soviet Union also became more intensive. However, the institutional development of their cooperation regime lagged behind those functioning in the market economies. Efforts to harmonise their economic development through a planned international division of labour basically failed, even though some elements of specialization emerged between them. (*Simai* 1990, pp. 61–108) While the reform measures in some countries introduced certain instruments of a market economy, their movement towards a more organic integration, or reintegration into the global markets, only became possible after the systemic changes of the early 1990s, and these are still incomplete.[3] The systemic changes have themselves been affected by the disintegration of the Soviet Union, Yugoslavia and Czechoslovakia. New countries have emerged, the majority of which in the past had no independent or autonomous relations with the rest of the world. For these countries participation in the international system implies the establishment of institutions for independent statehood, and the redefinition and redirection of their external political and economic relations. The politics of reintegration are, of course, fundamentally important for all the countries in the region, but they are also significant for all their trading partners.

could be seen the economic role of the state, the subordination of external economic relations to national priorities and plans, and the separation of prices and exchange rates from the global market trends. There were also important differences, particularly in the case of China which, in its international economic relations, developed a number of original patterns and, in certain areas, greater flexibility than the Soviet Union. After the political split with the USSR, China did not have the same "strategic" treatment by the West concerning constraints on technology imports.

[3] In my interpretation, a socio-economic system is defined by the character and development of the institutions, patterns and forms of ownership, the incentives and the sources of information for the main economic actors.

The political dimensions of reintegration

The political process is a major factor in the reintegration for it creates new realities, interactions and channels for communication with the rest of the world, and also within the countries. The disintegration of the Eastern Bloc and the Soviet Union brought about immediate and radical changes in the economic and political relations of the former socialist countries. The Central and Eastern European countries initiated the dissolution of the Warsaw pact and the CMEA and this marked not only the end of the era of Soviet hegemony in the region, but also formulated new goals in security and in political and economic partnership with the Western part of the continent. One of the main aims for most post-socialist countries is membership in the European Community. German reunification and the re-establishment of the Russian state created new realities not only in the evolving new European power structure, but also in the reformulation of the interests and policies of many countries. The most outspoken and active in this context was the Visegrad group, which was the first to formulate the issues in practical terms: i.e. how to enter NATO and the European Community as fast and as smoothly as possible. They also institutionalised their cooperation. The political changes have brought about changes in the self-image of the respective countries as well as the perception that other countries have about them. In this context the evolving new Russian identity became probably one of the most difficult and contraversial issues for the Russians, as well as for the outside world. Will Russia consider itself as a continuity of the Soviet Union in geo-strategic terms? To what extent Russia will be democratised and integrated into the global market system? Will Russia accept its new geo-strategic position as the "final word" or will it try to restore its sphere of influence (not forgetting that Russia no longer has direct frontiers with her former allies). A belt of independent states, large enough to be more than just a traditional "buffer zone", has been interposed between Western Europe and Russia. This belt has pushed Russia far away, geographically, from Central Europe, even with the new alliance between Belorus and Russia. Will the former allies of the Soviet Union be integrated into a new European security structure through NATO? No unambiguous answer can be given to these important questions in the mid-1990s. The integration of Central and Eastern Europe into a new credible security structure may not be an easy and immediate step given the absence of immediate external dangers and lack of a clearer perspective on the new identity of Russia.

The internal dimension of the political changes has involved political pluralism, the establishment of credible democratic institutions (similar to those in the Western countries), and democratization. These aspects are closely related to the future of the international relations of the countries, their relations with the Western world, and membership of European institutions. They are not merely domestic issues. Democratisation, including the honouring of human rights, is also a condition for receiving external assistance during the transition. Sustaining and strengthening democracy in this region also requires strong external, international guarantees, in a region without strong democratic traditions and with a long history of nationalism, xenophobia and intolerance. Nationalism in a region lacking democratic and liberal traditions, and in an environment of social problems and economic difficulties, when placed alongside a historical heritage of hatred, forced assimilation, and oppression, can easily become explosive. It could endanger the stability of the whole European continent. Ethnic problems and minority issues in the region could be further aggravated by the evolving social problems characterised and which are connected to the transition. One must remember that the two world wars of this century started in Central and Eastern Europe (including the Balkans), and in the 1990s the longest civil war since 1945 has been waged. The violent nationalism and chauvinist policies in certain countries have resulted in serious conflicts and global tragedies. What is more, these have been used in the competition between certain great powers in order to gain control over the region, and in their policies of "divide and rule".[4] In the past Central and Eastern European countries were situated in the traditional buffer zone between great powers, and such conflicts have played catalytic roles in precipitating the two world wars of our century. In the mid-1990s, the region is not apparently a stage for similar great power confrontation. Most of the countries in this geo-strategic zone are interested in avoiding any return to a buffer zone position. Potential tensions and conflicts in the region may be internationalised however, through new forces or through the traditional special interests of one or another regional power. Strong institutional guarantees are needed in this region of the world in order to avoid a repetition of the past.

In this context, it is a very important factor and an important external asset for the sustainability of democracy that, at least for the time being, there are no external dictatorial regimes in Europe which could support the domestic extremists in the Central and Eastern European countries. The world of the 1990s is not the world of the 1920s or 1930s. The USA is strongly committed to the support of democracy and human rights on a global scale. There are no dictatorial regimes among the great powers in the West. Today, Germany is a strong democratic state in a democratic European system. The Organisation of European Security and Cooperation, NATO, the European Union and the Council of Europe are all important international regional agencies for sustaining and strengthening democracy. Of course, a key issue will be the future trends of democratisation in Russia,

[4] The most important sources of international instability in the 1990s are rooted in ethnic problems. Russia now has twenty-one republics within its framework. In Central and Eastern Europe there are domestic ethnic problems practically in all states, giving rise to many sources of tension. The domestic sources of instability are the deteriorating standard of living, the increase of poverty, and the high levels of unemployment.

which is the most important power in the eastern part of Europe. She has "inherited" most of the economic, research and development, and military potential of the former Soviet Union.[5]

The future of democracy depends in the final analysis on the degree of popular support. This is also a long term issue. The first five years of the transition process have been accompanied by very severe social costs. Unemployment statistics from the region are not reliable enough to reflect the actual employment situation. In Russia, for example, workers are kept on in factories and paid very low wages, even in those cases where the capacity utilization is below 50 percent. From a working-age population of more than 220 million in the region—while the number of officially unemployed has been put at "only" about 10–12 million—the underemployed may be as much as 30–40 percent of the total labour force. The deterioration of the employment situation and the downgrading of skills are important and unfavourable characteristics everywhere. People's living standards are declining, while social insecurity, unemployment and poverty are rising. Hyperinflation has undermined economic life in a number of countries and, together with the increase of unemployment, contributed to the impoverishment of a large segment of the population. From a total population of close to 400 million, the number of poor has increased from 8 million to more than 58 million. (*World Bank* 1994) The high human costs of the changes and the adverse experiences of a significant mass of the population with the new regimes has exacerbated already serious political challenges for the often very fragile democratic institutions. This has fuelled popular discontent, xenophobia, ethnic tensions and political extremism in many of the former socialist countries.

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[5] Russia's economic consolidation requires extensive international cooperation and political stability. She has strong interests (which may also converge with the interests of other successor states of the Soviet Union) to sustain close economic and in certain cases security cooperation with the other republics. The CIS (Commonwealth of Independent States) has been conceived as the key instrument of this cooperation. Russia has a strong interest to hold together, as much as possible, those areas of the former Soviet Union where large Russian minorities reside. Russia will certainly protect the interests of these minorities and use them to sustain as much influence as possible (there are about 25–30 million Russians living outside Russia in various Commonwealth states). Indeed, Russia will sustain its efforts to hold all the Commonwealth republics together for strategic purposes. Russia's primary security concerns will be focused within its frontiers. It will be concerned with blocking secessionist trends. Russia might also engage in territorial disputes with some former republics and some potentially expansionist Islamic powers in the region. She will also sustain certain interests in Central and Eastern Europe. In this context, there are experts who predict the revival of certain traditional factors related to the cultural heritage of pan-Slavism or religious affinities. Following a long tradition Russia will maintain a relatively strong army for domestic purposes, prestige, and regional security. This strong military capacity will remain, for some time, very important in Russia's political relations, particularly with former members of the Soviet Union.

Liberalization, competitiveness and the socio-economic realities

Five years, or even a decade, is too short a period to evaluate the successes and failures in those processes of transition which are guided mostly by long term forces of change. The evaluation of the integration of the countries on the hard and bumpy road to the global markets is in itself a highly complex task which cannot be related to any ideal model, or to the specific goals set in a comprehensive policy document in quantitative terms. There were, in fact, no models and in most cases there were no specific measurable goals except, maybe, the speed and degree of privatization. This goal was seldom related, even in general terms, to modernization, increasing economic efficiency, and the better satisfaction of needs. The participation of the new countries in the global economy, under the new conditions, has required the simultaneous establishment of institutions and organizations for developing international, political, and economic relations, and for starting cooperation with old and new partners. The tasks were very similar to those which faced the new developing countries a few decades ago. There were, however, important differences. One of them was the continuation of economic relations between the metropolitan countries and their former colonies. Political decolonisation itself did not imply immediate changes in economic relations. In the case of the former socialist countries their markets collapsed too. The collapse of the Eastern markets had an immediate influence on those who participated in them as well as on external partners.

The former socialist counties are re-entering global markets shaped by strong forces of globalisation, with fragile institutions, and with very limited competitive advantages. The main force in the global markets differentiating between the countries and influencing global income distribution is competitive power. The competitiveness of a national economy is shaped by a number of interrelated activities, undertaken simultaneously at different levels and by a number of actors: macroeconomic policies and national institution-building by governments, specific sectoral policies (particularly those related to infrastructure), science and technology, education, trade, microeconomic activities by firms (depending on managerial skills), and correct strategies in the field of innovation, production, marketing, sourcing and sales. Such inherited problems as weak innovative capabilities, the lack of relevant experiences in management and marketing, the poor traditions of entrepreneurship, and a number of new difficulties created by the transition process do not allow optimistic hopes for an easy, harmonious and smooth path with regard to the transition economies' reintegration process to the global markets. These markets are characterised by intense competition, shaped by fast technological and structural changes. The process will be uneven by countries and economic sectors.

First, the level of development of the respective transition economies is a decisive factor which determines the niches and segments of the markets for their exports, and the patterns and technological level of foreign direct investments. The strength of this factor is often forgotten or neglected in the discourse about the reintegration process.[6] The institutions and patterns of competition of the global market system are shaped mostly by the strong industrial countries and corporations. Global competition has become more intense in the 1990s and so too have the results of slower global growth. The redrawing of the map of the global economy according to the new international division of labour—mainly through the entry of new powerful countries and firms—has created new competitive pressures, particularly in those segments of the global markets where the former socialist countries are also searching for opportunities. The strategic interests of the transnational corporations in the region are also rather mixed and often ambiguous. In certain cases they want to integrate certain industries of the former socialist countries into their international production and marketing system; in other cases, their goals are confined to obtaining new markets for their products, through acquisitions, and crowding out local competitors. The early experiences with this main global structure may of course be rather limited and it is difficult to draw meaningful conclusions about the future in this context. There are also differences between the countries, shaped by their policies, and by the attractiveness of their human and natural resources.

Second, the new regimes in the transition economies have had to face what have in many ways been unprecedented institution-building tasks. Several systemic changes have happened in the different countries, both pre-war and within very recent history. For example, the East European countries, which became part of the Soviet sphere of influence after the Second World War, had to dismantle the market system which had been operating before the Second World War and build the institutions of central planning and the one-party system. The systemic changes after 1990 represented the first time when a democratic, political, and market-based capitalist economic system had to be built from "above" by political initiatives and instruments in a large group of countries. The role of the state had

[6] The division of Europe into a more developed West, an underdeveloped East, with a partly developed centre in between, has a long history. The Iron Curtain followed, more or less, along those lines. While the gap between the East and the West narrowed somewhat in certain indicators, especially in human resource development, and the Soviet Union achieved a fragile parity in the defence-related areas, the modernization efforts of the communist era failed to develop internationally efficient and competitive economies. Their problems in this context became acute in an era of global changes, shaped by profound technological transformation and intense competition. The impact of the trade and other strategic restrictions imposed on those countries were also stumbling blocks in the upgrading of their economies. At the same time, the new forms of interactions in finances, especially through heavy borrowing from the West, built strong unilateral dependencies for a few East European countries. Since the 1960s, the gap in the level of development increased not only between the Western industrial world and the East, but certain former developing countries in Asia performed much better in the global economy than the former socialist countries. This is true even in those niches of the global market in agriculture, industry, and services, where the socialist countries enjoyed some competitive advantages.

to be transformed. They had to initiate profound structural changes in the main redistribution systems. New administrative structures had to be built within some countries which inherited disintegrated structures of the state. The task had to be implemented rapidly because the institutional changes were necessary both for the domestic transformation and for the countries' participation in the global markets as market economies. Since the beginning of this period the new governments have not been able to combine the domestic institution-building and macroeconomic stabilisation tasks with the measures related directly to the improvement of international competitiveness.[7] The new institutions and government structures in a number of countries were shaped more by copying the patterns of more developed market economies than by the domestic conditions and needs. External advice as well as domestic political struggles and misunderstandings have resulted in great diversity in the effectiveness of new institutions and the influence they have so far had on integration into the global markets. (Simai 1994, pp. XX–XXI)

During the first five years of the transition, privatization, marketization and liberalization have been the most important catchwords. Liberalization[8] has been the basic guideline for macroeconomic policy "umbrella" measures, directly influencing simultaneously the changes in the functioning of the transition economies and their relations with the rest of the world. There have been several sources of encouragement and pressures for a rapid liberalization process. One of them was the need for changes in the dismantling of the institutions of central planning. The advocates of the new regimes turned, in most of the countries, against public ownership, controls, regulations, state monopolies and subsidies. They considered these features to be the adverse consequences of the communist regimes. The state-owned enterprises, the majority of which had in the past strong vested interests in

[7] The process of China's and Vietnam's reintegration into the global market differs greatly from those of the former European socialist countries. First of all, the political background of the reintegration process of the former Soviet Union, and its former Central and Eastern European partners has been the collapse of the socialist regimes and the dismembering of the key power of the bloc. In China, the gradual opening of the economy to the rest of the world has been developed as an integral part of the reform measures, undertaken by the political regime, advocating a socialist market economy. Second, in the former European socialist countries, the entry of world market forces into their national economies was underpinned with the hope that there would be an acceleration of domestic marketization. In the case of China, since 1978 a number of measures have been introduced for external opening, originally with modest goals; these have tried to increase outward orientation for the growth of export earnings and to allow more extensive technology imports. The influence of world market forces on the domestic economy of China, as a consequence of the opening, is also growing but the effect is much slower and has had a much more limited influence on the functioning of the domestic economy than in the transition economies in Europe. In certain areas, however, it is quite substantial. Overseas-funded companies, for example, accounted for 40 percent of China's foreign trade in 1995. The employment implications of these firms are very important, particularly in the eastern coastal areas.

[8] In many cases in its neo-classical textbook understanding.

protectionism, lost their bargaining power in the new era. Their leaders were, by and large, discredited and in order to save their positions they remained silent.

Liberalization and the introduction of free market policies have also been most important in establishing new contractual relationships with the Bretton Woods institutions. These have included deregulation of the price system, abolition of subsidies, sweeping reforms in public expenditures, privatization, encouragement of foreign direct investments and the liberalization of the foreign trade mechanisms. Many Western economic advisers have suggested that fast liberalization could be the key remedy for curing all the economic ills of the transition countries, including the rapid improvement of their export potentials. Yet the assumptions of the advisers were based more on mainstream theories than on practical experiences. On such foundations, for example, it was thought that, regardless of their structural impediments, the opening of the previously closed economies would result in an increase in exports in exchange for increased imports. It was presumed that new export sectors would expand and as the result of the import competition certain inefficient sectors would be reduced in size. They predicted, of course, that there would be winners and losers and, due to the costs, differences between the industrial countries and the former socialist countries. However, they also suggested that the winners would soon compensate for the losers.

Another important source of pressure for liberalization has been the need for foreign direct investments, and not only for the liberalization of entrepreneurship, capital movements, prices and exchange rates, but also for imports.

The combined result of the strong pressures for liberalization was historically unprecedented speed in opening up many of the former socialist countries. The movement has been uneven—as between countries and over time—and it has revealed the structural weaknesses of the countries. The differences between the respective countries have not only been due to the variations in the degree of the domestic institutional changes, but also because in the size of the domestic market, and in the stability of the political system. Liberalization in a market system can be sustainable in the economy of a given country if it is sufficiently competitive. Competitiveness also requires adaptive efficiency, the postulates of which—particularly in middle-level economies—may be in conflict with liberalisation. The greater the difference between the recent past and the degree of liberalisation, the greater the impact of the measures on the transition economies, particularly on employment and incomes. The liberalisation process has resulted the rapid bankruptcy of many firms (which depended on the different forms of protectionism and subsidies in the past). However, the process has not really stimulated the establishment of more competitive firms. The abolition of import quotas and the increase of imports has brought more consumer goods to shops, in many cases at the expense of crowding out the local producers, or at the expense of the consumers by the creation of new monopolies and higher prices. The expected advantages of import competition have so far not materialised.

There have been some important achievements in fulfilling the institutional requirements of global market integration. In a few states a comprehensive legal framework for the market system has been instituted in some crucial areas, such as: property ownership and legal title, forms of incorporation, mergers and acquisitions, laws related to foreign direct investments and international business in general, and regulations concerning intellectual property rights. All these features attempt to correspond with the norms of the industrial countries (i.e. they are in the framework of the European Union). In other areas there has been a staggered progression towards that goal. A new banking system, involving foreign interests, has started to evolve and stock exchanges have been established in the majority of the transition countries and foreign participation in these is increasing.

It is too early to draw firm conclusions about the influence of measures related to the participation of the economies of the former socialist countries in the global markets. The different types of flows, like foreign direct investments (FDI), the trade of goods and services, or migration, are not influenced by the same factors and measures. Important progress has been made in the field of foreign exchange policies. As a result of these measures a few transition economies have been able to introduce convertibility within a rather short period of time. The liberalization measures have had a favourable influence on foreign investments, the stock of which has increased rather quickly, from less than USD 1 billion in 1990, to above USD 22 billion in 1995 (invested in about 55,000 foreign affiliates). This was distributed among the countries in a highly unequal way, reflecting also the degree of "microintegration" into the global market system achieved by any given country. (*UNCTAD* 1995, pp. 99–103) This represented about 1 percent of the global stock of foreign direct investments. Most of the foreign investments were takeovers or acquisitions. An increasing proportion of FDI has been instrumental for the integration of the given firms into the global production system of the TNC. In many cases however, the aim of the acquisition was entry into domestic markets. As a result of liberalisation measures, the strong competitive position of Western firms is felt in practically all important segments of the market.

Another important change which has taken place in the field of capital flows has been the growth of FDI from the transition economies in the OECD and neighbouring countries. This process may have a great influence in the future. Integration into the global market system implies simultaneously "inward" and "outward" internationalisation of the respective economies. The greater the outward internationalisation through exports (but particularly through foreign direct investments), the easier it will be for the countries to adapt to the needs and patterns of the global markets.

The process of reintegration through trade flows has been more contraversial and it has been influenced by a number of factors. Trade volumes have reflected declining external and domestic demand and shrinking output. The growth of the GDP has been decelerating since the 1970s. Between 1985–89 it was 2.9 percent, but between 1990–94 it had dropped to –9.8 percent. (*UN* 1994; 1995a) According to my calculations, during 1991–94 the total cumulative value of GDP loss in the former European socialist countries was about USD 1,200 billion—that is, close to 40 percent of their output. Industrial and agricultural output declined very quickly due to the collapse of the Eastern markets and the crowding out effect of imports and the shrinking domestic market. The output and income loss was similar to that in the USA and Germany during the Great Depression of the 1930s. The share of the former European socialist countries in global production declined to about 5 percent, in 1994 (from about 11 percent in 1984). In per capita terms in 1984 they stood at about 36 percent productivity of the industrial market economies, in 1994 at around 20 percent. In 1987–89 their share in world exports was 7.6 percent, but it had fallen below 3 percent by 1993–1994. The exposure of the former socialist countries to the world market forces brought to the surface all the deeply-rooted structural weaknesses in their economies. Their combined terms of trade deteriorated by about 10 percent between 1990–94. The imports of the Central and Eastern European transition economies declined at a slower rate than their exports and GDP between 1990–1995, resulting in large current account deficits. Their cumulative current account deficit was USD 32.6 billion between 1990–94.[9] The regional distribution of exports and imports has changed radically. In the case of most of the former republics of the Soviet Union there has also been a sharp decline in imports. The territorial restructuring of trade relations is a result of both political and economic factors. The share of former socialist countries in exports contracted from 49 percent in 1988 to about 20 percent in 1994, and their imports from 49 percent to 22 percent.[10] In the case of the former Soviet Union the share of the former socialist countries in exports declined from 36 percent to 21 percent and in imports from 38 to 18 percent. (UN 1995b, p. 233) There was a fast increase in the share of the industrial countries, both in exports and imports. There are of course great differences between the countries in all these indicators and also in economic performance. However, only one or two countries could manage to turn the adverse trends by 1994.

In the light of the structural and human problems of the former socialist countries, there is very little disagreement today that the region's transition process will take a much longer time than was originally anticipated by most politicians and observers. It is also becoming increasingly evident that neither privatization, nor the other pillars of the transition to a market economy—like the liberalization of international transactions—are sufficient guarantees themselves for the establishment of internationally competitive and efficient economies. In the 1960s the

[9] Calculated by the author on the basis of *UNCTAD* (1992; 1994) and UN (1995a) data and projections.

[10] There was some revival of mutual trade between the former socialist countries in 1994, but with increases in imbalances.

leaders of the Soviet Union put an emphasis on the goal of catching up with the industrial West within a historically short period of time. The European Bank for Reconstruction and Development in its 1995 report raised this issue in the context of the transition economies and suggested that the Central and Eastern European economies must grow by 7 percent a year for 30 years to catch up with OECD countries. (*The Economist* 1995) The catching up issue is, however, a rather complex one. The countries would need the successful implementation of more far-reaching domestic and international measures than the present ones. For instance, there is a need for increasing investments in production, human resource development and infrastructure in order to accelerate economic growth and implement structural changes. This is not possible without much greater external assistance than has been received during the first five years of the transition.

The new East in the global market

The external support of the transformation process in these countries—meaning simultaneously the consolidation of democracy, economic and political modernization and the integration into the global economy under new foundations—is the greatest challenge for Western countries in the 20th and probably a large part of the 21st century.

Redefining relations with a country or a region is of course not a new issue in the practice of international relations. The shaping of the future of relations with the former socialist countries has raised different issues and has been formulated in different ways in the USA, in the European Union, in Japan, and in the developing countries. Yet even in the Western world, in general, there are different dimensions of the problem related to security, business relations, and humanitarian assistance. An important and interesting dimension is the future relationships with past adversaries. This is the third time this century that Western powers have had to face such a dilemma: what policies should they pursue? In 1918–19 isolation, and political and economic weakening was the favoured policy choice in the context of Germany, the key adversary power, and neglect or punishment for the rest. The end result was the Second World War, and the keenest advocates of this policy had a very high price to pay. After the Second World War the recovery of the former enemies was a vital question for the security interests of the West and the strongest power of the era accepted its high costs. This was, of course, motivated by the fear of communism and the Soviet danger. The outcome of this policy was not just the stabilization of Western Europe and Japan, but the emergence of the two other competing centres of the global economy, the European Union and Japan, and the relative decline of American power. In the light of all this some experts raised the issue of whether the Western support to the former socialist countries, especially to

Russia, would not result in similar problems: i.e. new competitors. This dimension of the argument has gained strength in the post-Cold War situation.

During the first years of the new Russia the dilemma of what should be the guidelines for future relationships with Russia—efforts for its weakening, marginalization and isolation or helping it to build itself up as a new democratic power—has not been solved in the policies of her former opponents, especially the USA.

After the first half decade of liberalization and openness, most of the former socialist countries in Europe are increasingly realising that as they are becoming more closely integrated into the global market system they are becoming not only more and more dependent on international actors, traders, investors and corporations but also on the two key international prices of the market system: i.e. interest rates and the exchange rate. These are imposing new pressures and new disciplines on them which were unknown in the past. They are increasingly feeling the rewards of sound policies, but even more the penalties for policy errors. When confidence in their policies declines, not only do the external resources dry up but there is a rapid increase in the flight of capital. The high rate of inflation and the loss of confidence in local currencies have resulted in the dollarization or "D-markization" of the economies, especially in a number of former Soviet Republics. Due to structural and institutional weaknesses the bargaining power of the former socialist countries has been diminishing in multilateral institutions and in the bilateral frameworks as well.

As a result of the diverse economic consequences of the changes—on the different sectors of the economies and on the firms—within the countries new lobbies are emerging. Some of the new entrepreneurs are asking for special protectionist measures while others want not only the liberalization of exports but more incentives for exporters. Certain foreign firms are also looking for fast returns on the invested capital (risk-justified, ultra-high profits) and monopolistic positions in the shrinking domestic markets. There are also problems with the access to external markets. Their former partners are not too eager to give easy free trade or other concessions to each other, as they now consider each other more as competitors than partners. More of the traditional product categories in which they may have had certain competitive advantages to Western markets belong to regulated or protected groups.

Toward which world?

There are a number of questions in the second half of the 1990s which emerge in connection with the reintegration of the former socialist countries into the global market system. These questions are no longer academic ones. The early experiences of the European transition economies concerning the character, the level, the methods and efficiency of Western policies and assistance have raised certain concerns and questions about the future. The former socialist countries in Europe have been basically "price takers" in the world economy. With the exception of the role of the former Soviet Union in the markets of certain commodities (like oil, nickel or diamonds) the overall influence of the transition economies on the markets of goods has been very small, and it has been even more marginal in the case of the capital markets. Will the policy-induced approaches to the transition process gradually fade and be replaced by profit motivated approaches? Is the support of the integration of the former socialist countries into the global market system an issue which is important and high enough on the agendas of the industrial nations? Are there sufficiently strong specific political interests and motivations in the main Western countries for helping effectively the transformation and the consolidation process in the East? Are the ways in which the Western countries address the problems correct and relevant? Will there be sufficient additional external resources available for the purpose (additional in the sense that they will not cut the assistance for the developing countries) of helping the transition economies to be integrated into the global economy with a higher level of performance? Some of the doubts are also based on the historical experiences of the developing countries and their difficulties they will have integrating into the global economy after political decolonisation. In this context another source of concern is related to the way in which the potential gains and the actual costs of the process—in terms of trade, FDI, jobs, and competition—will be distributed between the unequal partners in a global market system which is influenced mostly by the short-term interests and the structural market power of such actors as the transnational corporations?

The most important countries which are usually considered as key external partners of the transition countries are the Western European countries. The large-scale modernization of the Central and Eastern European countries and the successor states of the Soviet Union offer unique opportunities for the member countries of the European Union. This is because of their geographic vicinity and historical ties with the region. Some political figures from other regions of the world suggest that the West European countries should therefore bear the external costs helping the transition economies.

Membership in the European Union is considered by many former socialist countries as the critical factor which will determine the future successes and failures in implementing the domestic tasks of the transition, and also in the development of new interactions with the rest of the world. The performance of the European Union is also looked upon as an important proof of the capabilities of the Western world. Is it able to accommodate a much greater number of states of increasing diversity in economic capabilities, interests, and actions, in a rather exclusive club of countries?

There is a very interesting correlation between the sharing of the costs of assistance and benefits in trade relations for this demonstrates the role of the European

Union.[11] The figures, however, concerning the benefits for the former socialist countries may be misleading. A large part of the much talked about assistance remains "commitment" only. It also should be mentioned that they still reflect clearly the critical and growing role of Germany in the region. The distribution of the real disbursements has also been criticised by certain experts—namely 80–90 percent of these have been frittered away unproductively through high payments to Western advisers, institutions and firms.[12]

The political future and the economic integration of the transition economies into the global market system has, indeed, created opportunities, but there are also new challenges to Western European business interests, countries, and to the regional integration process in Europe. At this early stage the scope of the problems and challenges are more visible than the economic opportunities. The fear of mass immigration and potential armed conflicts in the Eastern part of Europe may stimulate different measures for supporting the transition process. These might promote the modernization and integration of the transition economies into the EU. There is, however, agreement among the experts that there are great differences among the present members of the EU concerning the volume of assistance to, and the time span of, the integration of the potential member states. There are also increasing doubts about the speed and degree of their membership in the European Union, even in the case of those countries which have implemented substantial institutional changes and liberalisation measures. A more or less general consensus has developed which believes that, while consolidation can be achieved only as the result of domestic efforts and changes, favourable trading conditions and resource transfers are indispensable factors in the process. However, this consensus is not necessarily supported by sufficiently effective practical measures. In practical terms, for example, most of the currently exportable goods of the countries in Central and Eastern Europe fall into the category of "sensitive" imports to Western Europe and North America, and are covered by different forms of protection.

Among the main Western partners of the transition economies, the USA has already played a very important role in promoting their integration into the global markets through a multiplicity of channels and instruments. There is a major

[11] My calculations, based on the trade and assistance commitments shares for the first 4 year of the transition, revealed the following facts: the share of the member countries of the European Community in assistance commitments has been close to 75 percent and in total exports 64 percent. The share of Germany was almost 60 percent in assistance commitments and close to one-third in exports. The share of the USA was less than 10 percent in assistance commitments and about 12–13 percent in exports. Japan had a 4 percent export share and a 3 percent share in commitments.

[12] "Transformation in Central, Eastern, and South-eastern Europe"—document of the International Conference 17–19 June 1994, Institute for Development and Peace, Duisburg, p. 53. Another critical analysis of Western assistance to the transition economies in Europe stated that about only one-fifth of the promised assistance had actually been disbursed. (*The Philip Morris Institute...* 1994, pp. 70–80.)

difference in this context between the policies of the USA towards, respectively, China, Vietnam, Russia, and Central and Eastern Europe. With regard to Russia and China, national security considerations still play an important role, albeit of a different nature than the earlier situation. Economic factors are more important in the policies of the USA toward Central and Eastern Europe. The original idea of the Bush administration was, in the context of the transition economies, that it would be the American private sector which would play the leading role in the marketization process through FDI, trade and technology exports. The countries would be assisted by government funds, technical assistance and advice in institution-building as well. In the early 1990s the administration of the USA encouraged the advisory, the managerial and the funding role of the Bretton Woods institutions. USA private investments grew very fast in China. By 1994 their stock in China was over USD 6 billion (*Far Eastern...* 1995, p. 55) (the USA was the second largest investor, after Hong Kong). The volume of USA private direct investments in Central and Eastern Europe, and in Russia, taken together, was still below that figure. The early ideas of the USA administration were very optimistic. Some key experts of the Bush administration anticipated a rapid and successful transition, based on broad popular support. They also expected that the debt of a number of Eastern European countries would be "grown out of" by a fast increase in trade. Five years after the beginning of the transition process in Europe, it is evident that the role of the USA remains below the expectation of the countries; however, in China, the USA, as a source of capital and as a trading partner, has proved to be extremely important.

The developing world comprises one of the most contraversial and critical areas of the "external environment" of the reintegration of the former socialist countries into the global markets. This part of the world itself occupies a very special place in the market system. Due to similarities in development levels, and also structural and institutional weaknesses, many of the developing countries have faced similar problems in the past in the global economy (which the former socialist countries suffered earlier and are still struggling with). (China itself is, of course, a developing country, but the analysis of its political and economic ties with the former socialist countries in Europe and with the other developing countries is not a subject of this study.) The collapse of the Soviet Union influenced the global position of the developing countries in many ways. In political terms they lost some of the bargaining power which they had in a world divided into two hostile blocs. With the disappearance of the "Second World", the "Third World" as a concept lost its justification. This change is not just of symbolic importance. Some of the developing countries lost an important source of assistance and political support as the result of the disintegration of the Soviet Union. Moreover, the North does not need the South any more as a proxy or ally in the Cold War conflicts. A number of factors, such as non-alignment, which united the South in the Cold War, lost their earlier strengths. In economic terms, the asymmetries in interdependence between the North and the South were not only Cold War related. The minerals and agricultural commodities of the South became much less important for the industrial world because of the structural changes brought about by the new technological revolution. Economic interests and factors will play a much more important role not only in the future North-South relations, but also South-East relations. The cheap qualified labour from the former socialist countries, and the export potential of these countries (especially the commodity exports) mean increasing competition with many developing countries. There is also competition for external resources, foreign assistance, and FDI. At the same time some of the former socialist countries, especially Russia, are guided their own economic interests and they are making new efforts to increase mutual trade with a number of developing countries. This is particularly in Asia, where the continuity of relations from the Soviet era is supported by mutual interests. The relations between Russia and China are likely to become more significant, as they will be based more on economic interests, rationality and complementarity. The success of the consolidation of the former socialist countries and their integration into the global economy may, of course, open important opportunities to many developing countries, providing the latter with new markets and investors.

An important conclusion, which may be drawn from the external dimensions of the transition process and the reintegration of the former"second world" to the global market system, is that the whole process should be much higher on the global agenda, both in political and in economic terms, than it is today. Some experts even suggest that if the industrial economies of the West are increasingly able to transfer a major part of the costs of adjustment to the "Second World"—as they already have to the "Third World" of the South—the Second World will be "third worldized". (*Frank* 1993) The former socialist countries would not only require, of course, easier market access in areas where they are more competitive, but also more assistance in development. This requires massive inflows of new technology, expertise and capital under more equitable conditions in order to generate more quickly a new structure of activities, capacities and interactions so as to produce more competitive goods. All these would dictate a faster restructuring of the economies, with adjustment and temporary sacrifices on both sides. Even so, Eastern European countries often argue that they have already made important sacrifices in their adjustment to the new market system in terms of closing down inefficient firms, unemployment, and austerity programmes.

Issues such as easier access to Western markets and financial resources, the easing of the debt burden, technical assistance with institution-building, and technological modernisation would require more concerted, and better harmonised external and domestic efforts. The failure of these efforts to establish modern, efficient economies and democratic societies in the East would be a tragic loss not only for the people of those countries, but for the whole of humankind. I quote the warnings of Vaclav *Havel*, the President of the Czech Republic, who wrote about the potential consequences of the transition for the West:

"... it seems to me that the fate of the so called West is today being decided in the so-called East. If the West does not find a key to us, who were once violently separated from the West (with no great resistance on its part), or to those who somewhere far away have likewise extricated themselves from communist domination, it will ultimately lose the key to itself. If, for instance, it looks passively on at "Eastern" or Balkan nationalism, it will give the green light to its own potential nationalism, which it was able to deal with so magnanimously in the era of communist threat. If it closes its eyes to the post-communist ecological catastrophe, it will sooner or later bring on its own ecological catastrophe, and ultimately a global one. If it does not learn from our experience about where human pride can lead, the hubris of people who invent a rational utopia for themselves and try to create a paradise on earth, if it persists in its anthropocentric understanding of the earth, it will bear the consequences itself, and so will the whole world. If its own consumer affluence remains more important for it than all the foundations of that affluence, it will soon forfeit that affluence."

Politicians often use doomsday prophecies. Still, I agree with President Havel's warnings, but I would also add that in the absence of urgent strategic interests and considerations the reintegration process of the former socialist countries will take place increasingly according to the value judgement of the global markets, which recognise most of all competitiveness. In this respect, the outcome of the process will increasingly depend on the success or the failures of their domestic policies, actions and initiatives. They will have to devote more attention to relations with the "near abroad". The internal socio-economic problems of the Western countries, including unemployment, slow economic growth, the high degree of public debts, the aid fatigue of the population, and commitments to the developing countries will most probably weaken the feeling of responsibility and solidarity towards the transforming East. In other words, the "honeymoon" with the systemic changes is fading. In the second half of the 1990s however, there is still time for "corrections" and for the development of effective policies to support the transformation process in an integrative way, on basis of the mutuality of interests and gains.

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ON THE POLITICAL ECONOMICS OF PROTEST AND TOLERANCE

B. GRESKOVITS

In East-Central Europe there is no obvious reason why the economic transition should not continue in an increasingly stable democratic environment. This statement is related to the structures, regimes and political institutions of the countries concerned. These factors should help the citizens of this region to endure with tolerance the economic hardships that are concomitant to transformation. Even large sectors of the population which are unfavourably affected by transformation tend to channel their opposition to the reforms into non-violent "protest" (for instance, by voting down the government at election time and/or transferring a part of their working capacities to the black economy). The relatively long period of tolerance which has become evident should enable a process of consolidation to take place both in the economy and in politics.*

The present study addresses the following questions:

— Why are the economic reforms of the post-communist countries taking place in a political environment that is more peaceful than that found by researchers in Latin America, and how does this fact relate to researchers' negative expectations with respect to the future of East-Central Europe?

— What role can the *differences* between the respective political dynamics of the two regions play in social and economic structures, political systems, institutions and organizations?

— What are the *similarities* in the structures, institutions and situation of the two regions that may result, or have resulted, in *actual similarities* in the political and economic development of Latin America and East-Central Europe.

We shall confine ourselves to discussing the following questions:

Why has there been less political instability and violence in the first five years of transition in East-Central Europe than in several countries of Latin America during the radical economic austerity programmes, despite the economic crises and the tensions that accompanied the reforms, and contrary to expectations?

To be more precise, the subject of this study does not focus on the relatively peaceful nature of the transition in 1989–90—rather, it examines the issue of why it has been peaceful since then. What are the arguments suggesting that there are no reasons to expect violent political upheavals in the East-Central European region? What explains the fact that, only a few years after the collapse of communism, communist successor parties have been returned to government in democratic elections in several countries of the region?

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*This paper is based on the theses of a Ph. D. dissertation defended at the Hungarian Academy of Sciences on 12 April 1996.

The reader is probably familiar with opinions that interpret the course of events in this region on the basis of analyses of the situation and attitudes of elites. I do not challenge the importance of theories that focus on the role of elites, but my purpose here is to complement them with further observations which concentrate on the *societal aspects* of these processes.

What are "poor democracies" like? Or, in other words: how are the respective models of the new democracies influenced by the fact that in East-Central Europe—just as in most of the Latin American region—*the process of democratisation has been going on amid economic crisis, radical transformation of social stratification, declining living standards, and the shrinking role of the state?*

The question being put here does not ask whether democracy is in general compatible with transition to a market economy; instead the question has been formulated in the following way: what type of democracy can evolve in the East-Central European societies given the economic difficulties?

Why have *populist political forces so far failed to come into government in East-Central Europe* despite certain forecasts? More exactly, why *has a populist economic turnaround not taken place in any of these countries*, even though this method of direct political mobilisation has been repeatedly used in Latin America?

I consider these questions intriguing because, between 1990 and 1996—apart from the extremist parties—nearly all the parties (including some successor parties which at the outset were certainly handicapped) have had the opportunity, serving in government in turns, to demonstrate their governmental and economic ideas. A further question follows: to what degree is it justified to predict a left-wing turnabout in economic policy now that the communist successor parties have been returned to government at democratic elections? Why is the East-Central European scenario so different both from what many observes forecast and from that which followed in Latin America? I attempt to answer these questions below.

1. There are differences in the two regions with regard to the structural causes of the dangers which threaten the political and economic reforms; this is in terms of both their social and economic importance and other characteristics.

2. As a consequence, in East-Central Europe the condition have favoured such forms of opposition to transformation which—both in the economy and in politics—allow for a longer period of tolerance towards the unfolding and consolidation of reforms.

3. The structural conditions of "tolerance" are complemented and strengthened by the following components, (attached to the political sphere):

— there are differences in the political regimes of East-Central Europe and the "rebellious" countries of Latin America;

— there are differences in the two regions in terms of style of government and reform tactics;

— there are marked differences in the two regions in terms of internal conditions for political institutions and organizations; the latter is especially valid with respect to the character of relations between political parties, the professional organization of the business community, the trade unions and other organisations of civil society;

—finally, there are differences in the two regions in terms of economic situations, and also with regard to the regions' respective attitudes to the outside world.

In the rest of the study I put forward my answers to these questions and also some predictions for the future.

Social structure and politics

Research which has centred upon the peaceful transformation of Eastern Europe has given specific attention to the historical moment of seizing power peacefully in 1989–1990, and the related theories have dealt with the role of the elites. A comparison with Latin America has two advantages: it helps us understand why the transformation has continued peacefully in subsequent years, and the comparison enables us to augment the theory of transition with societal aspects.

The explanations given below are based on two premises:

According to the first premise, the presence of certain *structural characteristics* and institutional conditions promotes—and their absence hinders—the repeated and forceful effects of certain types of threats to reforms.

According to the other premise, the effect of such threats is also influenced by whether or not the various groups of the losers of the reform process have a chance to express their opinions and urge changes. There are structural, institutional and other preconditions for the freedom to choose which methods to use in order to express discontent. Below I will compare the two regions on the basis of these premises.

It is characteristic of East-Central Europe that, in contrast to Latin America, the *structural risk factors* of violent political actions are of a relatively lower importance. Some of the phenomena characteristic of Latin America are not found in East-Central Europe. These Latin American phenomena include extreme differences in income, poverty characteristic of the Third World, very fast urbanisation, large areas of destitute and volatile metropolitan slums, and the tradition of political violence based on recurrent coups and popular riots.

Hence, it follows that in East-Central Europe major groups of society have apparently *greater reserves for survival*. Therefore, there is less compulsion to resort to the most precipitate and radical forms of protest. These groups are apparently less prepared to indulge in such actions to halt the reforms or at least ward off their unfavourable consequences. In East-Central Europe the risk of riots and other violent opposition to reforms is rather low. From a structural point of view, this may explain why it has been less likely that—in contrast to events in Latin America during the 1980s—riots and demonstrations, including looting and casualties, will disrupt transition in East-Central Europe.

It is true that impoverished people, who can barely eke out a hopeless existence and lack sufficient reserves of "tolerance", are to be found in the post-communist region. However, their situation is different from their Latin American counterparts in that they are not numerous and are more isolated. Thus there is a much smaller likelihood that they might attempt to organise political action.

These groups lack sufficient reserves to be tolerant but they also lack the resources (numerical strength and organisation) for radical protest. Despite being without reserves, they are destined to be tolerant. As alternatives, they either make a living in the black economy or they have to wait until the next elections when they may vote against the reforms.

Poor people in East-Central Europe are occasionally *without the influential allies* needed to make their protest effective. Popular discontent over IMF policies in Latin America involved large-scale demonstrations. These were successful because, at a crucial moment, the relations of the organisers—who came *from civil society, the institutionalised political system and the trade unions*—were not marked by rivalry and exclusion but a desire to find allies and coordinate action.

With or without coordination protest action either does not take place at all, or is doomed to failure. It can be argued that the political dynamics of the economic reforms are more balanced in East-Central Europe than in Latin America because *the relationship of the potential organisers of protests are characterised* (owing to the transitional character of their position) *by the absence of solidarity and co-operation, the search for monopoly situations and defence of the status quo.*

This point about organisational and institutional features also has a strong influence on the forms and intensity of the ways in which the various *strata of workers* can assert their interests. Even though the organisation of workers in East-Central Europe is usually higher than in Latin America and the trade unions have a controlling position in strategic sectors of the economy, in East-Central Europe strikes do not have to be reckoned with as a serious potential threat to the political process.

One of the reasons for this is that, initially (with the exception of Poland), few of the East-Central European trade unions had the sufficient prestige to attract support for a strike, and they looked at one another as rivals. Later on, the road to radical forms of collective action was blocked by the fast deteriorating living conditions and the ever higher rate of unemployment. (Poland is not an exception in this respect.) Another reason may be that, when seeking to restore their tarnished prestige, trade unions have tended to prefer the strategy of co-operation with company managements, rather than starting risky open conflicts in the workplace.

This has an explanation which is partly structural: as a consequence of the dominant role of public property the members of the management in state-run companies are more prepared than private entrepreneurs to resolve workshop conflicts by exerting pressure on the state in co-operation with the trade unions.

Consequently, in East-Central Europe—partly for structural, institutional and organisational reasons—the workers, too, have to be more tolerant *vis à vis* the reforms, difficult as they are, than in the "rebellious countries" of Latin America. Even though workers' organisations hope that participation in lobbying will be successful, they still make money on the side in the black economy, or they wait for the opportunity to express their protest over the reforms at the next elections. All these factors help to make their attitude more conductive to balanced progress and the political dynamics of the reforms are rendered more peaceful than the respective cases in Latin America in the first half of the 1980s.

Another factor making the political dynamics of East-Central Europe more balanced is that, in this region, *the proportion of elderly people and rural residents in the respective populations is much higher* than in Latin America. These people have very *limited freedom of choice* as far as the forms of protest against reforms are concerned. As a rule, elderly people rarely ever take part in riots, organised uprisings, and mass demonstration; if for no other reason, this is due to their age and frail health. They cannot go on strike in order to express their discontent for they are usually out of work. In most cases, they are not wealthy enough to oppose the reforms by capital flight. Even if they attempt to lobby for better living conditions they have to depend on the help of other people, often those with little influence. Members of the *rural society* are often in a similar position: they rarely go on strike because they lack the organisations for such an action, and they are unable to bring about "effective" revolts because their settlements in the countryside are too scattered.

It is for these structural reasons that the above groups have no other alternative but to be tolerant. The only "weapon" left for them is the casting of a vote against the economic reforms which they hold responsible for their growing burdens.

It can be concluded from these considerations that in East-Central Europe it is elections which form the *principal political* method of protest against the reforms (reforms which are believed to bring about social hardships). Paralysing uprisings, demonstrations ending in violence, hunger strikes and industrial strikes have not played a part in the transition in East-Central Europe. Hence it follows that in East-Central Europe the structurally determined and typical dangers to apparently risk-laden reforms are much more "programmed" by the calendar of elections. This is not so in Latin America. The reason for this is not that citizens in East-Central Europe have more confidence in the new achievements of democracy than citizens in Latin America. Instead, in East-Central Europe the poor, the workers, the elderly and those living in the countryside (who, taken together, account for the greater part of the population) form the political basis for involuntary tolerance in relation to the economic reforms. On the other hand, and due to the same factors, it is mostly structural and partly institutional influences in East-Central Europe elections which are much more important as potential threats against reforms. This is not so for Latin America.

The political attitude of the populations of East-Central Europe tends to substantiate the criteria of economic reforms realised under democratic conditions, as defined by Przeworski: "... all groups must channel their demands through democratic institutions and abjure other tactics. Regardless of how pressing their needs may be, the politically relevant groups must be willing to subject their interests to the verdict of democratic institutions. They must be willing to accept defeat and to wait, confident, that these institutions will continue to offer opportunities the next time around. They must adopt the institutional calendar as the temporal horizon of their actions, thinking in terms of forthcoming elections, contract negotiations, or at least fiscal years." (*Przeworski* 1991, p. 180.)

The political management of economic reforms

It goes without saying that the social reception and political dynamics of the economic reforms are not affected solely by the dangers that are embedded in the economic and the social structure. Any conflict that arises in the wake of protests and opposition is a form of *interaction*. The dimension of a conflict, and its duration and direction depend not only on the people who start it and use it as a threat, but also on those people who are challenged. When in Latin America there was popular unrest in protest over the conduct of the IMF, the party challenged was, without doubt, the *state*. Given the facts that in East-Central Europe the post-communist state still wields tremendous weight and authority and paternalist attitudes have hardly been superseded, society has a good reason to think that the state has an enormous responsibility for all that happens to the economy or the living conditions.

Evidently, in interactions that characterise the political dynamics of reforms, the other pole, the state, must not be reckoned with as a merely passive actor. The state is not confined merely to responding to the threats that endanger its reforms. On the contrary, its characteristics, its attitude, shrewdness, action preferences, choices and tactics exert a massive influence on whether or not there are protest against the reforms.

Two types of the state's tactics and strategies related to reform seem to be relevant: the *bureaucratic organisational and oppressive measures*, which often precede or go together with the reforms; and the *compensation* granted for the genuine or assumed victims of the reforms.

As for the attitude of the state, it is an important precondition of tolerance that major social groups should have the will to wait *and it should be worthwhile for* *them to wait*. This criterion was brought nearer to realisation in the course of the transformation of East-Central Europe during the early 1990s rather than it was with the radical reforms of Latin America in the 1980s. While in the "rebellious" countries of Latin America the adjustment of the national economies was often started by regimes of an authoritarian nature, democracy is one of the main aims of the East-Central European countries. In Latin America, those protesting against reforms did not have the opportunity to express their discontent at the polls and thus were more prone to apply violent methods. In East-Central Europe going to the polls is already a universally accepted form of protest in the political system. Analysts have therefore to be familiar with this trait of the political regimes in this region if they wish to know the cause of East-Central European tolerance.

At the same time, reformist regimes in Latin America and elsewhere in the Third World, (including the democratic ones) have often resorted to pre-emptive bureaucratic organisational and repressive measures like the extension of presidential powers, rule by government orders, applying violence against the parliament, the establishment of special committees, cabinets and presidential advisory bodies to assist the work of influential economic policy decision-makers, reorganising the state bureaucracy, disbanding bureaucratic power centres which oppose government policy, secretiveness, shunning consultations within the bureaucracy and with representatives of capital and labour, capitalising on disunity between the professional organisations, and ignoring or repressing various forms of protest. Some of these measures have also been applied by governments in Eastern Europe while implementing reforms during the transition from communism to market economy. However, in East-Central Europe such measures have lessened the importance of *bureaucratic sabotage* as a potential weapon against reform.

The activities of the political management which have helped to implement economic reforms have not, of course, been confined—neither in East-Central Europe nor in Latin America—to repressive measures that have sought to neutralise collective action against reforms. *Compensation* has been one of the alternatives to the above measures. While in Latin America compensation, if it was used at all, was only given after public disturbances related to the IMF-inspired measures, in the early 1990s in Czechoslovakia, Bulgaria and Hungary compensation often accompanied or even preceded reforms as part of the stabilisation package.

Nevertheless, it is unlikely that preliminary agreements and compensation would certainly have prevented public disturbances over the IMF-inspired measures in Latin America. However, it seems probable that the agreement signed in East-Central Europe with regard to temporary moratoria on strikes and on granting modest compensation, were timed well so as to ensure that political tolerance related to the reforms in this region should rest on yet another pillar.

Returning for a moment to the structural conditions of "tolerance", the aforesaid train of thought enables us to argue against the view that democracy may be dangerous for the transformation process going on in East-Central Europe. It is regularly alleged that, owing to the newly won democracy, decision-makers are showered with numerous impossible demands by social groups. At an earlier period such groups were devoid of the right to voice their opinions. Others allege that democracy may help that sort of politician to achieve power who will then sacrifice (for his or her political aspirations) the countries' economic interests. Attention needs to be drawn to another aspect of democracy, which the above arguments overlook. In East-Central Europe democracy has made it possible to avoid a situation in which *economic and social demands might develop into devastating explosions and be channelled in a predictable manner*. These political conditions have not done harm to the economic reforms in East-Central Europe—instead, they have promoted the transformation of the respective economies. Thus they have a wholesome effect, in the same way as the structural and institutional conditions in this region have virtually compelled the populations to be tolerant towards the reforms.

If the prospects of the reforms really do face any danger in East-Central Europe, the source of the danger is not to be found in politics but rather in "*the economy*". The main threats to reforms may be those forms of opposition in which economic actors—who represent companies with intertwined ownership, and management and interests which often co-ordinate their actions—attempt to thwart the reforms. Furthermore, the typical threats to reforms in East-Central Europe—much more so than in Latin America—are programmed according to the rules of tolerance and have, in addition to political causes, structural and institutional causes which can influence *economic attitudes*. In East-Central Europe, the typical and dominant *economic* forms of opposition of the groups whose situation is unfavourably affected by the reforms do not tend to be direct and impulsive but rather ones whose effects are only felt in the medium term. Thus in East-Central Europe those opposing reforms prefer lobbying, raising loans without cover, abusing monopolistic dominance of power in order to transfer massive amounts of capital abroad. Even though the danger of a large number of people engaging in the black economy may assume "Latin American" dimensions, its harmful effects can only be felt in the medium term.

There can be tradeoffs between the various types of threats to reform. There have been several occasions in East-Central Europe when the possibility for precipitate forms of resistance, which posed a *direct challenge*, were transformed into threats of a *delayed effect*. In other words, the possibility of strikes, demonstrations or other forms of protest were converted to lobbying, engaging in the black economy, or voting for parties that oppose reforms. In East-Central Europe such tradeoffs also strengthen tolerance as a form of response to reforms.

Due to the fact that the sizeable and influential groups who are unfavourably affected by the reforms tend to express their opposition in delayed forms owing to structural and other factors in the economy and in politics, the consolidation of reforms can enjoy *longer grace periods*. Therefore, in East-Central Europe the reformist governments enjoy the *chance to make plans for longer terms*, even in cases when the measures involved are time-consuming and hazardous. As a consequence, the interplay of politics and economy policy in East-Central Europe offers more room for manoeuvre in the process of democratisation and allows the market reforms to progress along a stable path.

In East-Central Europe the casting of votes at elections is the most popular political type of threat to reforms involving austerity measures. However, voting has another consequence. Whenever a new occasion for voting arises (in a scheduled or unscheduled manner), the period of tolerance may be shortened, the span of time for forward economic planning may be reduced and there is an increased risk that the vote of protest will retard or bring to a halt certain reform measures, or indeed the whole process of reform. Whenever voters have the chance to express their protest at the polls, reforms may become key and sensitive campaign issues. In the cases of referenda, of presidential elections or of votes of no confidence that bring down governments (and held between scheduled general elections), the chronological rhythm of democracy may be speeded up; in fact, the entire democratic calendar may be restructured. This explains why we consider the structural approach to the complexities of political dynamics to be so limited, and why we regard it as necessary to extend our analysis to the country-by-country characteristics of political institutions, patterns, the relationship between government and parliament, and the internal set-up and tactics of the government.

Viewed from a structural point of view, it is a tenable proposition that in East-Central Europe the main political danger to reforms which involve social hardships are the protest votes. Provided this observation holds true, political parties, along with governments, are the principal actors in the political dynamics of reforms. Extraordinary political importance is gained by political parties due to the fact that they are—also for structural reasons—more effective vehicles for the expression of opposition to reforms than are other organisations. This conclusion poses interesting questions for further analyses. First of all, what have political parties themselves done to employ their dominance over other organisations of political importance, and how have they used their influence?

The case of Hungary shows that in this country they have done a lot to attain these goals. Since the beginning of the transition, at times of social or political conflicts, the political parties and other institutional representatives of democracy have usually closed their ranks. They have shown themselves to be committed defenders of the status quo whenever the various professional organisations or civilian organisations (which were excluded from having a control over economic policy) have attempted to reorganise the political and institutional system.

Even if the conduct of the political parties has often been defensive and excluding, it has to be admitted that it has promoted the consolidation of democracy because it has encouraged the process of learning the rules of democracy. With that conduct the political parties have contributed to the process in which the transitional society has been able to get over the chaotic, "fluid" state of imbalance (in fact, faster than some observes would have predicted).

Characteristics of the East-Central European democracies

It is probably easy to accept the arguments related to the consolidation of the political system. However, there is a more difficult question: What kind of a regime, *what kind of democracy* is striking roots in Hungary?

It is, first of all, a democracy which has *occasionally been built with other than democratic methods*: exclusive and secretive negotiations between members of the elite, as well as covert pacts and agreements.

It is a *poor* democracy which somewhat contrasts with the expectations attached to the change of regime. For economic reasons it is unable to satisfy the demands of the social groups which have long been neglected, however justified the demands of the latter are.

Consequently—as far as the control of economic policy and related political aspects are concerned—this democracy has *marked exclusive characteristics*. Using the terms of *Acuna and Smith* (1994), we could describe it as a *dual democracy*. The balance of a dual democracy is based on the alliance concluded by the state elites and a strategically important minority of the opposition, the compensation with political and material means of the minority, and on pushing the rest of the population to the periphery.

At this point, the theory which is based on the *analysis of the elites* should be complemented with *societal aspects*. When the regime set out on a course of dual democracy, the state elites started *to share* the selective decisions and the exclusive measures concerning the persons and proportion of those to be excluded, and the measure and method of their exclusion. The sharing was done with those forces whom they chose to be involved in the exercise of power.

In this connection, it is justified to look at the issues which always arise whenever the various types of democracy are analysed. Were not those who drew the demarcation line between those to be involved in the exercise of power and those to be excluded from it too rash and too ungenerous? It can be said that the status quo that has been maintained has not excluded from the exercise of power unjustifiably large groups of people. Is the regime suitable for allowing the "liberal component of democracy"—i.e. those connected to basic freedoms—to unfold?

To complement what has been said so far, let us make it clear once again that in the evolving new regime, the *elections*, which is the dominant—and for the majority, only available—mode of expressing opinions and influence, have been *institutionalised* with striking *speed* due to the structural, institutional and organisational apparatus which has been set in motion.

In East-Central Europe even the political dynamics of the rejected economic reforms is affected primarily by the rhythmic and predictable alternation of tolerance. The occasions of democratic protests make it easier to explain how *communist successor parties have been able to come to power in several countries of the region only a few years after the collapse of communism.*

The explanation which confines its attention to the *political* elite lays emphasis on particular historical aspects of the transformation and the ways in which the elite of the former regime was affected by the changes. It is valid to argue that in East-Central Europe the transformation has been of a negotiated rather than of a revolutionary character. As a consequence, former elites have not been eliminated. Hence it follows that the intact elite of the former regime remained re-electable for the subsequent cycle of elections. Moreover, the nostalgia for full employment, stable prices and social security for all also helped the post-communist elite in several countries of the region to score a decisive victory at the elections. Based on what has been said so far in this study, these arguments can be complemented by explanations emphasising the *societal aspects. In East-Central Europe, the absence of radical, direct and emotional protest actions* on the one hand, and *the dramatic shift of democratic political confidence and support between the opposing political poles* on the other, *form the two sides of the same coin*. The more valid the statement which says that the societies of East-Central Europe are "destined to tolerance" in periods between the elections for structural and institutional reasons, the greater is the amount of pent-up animosity which originates from grievances caused by the reform, and this may be unleashed on election day. The more economic hardships the people have to endure with tolerance, the stronger the citizens' desire to punish in a democratic manner at the polls by dismissing those they hold responsible for their losses. It is largely due to the factors which bring about social tolerance, explored above, that the political parties have proved to be more efficient than the trade unions and the other organisations and movements of civil society in translating economic grievances into the language of political protest.

As a result there is a strong demand for political parties who are the most suitable for mobilising people to protest against reforms. That demand is so strong that already, during the first five years of East-Central Europe's history after the collapse of communism, in most countries of the region the attraction of such parties repeatedly been exempt from prejudices arising from voters' ideological likes and dislikes. The demand for parties which seek to enlist votes of protest has been so keen that nearly every actor of the emerging party spectrum—initially even the post-communist parties, which started with a serious handicap—has had the chance to try and tackle, in a position in government, the extreme difficulties of transformation into a democratic market economy.

One of the possible offshoots of this is that the governments dominated by post-communist parties in Lithuania, Poland, Hungary or elsewhere may receive the same devastating democratic punishment if they fail to handle successfully the problems of economic transformation which confronted their predecessors.

Finally, if it is assumed that the political parties in East-Central Europe are indeed the most important vehicles of the process which transforms discontent over the reforms into protest and results in democratic support for those demanding changes, the essential question arises: to what extent are the reforms themselves influenced by the ideologically-tainted economic ideas of the various parties?

The economic policy pursued in East-Central Europe hardly reflects the ideological preferences of those who have provided its outlines and who are implementing it. In this sense, it seems to be rather colourless. For the time being it seems that whoever comes to power in the region is, on the whole, bound to continue the same economic policy—as approved by the international financial organisations and supported by the European Union—which has compelled those aggrieved by the reforms to dismiss at the elections the incumbent governing parties.

The reason for this is that *the unfavourable macro-economic conditions and the strict international rules of the game have reduced to a minimum the room for political manoeuvre and thus the direction of economic policy* is not the subject of choice. The influence of politics has not been entirely neutralised by the economic crisis and international obligations. Nevertheless, as far as economic issues are concerned, the influence of politics is *confined to a relatively narrow area*—namely, within an economic policy approved by consensus. The austerity of the situation hampers the realisation of even those principles of economic ideology with which the actors in the political arena traditionally associated themselves during their public performances before the voters. In fact, even the economic programmes of the strongest political parties—as set out in their election manifestoes—are rather similar. Yet even if they are not, the necessities of economic policy at governmental level block the way for anyone to act as a "maverick".

In view of these circumstances, in East-Central Europe—contrary to the expectations of certain observers—*populist economic episodes* of the Latin American type are unlikely to occur. Moreover, the dominance of economic austerity over politics is reflected both by the absence of populist episodes and the fact that economic policy is only to a small extent manipulated for election purposes.

The macro-economic indicators of transformation in East-Central Europe show no sign of either "opportunistic" or "party political" cycles. It has not been the case in any of the countries of the region that, after the elections, inflation and economic growth have shown a tendency to decline and unemployment grow while, as new elections approach, employment and the growth rate increase. Instead, each of these macro-economic indicators move up or down on their own, independently of the governmental terms: recession has been the order of the day for four to five years; it has gone rather deep during the past four years, and there have been no signs of any decrease of unemployment. Even though galloping inflation has been curbed in several countries (although not everywhere), it is still rather high. The coming and going of various parties leaves little imprint on the economic indicators. Instead, parties of the most various political and ideological character, which keep changing places in government, have carried out with more or less success the same economic policy measures of stabilisation and adjustment.

It can be concluded that the mere fact that post-communist parties have in some countries come to power does not justify the fear of the imminent dominance of economic populism and of the occurrence of irrational economic adventures. On the contrary, for the politicians of East-Central Europe, including those of left-wing and the populist views, will probably have to wait until the next phase of economic recovery before they become able to reorient economic policy in accordance with their ideological and political preferences.

The other conclusion is that in East-Central Europe the most typical weapon employed against the reforms—i.e. the democratic vote of protest—does not seem to be efficient. Time and again, the voters vote down the parties associated with economic policies that severely afflict their interests, only to witness the return of the same economic policies under the banner of other parties.

The central thesis of this short study is that *the citizens of East-Central Europe are destined to profess tolerance in the phase of the hardships of transformation for structural, regime-related and institutional reasons. The involuntary tolerance of the societies of this region are—as Hirschman would put it—a "credit with limited maturity", but because the period of tolerance is longer, it will probably be easier to remedy the situation than in Latin America. It is impossible to tell whether or not the protracted period of tolerance will, ultimately, be long enough. However, the fact that it has not come to an end yet strengthens the arguments of those who say that East-Central Europe will not be "Latin Americanised". In other words, the chances are greater than might be expected for economic transformation to take place in East-Central Europe in parallel with a process of increasingly consolidated democratisation.*

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ECONOMICS IN THE TRANSFORMATION OF ECONOMIC SYSTEMS IN EASTERN EUROPE

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Even several years after the beginning of transition from the collapsed communist systems to parliamentary democracy and market economy it cannot be convincingly stated that economists have been able to contribute to the fundamental systemic change. In spite of the doubtless successes of economics in the *ex post facto* analysis of economic processes of various social systems, economists' intellectual efforts have only been satisfactory to a limited extent.

Since economics failed to deliver scientific foundations of a sound economic policy, trial and error and intuition have apparently been more useful in shaping economic policy than the contradictory views of respected economists.

Economics cannot disregard the necessity of developing consistent and universally valid explanations that do not contradict each other and discovering the reasons of conflicts between existing theories. Taking this approach would also make it easier to determine those conditions under which it is appropriate to apply various theoretical explanations.

The collapse of the communist systems in Eastern Europe in 1989–90 was also accompanied by the breakdown of the economic systems existing in the respective countries of the region. After the collapse, two of the main economic aims in all the countries concerned were that social ownership of the means of production should largely be replaced by private ownership, and in the place of directive planning the market mechanism should be allowed to dominate. Structural disproportions which had their origins in political dogma were to be abolished and foreign trade was to be opened up so that a place could be found in the competitive structures of the world economy.

The aims of economic transition, briefly outlined above, were virtually the same in all post-communist countries and their basic ideas were not difficult to interpret.[1] What was less clear and what varied from country to country was the idea of how to realize those aims. For economics, law, politics, sociology, and even philosophy, the transformation presented itself as a historically unique scientific task: in seven (in 1991) countries[2] (amongst them the huge Soviet Union), with a total of about 500 million inhabitants and demonstrating a range of economic

[1] This may at least be said about the beginning of the transformation process. Due to the hardship connected with the economic transition, and with the partial revival of communist ideas, nowadays one can hear some doubts about the necessity of such a complete change in the economic system.

[2] 25 countries have emerged since the collapse of the Soviet Union and Yugoslavia and the partition of Czechoslovakia.

standards from medium to high, social orders which had lasted for between 40 to 70 years were to be changed fundamentally.

The transformation process relates to all spheres of life. It calls for solutions from all fields of the social sciences. However, this little essay deals only with some reflections on the changes being attempted in the economic systems. There is no doubt that in the East and the West this topic has inspired many economists to offer some advice or at least make some comment. Nevertheless, five or six years after the beginning of the transformation process, today it cannot be convincingly stated that economists have been able to show politicians the best way to accomplish this fundamental system change, nor has economic science developed a general theory for the system transformation. In all East European countries the systemic change is being carried out using trial and error procedures. So far, economists have offered several variants, starting out from the "shock therapy" through to a slower, gradual process. (*Lavigne* 1995; *Spanger* 1994) Here, the intention is not to try and analyse all the different experiments, but rather to discuss generally whether or not contemporary economic science is capable of really contributing to the implementation of the aspired systemic changes.

As the economic transition in Eastern Europe has set as its general aim development into a market economy, perhaps it needs to be asked if western economics can possibly explain the market system.

Economic science as an independent branch of the social sciences is relatively young—it goes back just over 200 years. During these two centuries a number of economic theories have been developed in order to explain the forms taken by society's efforts to satisfy needs adequately and to distribute the results of economic activity. However, these intellectual efforts have only been satisfactory to a limited extent: economic science has been of great significance insofar as it has drawn attention to social weaknesses in a capitalistic system based on an industrial economy. It has thus provided impulses for changing the interpersonal distribution of goods and services and has helped to improve the economic situation of large segments of the population, especially of wage earners. Economics has initiated a continuous evolutionary process of change in the capitalistic countries of the West, and the state has also contributed increasingly to implementing such change by means of its social policy, as well as by means of direct intervention with regard to the distribution policy. At the same time, the state has created a framework for the redistribution struggles which regularly arise between enterprises and employees (organized in trade unions). Such struggles have also had a significant influence on social change under capitalism up to the present time.

It should be noted that economic science has not only provided impulses for the process of social change under capitalism described above, but has also always tried to explain the functioning of the system as a whole. In fact, it could be argued that its influence on improving the system, increasing its overall efficiency, eliminating malfunctions, and preventing waste, has been much less significant than its influence on social change. It is true that numerous theories have been developed to explain specific phenomena, but for the most part these theories have provided widely differing and sometimes totally contradictory explanations and have usually represented *ex post facto* attempts to explain a concrete situation. Repeated attempts have been made to formulate a "general theory"—a claim occasionally made in well-known book titles—but such attempts have by no means been widely accepted. Instead, they have tended to reflect differences of opinion among various schools of thinking, and they have not been genuinely capable of formulating or explaining longer-term economic changes in the system as a whole.

Up until now, economic science has been unable to offer a generally accepted explanation of how individual economic systems function or how they function in comparison with each other. Yet such an explanation would be the basis for a scientific approach to the problems of the transformation process in Eastern Europe. Nevertheless, during the course of its development Western economic science has provided arguments for changing the overall system. In this connection, the fact that it has pointed out obvious defects or problems in the functioning of economic systems or could explain them in part, was important. In addition to the social problems already discussed, the following problems have been addressed in particular: the intensity of economic activity in the business cycle; the limits of the price mechanism as a coordination instrument, including the creation of monopolies and insufficient allocation of funds for the needs of society as a whole ("public goods"); full employment, monetary value and foreign trade equilibrium as problems of economic stability, closely associated with business cycles in particular; and problems associated with achieving economic growth in order to improve satisfaction of needs.

These multifarious attempts at explanation undertaken by economic science have tended to arrive at the overall conclusion that a functioning economic system should not only be influenced by free enterprise based on private ownership of the means of production and market coordination of individual economic processes (the "laisser-faire" principle or the "free play of market forces"); they have also pointed out that the state should be involved in establishing the legal framework for this system, and should provide means for corrective intervention through its economic policy (particularly with regard to social problems). It is well known that views vary greatly about the extent to which the state needs to intervene or whether such intervention is even compatible with a market economy. Such views are based more on ideological conviction than on scientific proof. They range from arguments for a minimum of economic policy-making, (which still includes considerable government intervention in a modern Western economy, as could be seen in the cases of Thatcherism and Reaganomics), to those stressing the limiting of private ownership of the means of production by nationalizing sectors of the economy or enterprises, and by employing nondirective government planning ("indicative planning", "planification") in addition to market relations. Views about the application of direct and indirect economic policy instruments within the framework of a basically capitalistic economic system are equally diverse.

Today, it can be seen that all developed industrial countries have mixed economic systems in which private ownership of the means of production is subject to various degrees of limitation. Although the market mechanism continues to be the most important instrument of coordination it is supplemented (or even replaced) in many areas by specific economic policy measures (when these measures are coordinated, this can be described as central planning—it is only a question of terminological convention). The European Union's Common Agricultural Policy (CAP) probably serves as the clearest example, but in West European countries coal and steel, energy supply, transport and communications, community services, the monetary and credit system are all subject to the particular influence of the state, i.e. its economic policy. Even so, it is striking to see how effective market coordination continues to be.

It is true that economic science, by studying the problems associated with the functioning of a capitalist economy, has helped to identify the areas where government needs to formulate an active economic policy. However, it is fair to say it would have been possible to identify these areas by using common sense even if no scientific findings were available. The investigations carried out by economists have certainly made many complicated relationships more understandable and, at least in some areas, the scientific foundations of economic policy have been expanded enormously (compared to sixty or seventy years ago). Despite this, I think it is obvious that, with regard to very important questions, economic theory has not been capable of developing a reliable foundation upon which economic policymakers can base their decisions. This is not meant as a reproach, but simply as a statement that there is something lacking. After all, a national economy is enormously complex and, in view of the limitations to which human thinking is subject, economic science can explain only a few aspects of past and present situations. In this connection, the real reason economics is often so isolated from reality lies in the inevitability of the *ceteris paribus* condition, which sounds highly scientific to the layman.

The social significance of economics is clearly limited by the restrictions on the applicability of its theories, and by the lack of any connection between the theories and reality. The knowledge available today shows no signs that this situation has changed or will change. Current economic science can offer only a limited basis for making decisions about important economic problems like the transformation of economic systems. The weakness of economics is also obvious, for instance, with regard to the search for policies for reducing or eliminating unemployment in most Western industrial countries. Furthermore, economics has produced no concrete solutions for cyclical fluctuations, inflation, long-term deficits or surpluses in national budgets and foreign trade—all of these being areas where trial and error or intuition have apparently been more useful for economic policy than the contradictory views of respected economists. From an international point of view, the problems mentioned above are in reality of a quite local nature; however, when considering the continued existence or satisfactory development of the developing countries, overcoming their population or nutritional problems or even solving the problems posed by their foreign debts we are looking at issues which represent much greater challenges to economic scientists. The social changes that have necessarily unfolded as capitalist economies have undergone continuous development have created global problems.

In dealing with the latter worldwide economic doctrine varies considerably due the respective ideas of the neoclassic, neoliberal, and (neo-)historic schools of economic thinking. Over the past few years the "New Economics" has tried to take into consideration ecologic points of view and has focused on the need for changes in human behaviour. In several ways these theories may be partially relevant for the systemic change in East Europe. Yet we should not forget that in the former socialist countries a different economic way of thinking dominated, mainly based on Karl Marx's economic ideas (even though he himself started out from the works of the classic school). There can be no doubt that, from a historical point of view, Marx is a particularly important 19th-century scholar, but his significance is due less to the economic theory he developed than to the emphasis he, more than most "bourgeois" economists (and actually there were no others at the time), placed on the social problems of capitalism in his time.

Given this assertion, it seems to be worth considering if Marxian economics, which economists in the post-socialist countries are more familiar with than they are with the western schools, can provide insights for the economic policy-makers who are trying to solve the problems of the systemic transformation. In the past, the applicability of Marxian economics for economic policy was greatly limited by the extremely one-sided orientation of economic science in connection with Marxist teaching in the Soviet Union, and also in the smaller socialist countries of Eastern and Central Europe following World War II.

In contrast, the pluralistic approach of Western economics does include at least the potential for falsification of a theoretical assertion. That approach to Marxist economic theory which defiantly gives all Marxist thought (as it was interpreted in the Soviet Union) a monopoly on the truth and which dominated economic science by reducing it to Political Economy—at least in the publications of the Stalin era—seems to have nothing which could provide a theoretical basis for the new economic system.

During the Stalin era the Soviet economic system was set up and developed on the basis of trial and error. The economic policy measures of this period can best be characterized as a policy of intervention on a case-by-case basis. Like modern capitalism, the economic system which emerged by adopting using this highly pragmatic approach was a mixed system, although the emphasis was reversed. In other words, the means of production were owned primarily by the state, while the extent of private ownership was much more limited, and in fact it varied among the individual socialist countries. Centralized government planning with a hierarchically organized economic administration formed the predominant control system, but at the same time market mechanisms were retained in areas in which there were large numbers of economic units (e.g. distribution of consumer goods to households, allocation of labour). (*Brus* 1961)

After Stalin's death the restrictions imposed on Soviet economists were certainly eased, but it is only recently that they have been able to move freely away from the scholastic argumentation which they had been accustomed to for so many years. However, it should be mentioned that as early as 1955 there were serious discussions in the socialist camp about some of the more important problems posed by the Soviet-type economic system. These discussions centred on issues such as the law of value, price formation, the efficiency of investment, and foreign trade. From about 1962 (E. *Libermann*), more began to be written about the general functional weaknesses of the overall system and the ways to overcome them. Discussion of this last issue had been preceded by discussions in Poland in 1956 (O. *Lange*, and slightly later W. *Brus* in particular) and in the former GDR in 1957 (F. *Behrens*, A. *Benary*). Once the debate came out into the open the problems presented by the functioning of the Soviet economic system—usually reduced to the system of central planning—as well as proposals for reforming this system began to dominate much of the economic discussion and the economic policy activity of the socialist countries. This discussion was particularly intensive during the 1960s (e.g. discussion of the New Economic System of Socialism in the GDR in 1962, in the Soviet Union in 1965, in Czechoslovakia in 1964–1969, and in Hungary starting between 1966 and 1968), and it intensified again during the last decade of the Soviet system (in Hungary, Poland, and the Soviet Union starting in 1979 and especially after 1986).

On the whole, these discussions about economic reforms were more closely linked with economic policy than is the case with Western economic science. However, there is unfortunately no indication that the discussions resulted in special advantages with respect to systemic efficiency. In this respect a reality-oriented theory for the socialist economic system was lacking, and so there was no foundation for the theoretical preparation of economic reform. The number of reform proposals (which continued to employ Marxist terminology as a matter of form) increased in an inverse proportion to their respective values as decision-making aids for economic policy. Furthermore, many reform proposals prepared by economists were subject to political and ideologic limitations, or at least they met with resistance from conservative circles.

Before 1990, discussions about economic reform and attempts to incorporate reforms into economic policy tended to favour greater decentralization of decision-making and also more scope for coordination through market forces. On the whole reform programmes tended to put more emphasis on private enterprises in agriculture, in the small trades, and in the service sector. Such trends were by no means consistent, but it is a fact that the societal significance of economic science in the socialist countries increased continuously, even if unevenly, after 1956. Discussions about economic reform gradually came to include a much wider range of ideas and these ideas also became more open. Yet having said all this, the contribution made by economic science in socialist countries continued to be just as unsatisfactory as in the West.

It seems that these observations lead to a rather pessimistic conclusion: Western economics offer a wide variety of sometimes highly intellectual explanations that, however, are quite isolated from reality. Furthermore, except for establishing very elementary relationships, such explanations were not able to develop a generally accepted theory which could be applied to a variety of systems. In the past economic science in the socialist countries of Eastern Europe claimed that Marxism-Leninism itself represented an all-embracing general theory. However, this dogmatism was really limiting in its effect and it became even more so as the socialist economic system continued to develop. Thus the apparent possibilities for making a reality-oriented contribution to the theoretical basis of the system being established or developed were in fact little more than wishful thinking. In neither the capitalist system nor the socialist system has an adequate theoretical foundation for economic policy been formulated which can be of lasting help in the transformation process in Eastern Europe.

Experience so far indicates that there is not much reason for being optimistic about possibilities for creating a theory applicable to the change of economic systems in Eastern Europe. In the first place, it seems reasonable to question whether research on such a complex subject can even lead to detailed findings that are generally applicable—i.e. findings that can be used as a basis for economic decision-making in a variety of situations. In my opinion, economic theory (at least in the foreseeable future) will only be able to provide highly abstract and generally theoretical analyses and thus will serve as basic research—which is by no means a disgrace. As a basis for economic policy, economic theories will always have to be applied to a concrete situation or tested in order to see if they are valid under the respective circumstances. Regardless of whether or not economic theories are of practical use, it is necessary to develop consistent and universally valid explanations that do not contradict each other, and also to discover the reasons for conflicts between existing theories (e.g. logical errors or, probably more common, differences in the assumptions made). Taking this approach would also make it easier to determine those conditions under which it is appropriate to apply the various theoretical explanations.

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PENSION REFORM: CALCULATIONS AND CONCLUSIONS

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This article is a contribution to the ongoing debate about the reform of the pension system. Its peculiarity lies in the fact that it does not rely merely on verbal reasoning, but also on calculations carried out using new methods. It analyses the characteristics of the current pension system and its likely course in the future. In then examines the goals that apparently need to be set and the possible options of the reform in the light of, and in comparison with the above. The conclusions are based on demographic, economic, social and individual factors.*

Motives, goals, methods

The resolution passed in 1991 by the Parliament outlines the following three-pillar perspective for the transformation of the pension system:

1. basic flat-rate state pension,
2. work pension based on employment and obligatory contribution payment,
3. voluntary supplementary insurance.

A few voluntary mutual insurance funds have been created in the meantime covering the scope offered by the third pillar. However, nothing has happened to advance the fortunes of the first and second social insurance pillars. Nevertheless, given the effect of distressing financial deficits, the reform of the pension system has come to the fore and it has been publicly declared that it is an extremely important and urgent factor of the reform of public finances. However, without a sound technical preparation the reform cannot be carried out, and yet this preparation requires several years of work.

Naturally, our raw calculations cannot be presented as a complete solution to the problems. However, our methodological results may be utilised in laying the real technical foundations for the reform, while the results of our calculations have led to certain qualitative conclusions which might be recommended for consideration in the—often heated—conceptual debates.

Our calculations relate only to the first two pillars cited above. Only mandatory forms are taken into account when indicating the number of pillars. Voluntary private insurance is of course a possibility open for everyone, but it is not considered to be one of the pillars of the *social insurance pension system*.

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A pension system must fulfil two functions and its social acceptance (i.e. being judged to be fair) is generally based on meeting the—partly contradictory—requirements of both.

One of the functions of the pension system is to *share* among individual citizens the *risk* underlying an early death or long life, as this risk essentially influences the result and possible utilisation of the savings underpinning an old age income. As a risk-sharing community, the pension system must be based on *insurance principles*. Generally, such a system is regarded as fair if it strictly links the pension benefits to the contributions paid during the earning age, and if everyone is provided with benefits until the end of their life (depending on their respective contributions paid-in during their earning age). This kind of fairness is also *economic rationality*, as this is what promotes savings for pensions and protects society against individual short-sightedness. The application of this criterion of fairness is made possible by an old mathematical discipline—actuarial mathematics—and traditionally processed statistics in the form of mortality tables.

The other function of the pension system is to provide the means for old age living to a level and proportion that are deemed socially acceptable. It must, therefore, meet the requirement of *social solidarity*, and this can be achieved by means of *redistribution* only. However, there is no technically adopted set of tools for measuring social acceptability, (and this is also why this term has become the subject of futile debates which provide no definite answers). In our study we attempt to measure the social acceptability of the pension system. We can start by stating that one of the important tasks (perhaps the most important task) of the social insurance pension system is to continue the flow of work income achieved by the insurees during their earning age. This is valid despite the fact that the proportion of the closing wage and the starting pension—i.e. the *replacement rate*—will be different for everyone because the size of the pension will also be influenced by other factors. Our second assumption is that we consider the wage differentials which actually exist to be such that their extent is accepted by the society. Consequently, the inequality" of closing wages can and should be transferred to the initial pension income. Thus we can measure the social acceptability of the pension system by examining the difference between the inequalities of work incomes and pension incomes. In general, the greater the difference between the two inequalities, the less socially acceptable the pension system. In an ideal situation the two inequalities are the same, or at worst the pension income only falls slightly behind that of wages. In adopting this concept we have already stepped on a sounder basis: much has already been written about methods for measuring inequalities of incomes. (A good summary is provided by *Kakwani* (1980).) Often the necessary income statistics are also available.

Insurance and solidarity principles cannot be clearly separated (although it is frequently assumed that they can). However, the current Hungarian pension system still labours under the influence of the events of the past several decades and, without going into detail, it can be said that the insurance and the redistribution functions have been hopelessly and confusingly mixed. Neither of these functions operates on an acceptable level, and the system is neither rational nor fair. This is why the initiative to contemplate a separation of the two functions is not illogical and it is also apparent in the conception of the two-pillar reform. This would assign the solidarity, redistribution task to the basic pension, and the insurance function to the work pension. However, we are not convinced that this really requires two pension systems operating in parallel. The methods we have elaborated and the results of our calculations suggest that the relation between the two functions can be clarified within one single social insurance system.

It is even more debatable as to whether it is wise, in the case of a two-pillar solution, to transform the work pension system into mandatory private insurance and to assign its management to non-profit funds or commercial insurers. The reasons quoted in support of this option do not start from the tasks related to the pension system—rather, the aim is to uplift the economy with the help of the pension system. The idea is that this kind of reform increases the willingness to make savings, it also raises the aggregate savings rate, and these savings appear on the capital markets in order to finance the investments being made in the economy and to induce economic growth.[1]

In our research we tried to make our calculation methods suitable for all options: i.e. it should be able to quantify both single pillar and two-pillar reforms, within the latter embracing pay-as-you-go and funded work pension systems.

It is our conviction that well-founded conceptual conclusions can be arrived at on the basis of such a parallel—i.e. in the framework of comparative studies. Our assumption was that, regardless of the option chosen, the reform should meet the following fundamental requirements:

1. it should create direct links that are clear and can be calculated by everyone, between the contributions paid during a career, and the benefit that can be collected as a pensioner;

2. thus, with the personal financial interest, it should promote the payment of contributions on the one hand, and a delay of retirement on the other;

3. for individuals, it should provide ample room for free decisions determined by differences between personal careers;

4. the new pension system should be stable, it should adapt well to economic cycles and expected demographic fluctuation, and it should be able to finance itself through the correctly determined contribution rates.

If the work pension remains within the scope of social insurance, then both the single and the two-pillar solution can be made to comply with the requirement that

[1] This is the assumption which underpinned the much advertised pension reform in Chile (*Cortazár* 1995), the introduction of 401/K pension saving accounts pampered for such a long time by economists in the United States (*Papke et al.* 1994), and the ordering of mandatory private savings (superannuity) in Australia (*Rosenman* 1993).

the "old"pensions (i.e. those determined before the new rules came into force) could be integrated into the new system, possibly without changing the respective levels. If the work pension takes the form of funded private insurance, then naturally the above goal is invalid because it would inevitably split the contribution paying and the pensioner communities into "old" and "new ones", and this situation would remain for many decades to come.

It is obvious that all the versions we have considered are based on available data. Our calculations were made at the end of 1994 and the beginning of 1995; the data for 1994, and in certain aspects for 1993, were not known at that time. However, we think that from the point of view of the long term future, one or two years' changes are not critically significant. It is much more important that, given the lack of elaborated and quantified reform proposals, we had to determine the major parameters of certain reform versions ourselves, applying more or less arbitrary assumptions. In this we do not expect anyone to consider any of our versions as his own in the usual "number war" which customarily precedes the elaboration of reform proposals. However, certain trends appear so powerfully that they will probably prevail under other parameter values and assumptions with regard to details.

Our considerations and calculations are restricted to the *old age* pension system. The high and increasing number of disability pensioners is a serious problem, but it requires a different solution. In our view, the future of the old-age pension system can be realistically assessed only if it is treated as a clearly separate entity.

In the second part of the article we present macrosimulation calculations which run until the end of the next century. At first they assume an unchanged pension system, and then they are linked to different reform versions. The simulation examines the relation between the aggregate pension expenditure and the aggregate contribution base. Its goal is to explore the trends which determine the *macro-level financial (dis)equilibrium* of the pension system; we neglect all details which cannot be decisive from this aspect. The very long time horizon may seem unusual although it has the same important role as that of the headlight mounted at the front of a car: namely, we have to be able to see far ahead in order to steer well over the next few metres. Referring to the pension system, the next few metres mean decades.

In the third part we deal with the *determination of individual pensions*, connecting the benefit with the contribution at the level of the individual—i.e. issues related to the so-called "pension formula". We examine the difference between the inequalities of work incomes and those of pension. We provide methods for elaborating and sustaining a differential that is socially acceptable, for connecting and separating the insurance and the redistribution functions in a clear and fair way, and for integrating old pensions into new system.

In the fourth part of the article we formulate conclusions that can be drawn separately and jointly from the two types of theoretical experiments.

Macrosimulation for the next century

First we present the simple model which served as a basis for the calculations. (Readers who do not like formulas may skip the whole of this part, except the last paragraph where we define the terms *effective* and *actuarially correct contribution rates*.) It is primarily with the help of these two terms that we present the results of the calculations with demonstrative charts instead of tables of long time series. (As far as the relative interest factor defined in the formal description of the model is concerned, in this article we discuss versions where $u = 1$—i.e. according to the *golden rule* of economic growth, *the interest rate is equal to the nominal growth rate of average gross wage* selected as *numéraire*.) Then we examine the effect of demographic and economic factors, while in fact leaving the basic features of the current pension system unchanged. This will be followed by the single pillar and the two-pillar systems with one version for each.

A simple model

The task of the model is to provide aggregate indicators which characterise the cross-sectional and longitudinal (dis)equilibrium of old-age pension insurance with the possible simplest means. The characteristics of average pension insurance for *one cohort in one calendar year* are the *elementary data*, and we do not go into the deeper details. We do not characterise the cohort by gender, nor by social groups; we also neglect differences in the state at the beginning, middle and end of the year.

Demographic bases. In contrast to usual demographic practice, by x we indicate the year of birth and not the age. Let b_x be the number of births in year x, $m_{x,j}$ be the mortality rate in year j of the cohort born in year x, and T the highest possible age. Then the number in year t of those born in year x is:

$$l_{x,t} = b_x \prod_{j=x}^{t} (1 - m_{x,j}) \qquad x = t - T, \ldots, t. \tag{1}$$

Furthermore, let K be the first age year of the earning age and N be the lowest age limit of retirement. The L_t^A is the population of *active age* in year t and L_x^A is the *total number of years of active age* of the cohort born in year x:

$$L_t^A = \sum_{x=t-N+1}^{t-K} l_{x,t} \qquad L_x^A = \sum_{t=x+K}^{x+N-1} l_{x,t}, \tag{2}$$

and similarly, L_t^P is the population of retired age and L_x^P is the *total number of years of retirement* of the cohort born in year x:

$$L_t^P = \sum_{x=t-T}^{t-N} l_{x,t} \qquad L_x^P = \sum_{t=x+N}^{x+T} l_{x,t}. \tag{3}$$

From the above, f_t *is the cross-sectional demographic dependency rate* in year t, while f_x is the *longitudinal demographic dependency rate* in year x.

$$f_t = L_t^P / L_t^A \qquad f_x = L_x^P / L_x^A. \tag{4}$$

The economic environment. Preparing an economic prognosis or even a scenario for decades would be a hopeless and unreasonable venture. Therefore, we select the actual *average nominal gross wage* of active earners for *numéraire*, i.e. the unit of calculation, and we denote it with ψ_t for the t-th calendar year. If we express a flow of income in this unit, then we will refer to this with the attribute *relative*. We do not need any assumption about the future development of the numéraire, as we do not wish to quantify forint amounts of indefinable purchasing power, but *proportions only*.

For determining the longitudinal categories we will also need the procedure called *relative discounting*. Therefore we introduce the following definitions:

$$\begin{aligned} \lambda_t &= \psi_t / \psi_{t-1} - 1 && \text{the growth rate,} \\ \rho_t & && \text{the interest rate,} \\ u_t &= (1+\rho_t)/(1+\lambda_t) && \text{the relative interest factor} \end{aligned}$$

In the description of the model we might keep the relative interest factor varying over time. However, in the quantification we would once again be forced to make unreasonable long term prognoses. Therefore, in harmony with the general practice in the literature, we introduce a single *stationary assumption* of the model:

$$u_t = u \qquad \text{for all } t. \tag{5}$$

Let us look at the present value in t of a flow $\hat{y}_{t-n} = \psi_{t-n} y_{t-n}$ having taken place in $t-n$:

$$y_{t-n}(t) = \psi_{t-n} y_{t-n} (1+\rho_{t-n+1}) \cdots (1+\rho_t),$$

however,

$$\psi_{t-n} = \psi_t/(1+\lambda_{t-n+1})\dots(1+\lambda_t),$$

and so

$$\hat{y}_{t-n}(t) = \psi_t y_{t-n} u^n, \tag{6}$$

where $\hat{y}_{t-n}u^n$ is the *relative present value* in t of the relative flow y_{t-n} (that is its present value expressed in terms of ψ_t).

Elementary data. $\omega_{x,t}$: proportion of retirees in year t born in year x to those still living in year t; this is what characterises *retirement behaviour.* $\pi_{x,t}$ is the *replacement rate* of their average relative starting pension, and this is what determines the proportion of their previous work income replaced by the pension. The number in t of those retiring from the cohort of x is $\mathring{z}_{x,t}$ and their total *relative pension* is $\mathring{p}_{x,t}$ $(x = t-T,\dots,t-N)$.

$$\mathring{z}_{x,t} = l_{x,t}\omega_{x,t} \qquad \mathring{p}_{x,t} = l_{x,t}\omega_{x,t}\pi_{x,t}. \tag{7}$$

The *total number* in year t of *pensioners* born in year x is:

$$z_{x,t} = \sum_{i=x+N}^{t} \mathring{z}_{x,i} \prod_{j=i}^{t}(1-m_{x,j}) = l_{x,t} \sum_{i=x+N}^{t} \omega_{x,i}, \tag{8}$$

the total *relative* and *absolute pensions* of the cohort of x are:

$$p_{x,t} = l_{x,t} \sum_{i=x+N}^{t} \omega_{x,i}\pi_{x,i} \qquad p_{x,t} = \psi_t p_{x,t} \tag{9}$$

We should note that relative starting pensions (determined earlier) are also multiplied by average wage ψ_t in t. By this, we assume that *pensions are indexed by actual wage indices* without lower and upper limits. Thus the proportions between pensions and the average wage, as well as between individual pensions, remain unchanged.

If $d_{x,t}$ is the number of elderly people who were not eligible for a pension, then the number in t of the *active earners above the age limit* born in x is:

$$a_{x,t} = l_{x,t} - z_{x,t} - d_{x,t} \qquad x = t - T, \ldots, t - N \tag{10}$$

Let A_t be the demand of the labour market for active earners in year t. Then the total number of *active earners of active age* from the cohort born in year x is:

$$a_{x,t} = \frac{A_t - \sum_{x=t-T}^{T-N} a_{x,t}}{L_t^A} l_{x,t} \qquad x = t - N + 1, \ldots, t - K. \tag{11}$$

The numerator of the fraction determines the number of active earners below the age limit from the labour demand and from the number of active earners of retirement age (i.e. indirectly from the retirement behaviour). The quotient is the *participation rate of those of active age*, and this is the average we apply to all cohort of active age.

From the cohort born in year x the total number of those inactive below the age limit is $l_{x,t} - a_{x,t}$. From among them $g_{x,t}$ is the number of "paying" inactive ones, who pay pension contributions (or someone pays for them). If h_t is the average (actual or imputed) income of the "paying" inactive individuals as a proportion of the average wage of active earners, then the total *relative and absolute contribution bases* in t of the cohort of x ($x = t - T, \ldots, t - K$) is:

$$q_{x,t} = a_{x,t} + h_t g_{x,t} \qquad \dot{q}_{x,t} = \psi_t q_{x,t} \tag{12}$$

Aggregates and (dis)equilibrium. The cross-sectional aggregates are produced by simple addition, while for the calculation of longitudinal (lifetime) aggregates we utilise formula (6).

$$P_t = \psi_t \underbrace{\sum_{x=t-T}^{t-N} p_{x,t}}_{P_t} \qquad \boldsymbol{P}_x = \psi_{x+T} \underbrace{\sum_{t=x+N}^{x+T} p_{x,t} u^{x+T-t}}_{\boldsymbol{P}_x} \tag{13}$$

$\dot{P}_t$ is the *absolute* while P_t is the relative *aggregate pension expenditure* in t. $\dot{\boldsymbol{P}}_x$ is the *absolute* while $\boldsymbol{P}_x$ is the relative *life pension* of the cohort x (present value at the end of the life cycle, of the total pension collected through whole life).

$$Q_t = \psi_t \underbrace{\sum_{x=t-T}^{t-K} q_{x,t}}_{\hat{Q}_t} \qquad Q_x = \psi_{x+T} \underbrace{\sum_{t=n+N}^{x+T} q_{x,t} u^{x+T-t}}_{\hat{Q}_x} \tag{14}$$

$\hat{Q}_t$ is the absolute, while Q_t is the *relative aggregate contribution base* in t; $\hat{Q}_x$ and Q_x are, respectively, the absolute and relative *life incomes* of the cohort born in x, and they serve as a contribution base (i.e. present value at the end of the working career of the total income gained in the course of the life career).

Given the pension and the contribution base, the equilibrium or its absence depends on the *contribution rate* applied. It is obvious that the *balance of income and expenditure* of the pension fund in t is the difference between the contribution base multiplied by the rate and the aggregate pension expenditure; while the *heritage* of the cohort born in x is the difference, at the end of the working career, of the contribution base multiplied by the actual rate and the present value of the pension. These could be calculated in many versions, with arbitrarily selected contribution rates. However, we get a much clearer picture about the economic characteristics of a pension system if we determine the *effective* contribution rate μ_t which is variable over time. This would ensure cross-sectional equilibrium (zero balance) in each year. Moreover we define the constant *actuarially correct* rate μ_x. It creates longitudinal equilibrium (zero heritage) for a given cohort:

$$\mu_t = P_t / Q_t \qquad \mu_x = P_x / Q_x \tag{15}$$

The effective and the actuarially correct contribution rates are the synthetic indicators of all pension systems, as they depend on all the parameters considered. They do not depend, however, on the interests forming the contribution rate in practice. Thus it shows from the true, economic aspect how much contribution in the active age is necessary in order to ensure an old age living. The level of the latter is determined by the replacement rate, cross-sectionally and longitudinally, respectively.

The demographic bases

Here we present variants of the calculations where we have assumed that both the number of births in 1993 and the age-specific mortality remain constant in the future. Of course, this is not a forecast but it is the simplest point from which to start (given that nowadays nobody can give a reliable prognosis of the real changes in fertility and mortality).

On the basis of the above assumption the population will become stationary by the end of the next century, i.e. its number and age structure will stabilise at a level which corresponds to current mortality conditions. Also following on from this, starting from the year 2070, the calculated pension system indicators will also settle down and become constant on a certain level. Of course, this is not a prognosis either, but the presentation of the levels which correspond to the *current birth and mortality conditions*. Differences and fluctuations occurring in the first half of the next century will not stem from the present, but from the past—i.e. *the 20th century history* of births and mortality.

It is a well known and widely discussed fact in the international and the Hungarian literature that the population due to retire according to the current age limit will considerably increase in two waves in the next century—namely, in the decades of 2010 and 2030. This is when the large cohort born in the fifties—i.e. the Ratkó children here and the baby-boomers in the West, as well as the large number of their children born in the seventies—will retire. Raising the age limit would not change this situation, but it would postpone the period of culmination by a few years.

The literature which forecasts the collapse of pension systems suggests that these large cohorts will not be able to accumulate enough for their own retirement, as in the current pay-as-you-go system they only have to support the current smaller pensioner cohorts. Unfortunately, I have never checked this belief numerically, and have even avocated it myself (*Augusztinovics* 1993)—although it is not true, at least certainly not in Hungary.

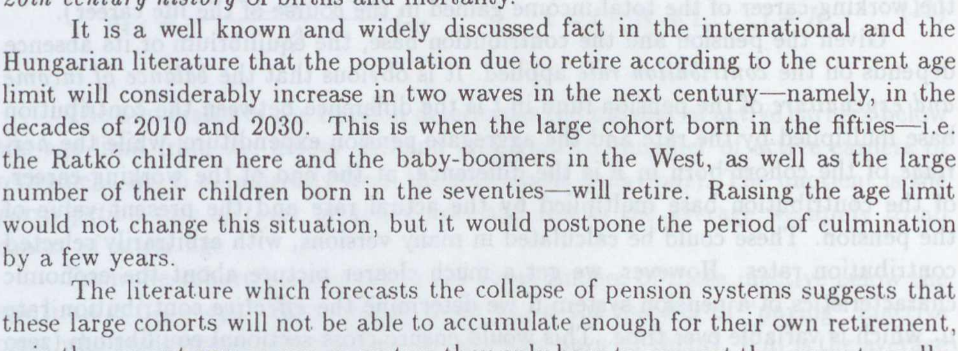

Fig. 1

The current retired cohort were not born directly before the baby-boom cohorts, but in the first half of the 20th century. On the left hand side of *Figure 1* it can be seen that up until 1930, with the exception of the 4 years of the first world war, the number of births was much higher than at the respective peaks of the fifties and the seventies. In addition, the current pensioners lived the first half of their life path in the midst of a rapid fall in juvenile mortality. In other words, compared to their predecessors, a relatively high proportion of their number reached the beginning of retirement. However, from the middle of the sixties the improvement in the mortality figures stopped. The average life expectancy at the age of 60 is practically the same today as it was in 1960. To put it shortly: the number of today's pensioners is relatively large, yet this fact pertains not because they live long, but because their cohort was large at birth.

On the right hand side of *Figure 1* the curve marked by $L40$ shows the longitudinal dependency rate of the actual 40-year-old generation (indicator f_{t-40} for all t). The curve marked by CR shows the actual cross-sectional rate (f_t), which is already higher, and will certainly remain higher in the first three quarters of the 21st century than the longitudinal rate. In Hungary the situation is already now such that is expected elsewhere after 2010 only: i.e. the proportion of the elderly in the population is higher than the weight of old age in the life path of the cohort. In the current pay-as-you-go system those currently of an earning age "support" not less, but *more* pensioners per capita on average than the number they will have in their age cohort "to be supported".

The above have far-reaching consequences from the aspect of the possible transformation of the pension system: the cross-sectional effective contribution rate (μ_t) is much higher and will remain higher until the second half of the next century than the actuarially correct rate ($\boldsymbol{\mu_x}$) of the cohort around and younger than the age of 45. If we switched to a pension system where those of an active age have an actuarially correct burden, then in the coming decades fluctuating, but always considerable cross-sectional deficits should be expected.

The economic activity

It is worth making some brief comments on our first discarded calculation. Here we did not determine the number of earners of an active age in the way given in formula (11), but according to general practice we retained the participation rate at the level of 1993. Thus, not only the actual number of pensioners depended clearly on demographic trends, but also that of active earners and those classified as inactive. However, this produced rather non-sensical results with respect to both the medium and the long terms.

In the medium term—i.e. from 1993 to 1999—the number of active earners increased continuously each year in accordance with the demographic facts, as the number of individuals in the cohort of earning age is currently increasing. At the same time, we know that the actual number of active earners has been falling since 1993 and will continue to fall with all probability until at least 1996.

In the long term—i.e. from 2000—the number of active earners starts to dive according to this calculation. This trend continues until the middle of the critical decade of 2010, and it then falls back to 3.5 million. Then, by the middle of the century, it reaches the lowest point with hardly 3 million active earners. In reality there is no reason for the absorption capacity of the labour force to follow the demographic trend. The number of active earners does not have to decrease merely because those of earning age are fewer. If the demand for labour is higher, more can work and the number of unemployed falls.

This calculation made us realise that another general assumption in the literature of pension reforms is also erroneous: demographic trends do not definitely determine the number of "supporters" (i.e. the earners). Under the current activity rates the economies of today have—and indeed leave—huge labour force reserves under-utilised. This happens in developed economies because they are developed, while in underdeveloped economies it is because they are underdeveloped. If this reserve is absorbed because of the demographic facts, and if instead of the presence of young unemployed people we can talk about the dominance of young earners, this could be advantageous both socially and economically. Therefore we rejected the simple assumption of a constant activity rate, and in the variations to be presented here we do not calculate the number of active earners from the participation rate, but arrive at it from the outside, according to formula (11).

We assumed that from 1993 until 1996 the number of active earners will continue to fall by 100 thousand annually, (today we know that in 1994 it decreased by more than 150 thousand people); then until 1999 it will increase by 100 thousand people annually in a sort of "restoration period". We examined three variants for the next century, where from 2000 onwards the number of active earners:

K_0 remains constant at the level of 1993 when reached again,
K_1 increases by one percent until 2016,
K_2 increases by two percent until 2010.

In the K_0 version the participation rate increases in the first decades of the next century, (as the number of those of active earner age falls). However, it never reaches the 87.8 percent of 1985. The K_1 version "hits" this limit in 2016 and K_2 reaches it by 2010; from then on we determine the number of active earners with the constant activity rate according to the demographic facts.

In all three versions the retirement behaviour and the replacement rate which characterise the pension system were kept at the level corresponding to the base year 1993. The major indicators of 1993 are that, at the age of 56, 55 percent of the cohort's had retired, while at the age of 61 the corresponding figure is 95 percent; accordingly, at the other ages the proportion of retiring individuals is insignificant. The relative starting and average pensions are noticeably levelled, and to a significant degree; between the ages 56 and 70 the relative pensions of the different ages hardly differ and where they do it is no more than 4–5 percentage points. The inequality of pensions is much lower than the extent of both the actuarially justified and the socially acceptable levels.

The changes in the effective contribution rate in the three versions are shown in *Figure 2*.

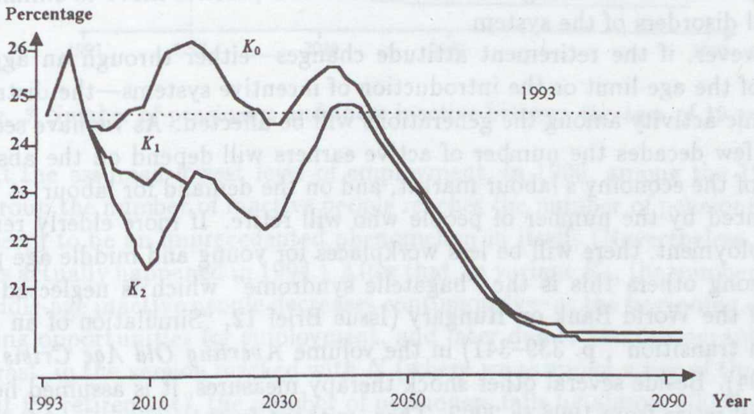

Fig. 2 Effective contribution rates in the variants of economic activity

It should be noted that:

1. In 1993 the effective rate was 24.6 percent, which is much lower than the legal 30.5 percent. The explanation for this is that *a)* a considerable part of the legal contributions was not collected, and outstanding claims continued to increase; *b)* yet the contributions received exceeded pension expenditure, but the surplus of the Pension Insurance Fund was used to finance non-pension benefits instead of the state budget.

2. In the course of the "restoration" period (forecast as due to take place after 1996), the effective rate falls slightly below the level of 1993, and it reaches it again only in the pessimistic K_0 version—namely, in the demographically critical decades of 2010 and 2030. The effective rate in the K_1 and K_2 versions, merging in 2016, never reaches 25 percent.

3. In the second half of the 21st century, after the damping of the birth fluctuations of the 20th century, the effective rate quickly reduces and stabilises at a level below 21 percent.

To summarise: we do not even get close to the legal 30.5 percent, although in these variants we left all parameters of the pension system unchanged. This means that there are in fact considerable reserves here. The legal rate could be reduced considerably if the legal contribution was collected and the further burdening of the pension system with other social policy tasks was discontinued. Such tasks should be dealt with by other areas (for example, unemployment should not be the responsibility of the pension system).

Thus those assumptions which hold that "it is impossible to finance this pension system in the long term" are unfounded. (This is also the conclusion *Bod* came to (1992).) This is why the reform should not be seen as an attempt to prevent a sort of permanent financing crisis, but rather as a positive move to eliminate the functional disorders of the system.

However, if the retirement attitude changes—either through an aggressive increase of the age limit or the introduction of incentive systems—the distribution of economic activity among the generations will be affected. As we have seen, over the next few decades the number of active earners will depend on the absorption capacity of the economy's labour market, and on the demand for labour; it will not be influenced by the number of people who will retire. If more elderly remain in their employment, there will be less workplaces for young and middle age people.

Among others this is the "bagatelle syndrome" which is neglected by the "brief" of the World Bank on Hungary (Issue Brief 12, "Simulation of an Eastern European transition", p. 339–341) in the volume *Averting Old Age Crisis* (World Bank 1994). Beside several other shock therapy measures, it is assumed here that no one will retire from 1996 to 2002. Then, without further arguments, it is stated that as a consequence of this the GDP will increase. Naturally, this latter could only come true if the Hungarian economy was currently struggling to cope with a lack of labour and early retirement was the only obstacle to the increase of the GDP.

The various proposals to increase the age limit considerable in their number. In order to examine the consequences of these proposals we put the simple question: what would happen if the women's age limit were to be increased to 60 from 1996? (We assumed that this would not change individual attitudes, for everyone would escape to retirement as soon as possible—i.e. at the age of 61—and thus same proportion of the cohort would be in retirement as now.) As might be expected, this solution implies that miracles will occur with the financial balance of the Pension Insurance Fund. The current deficit would disappear immediately in 1996 as, through five years, almost 60 thousand people less would retire each year than is the case at present. By 2000 the effective contribution rate would decrease by 20 percent and even the periods which are critical from the demographic aspect would hardly count any more: in the assumption being considered here, even in the worst years the rate does not rise above 22.6 percent. The effects on the different generations are shown in *Figure 3*.

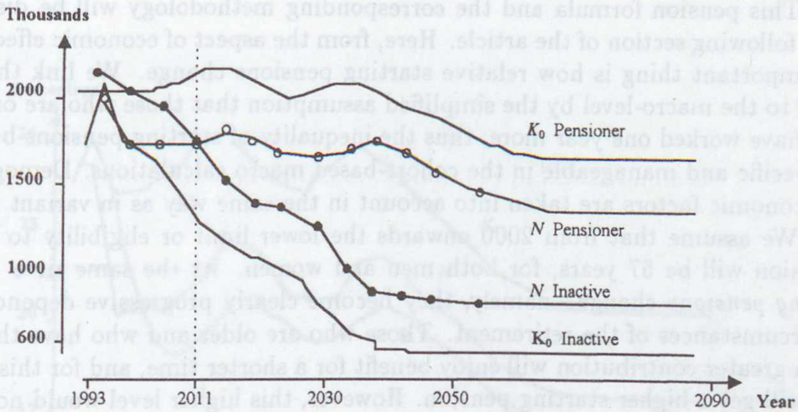

Fig. 3 Number of pensioners and those inactive between the ages of 19 and 60

At the assumed lowest level of employment, in 1996, among the 19–60 age-range group the number of inactive people reaches the number of pensioners, which would seem to be an unprecedented phenomenon in itself. (Nevertheless, we know that this actually happened in 1994.) After that, in variant K_0, the number of young and middle-age inactive people decreases continuously—at the beginning due to the improving opportunities for employment, and later due to the demographic trend. In contrast, in the version marked with N (where we assumed a rise of the women's age limit for retirement), the number of pensioners falls by almost 300 thousand in a few years, *but the number of inactive people of earning age exceeds the number of pensioners until 2012*. So the "support burden" is not reduced for anybody; instead of pensioners, it is young and 50–60-year-old "inactive" people who must be supported. Is this advantageous? Is this reasonable? This question far exceeds the apparently more pressing problem of the pension system. In fact the former requires a comprehensive, long term social and economic solution.

One-pillar reform

This reform achieves both the insurance and the redistribution functions within a single pay-as-you-go type social insurance system. The individual pension would consist of two components. The part which can be called "work pension" is actuarially fair, and it corresponds to the work pension system of the two-pillar case. The pertaining tax/subsidy system, on the other hand, functions as the basic pension system of the two-pillar case—namely, it brings about redistribution, and a moderation of inequalities. The individual always possesses accurate information on how his actual pension is built up from these components.

This pension formula and the corresponding methodology will be discussed in the following section of the article. Here, from the aspect of economic effects, the only important thing is how relative starting pensions change. We link the individual to the macro-level by the simplified assumption that those who are one year older have worked one year more; thus the inequality of starting pensions becomes age-specific and manageable in the cohort-based macro calculations. Demographic and economic factors are taken into account in the same way as in variant K_0.

We assume that from 2000 onwards the lower limit or eligibility to receive a pension will be 57 years, for both men and women. At the same time *relative starting pensions* change—namely, they become clearly progressive depending on the circumstances of the retirement. Those who are older and who have therefore paid a greater contribution will enjoy benefit for a shorter time, and for this reason they will get a higher starting pension. However, this higher level would not be to the actuarially correct extent, for the inequality is moderated by the tax/subsidy system. For example, in case of somebody retiring at the age of 65, the starting pension would be—*ceteris paribus*—42 percent higher; at the age of 70 it would be as much as 80 percent higher than at the age of 58.

Given the age-specific replacement rate, the *average pension level* depends on a single external parameter, which is used to "calibrate" relative starting pensions. This parameter was selected so that the starting pension of those retiring at the age of 64 should be identical with the average pension of 64-year-old people in the current system.

We assume that the effect of all this would be a fundamental change in *retirement behaviour*, and this is made possible by the protection provided by the labour law to workers who have reached the lower age limit. Around the lower limit, the effect of the low starting pension will be that a smaller number will opt for retirement: 8 percent of the cohort at the ages of 58 and 59 respectively. Also, few will remain in employment after the age of 65: 16–17 percent only. Thus, the weight of retiring—so called the "age centre"—shifts to between 62–63 years old. Naturally, we imagine that the change of behaviour will be gradual. In the year of the reform there will be 14 transitional cohorts, whose members will be partly retired; the others will slowly adapt to the new rules, but certainly in a different way from those who will "grow old into" the new system.

Naturally, this is pure presumption without empirical bases. In the course of the preparation of a real reform the expected reaction of the eligible parties to the changing starting pension scale should be assessed using a number of different methods, among others with micro-simulation and a comprehensive public opinion poll. Parameters for the average pension level can be determined arbitrarily, but not on the basis of narrow-minded fiscal considerations. Social agreement is needed, given that a higher pension level involves a higher contribution rate.

Despite the gradual nature of adaptation, the number of pensioners falls considerably in the first decades of the 21st century. This is partly because we have

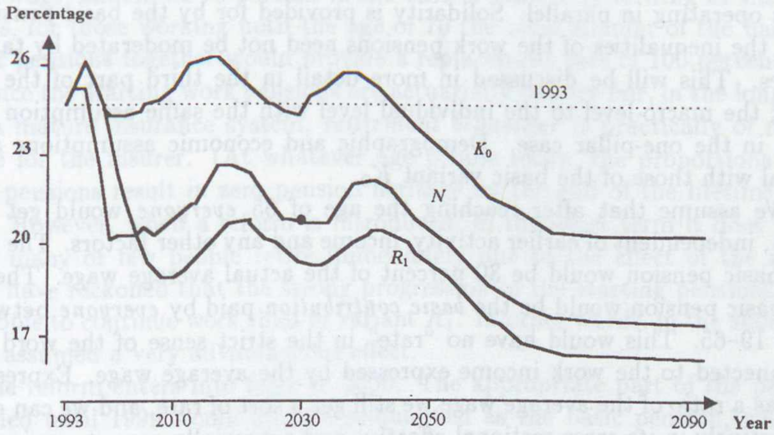

Fig. 4 Effective contribution rates. One-pillar reform or an increase of the women's age limit

excluded the retirement of women aged 56–57, and partly because the financial incentives deferred retirement prevails from the outset. It is worth noting that from 2004 the number of pensioners is lower than in the variant involving an increase of the women's age limit, discussed above. The effective rates of these two versions are shown in *Figure 4*, where they are compared with the basic version K_0; we have marked the curve of the single pillar reform with R_1. We can see that in the reformed, uniform pension system the effective rate is rapidly reduced. Even in the decades critical from the demographic aspect it hardly increases above 20 percent, while in the second half of the 21st century it stabilises below 17 percent. This is a reasonable reform involving incentives which enable individual choice after the age of 57 both for men and women. It also produces a "better" result in the long term when compared with an abrupt and immediate increase of the age limit, which finally does not influences individual behaviour.

Naturally, the decrease in the number of pensioners affects the number of inactive people of earning age in the same direction, but more powerfully than the administrative increase of the women's age limit; consequently it requires the same considerations. It should be noted, however, that this prevails only from the year 2000 and the number of inactive people never exceeds the peak of 1996.

Two-pillar reform

This reform achieves the redistribution and the insurance functions in two systems operating in parallel. Solidarity is provided for by the basic pension system, so the inequalities of the work pensions need not be moderated by taxes and subsidies. This will be discussed in more detail in the third part of the article. We link the macro-level to the individual level with the same assumption as that applied in the one-pillar case. Demographic and economic assumptions are also identical with those of the basic variant K_0.

We assume that after reaching the age of 65 *everyone* would get a *basic pension*, independent of earlier activity, income and any other factors. The amount of the basic pension would be 30 percent of the actual average wage. The source of the basic pension would be the *basic contribution* paid by *everyone* between the ages of 19–65. This would have no "rate" in the strict sense of the word as it is not connected to the work income expressed by the average wage. Expressing its extent as a ratio of the average wage we still get a sort of rate, and we can examine it respectively in its cross-sectional effective and actuarially correct versions.

Several versions are possible for the collection of the basic contribution. In my personal opinion individual, civil obligation would be very desirable. Someone else should pay for those who are unable to pay in the absence of personal income: the spouse with a nice income, the army, the office caring for the jobless, in the final case the municipality. In this case the society would be much more sensitive to the problem of "inactive people", for payment should be made *here* and *now* not only for their present living, but also for future pension. This burden should not be shifted to future earning generations. According to other opinions the source of the basic pension should be the personal income tax. This is primarily because in this way solidarity among generations would be represented. Moreover, the personal income tax has its own income base and this is wider than the work income. However, the way in which the basic contribution is collected and its distribution or redistribution among individuals are in fact not relevant from the aspect of our calculation—that is, its aggregate amount corresponds to the alternative degrees discussed earlier.

The work pension is the benefit provided by the mandatory pension insurance system for those who have been active earners; its source is the *work contribution*. After reaching the age of 57 the insurees can decide freely when to commence receipt of this benefit; for the sake of simplicity here it is assumed that this happens before the age of 71. Naturally, the individual proportions of the *starting work pension* (determined at the given age) depend on the previously paid contribution; but, on average, the age-specific proportions are *actuarially strictly fair*. This involves a quite strong progression according to age: under identical conditions, the starting work pension at the age of 66 would be twice the amount of that at the age of 58, and at the age of 70 it would be three times the amount.

The *level* of the starting work pensions can again be regulated by one parameter: namely, the *replacement rate* (the ratio of the work pension to the last received wage) should be 70 percent in the case of somebody retiring at the age of 70. Thus, for those working until the age of 70 the total amount of the basic and the work pensions together would provide a replacement rate of 100 percent.

Since the starting work pensions are actuarially strictly fair, in the long term, and in a mature insurance system, *retirement behaviour* is practically of no consequence for the insurer. (At whatever age people retire, the proportions of the starting pensions result in zero pension heritage by the end of the lifetime of the cohort.) However, when a reform is introduced, in the short term it does matter whether many or few people retire immediately due to the effect of the reform. Here we have reckoned that the strong progression of the starting pensions drives more people to continue work than in variant R_1. In other words, in the short term we have assumed a very advantageous effect.

The reform enters into force in 2000. The appropriate part of the pensions determined until 1999 would also be re-qualified as the basic pension, while the rest would be taken further as "old work pension" without changing its level. For the economic estimation of the "new work pensions" we assume that in the new system the average members of the different cohorts acquire eligibility to a work pension which is proportional to their *career activity rate*. (This rate is the number of years lived as an active earner between the ages of 19–57, in proportion to the total number of years lived in the same period of life.) The work pension is a form of insurance exclusively for active earners. Consequently, the rate of eligibility strongly depends on economic activity (i.e. the opportunities for employment). The latter varies over time and thus affects different generations differently.

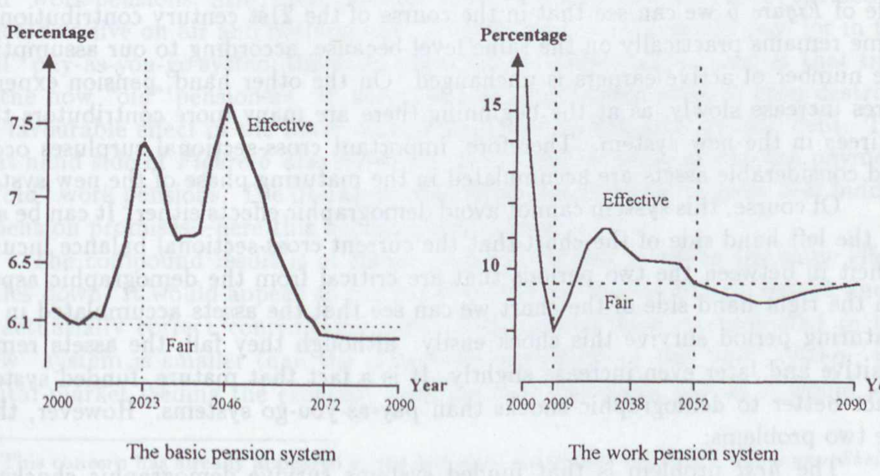

Fig. 5 Effective and actuarially fair contribution rates

Figure 5 shows the actuarially correct and cross-sectional effective contribution rates of the two systems. The correct rate of the basic contribution is 6.1 percent, that of the work pension is 9.5 percent, the total of the two is 15.6 percent. This is much less than the approximately 21.4 percent which is the correct rate in the current pension system. The reason for this is that, altogether, this double system provides lower aggregate and average pensions than the earlier system, as the basic pension starts at the age of 66, while for those younger the work pension provides just a fraction of the final replacement rate.

Naturally, the demographic fluctuation expected in the next century will primarily affect the basic pension system. As can be seen in *Figure 5* the two maxima of the effective contribution rates can be expected 10 years later than in the current pension system, as it is the population older than 65, and not 55, which is affected.

Complex dynamics prevail in the social insurance work pension system as this system itself comprises two subsystems: the higher "old" (i.e. determined before the reform) and the lower "new" work pensions (coming in the wake of the reform). The previous ones will, of course, slowly run out, while the latter ones will slowly increase. Approximately, until 2010 the reduction of the higher old pension volume will dominate. Therefore there will be a situation in which the effective rate suddenly falls, and then it will increase almost as suddenly. However, demographic fluctuation will not leave this system unaffected either: if actuarially correct rates are applied, considerable cross-sectional deficits will occur until the middle of the next century.

However, if the new work pension works as a funded private insurance it will start to live a life which is completely independent of the old pensions. Therefore, the *new work pension system* has to be considered on its own. On the left hand side of *Figure 6* we can see that in the course of the 21st century contribution income remains practically on the same level because, according to our assumption, the number of active earners is unchanged. On the other hand, pension expenditures increase slowly, as at the beginning there are many more contributors than retirees in the new system. Therefore, important cross-sectional surpluses occur, and considerable assets are accumulated in the maturing phase of the new system.

Of course, this system cannot avoid demographic effects either. It can be seen on the left hand side of the chart that the current cross-sectional balance incurs a deficit in between the two periods that are critical from the demographic aspect. On the right hand side of the chart we can see that the assets accumulated in the maturing period survive this shock easily: although they fall, the assets remain positive and later even increase slightly. It is a fact that mature, funded systems react better to demographic shocks than pay-as-you-go systems. However, there are two problems:

The *first* problem is that funded systems survive demographic shocks by disinvesting in the critical period. In other words, they withdraw capital from the

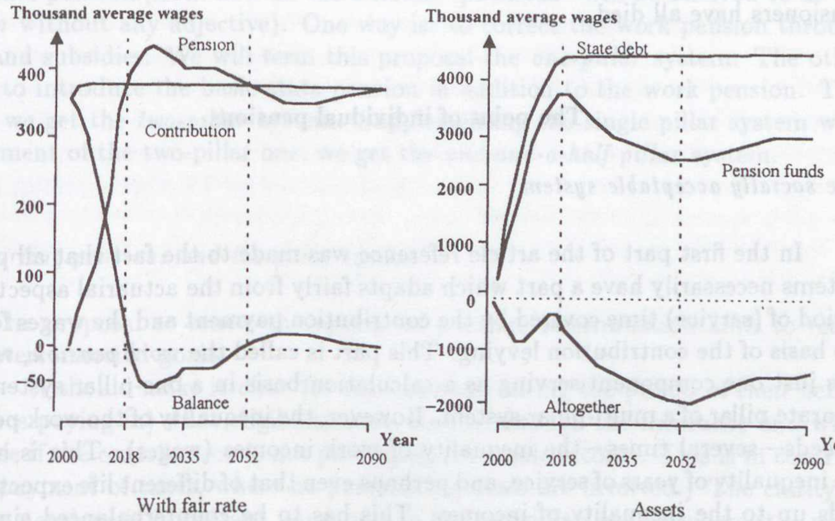

Fig. 6 The new funded work pension system

capital market rather than continuing to contribute to it. The effect of this is that the aggregate savings rate is exactly the same as if the Pension Insurance Fund or the state budget had a deficit.[2]

The *second* problem is that if the "new" work contributions are capitalised from the beginning of the reform, then there is no coverage or resources for the "old" work pensions. Still, these pensions must be paid unless we expect the people affected to live on air and nothing else. It is the state which should pay, for in the "old" pay-as-you-go system the state pocketed the contributions paid at that time by the now "old" pensioners. If, therefore, the state raises taxes it then destroys the favourable effect of the lower contribution rate. If not, will go into debt. The right hand side of *Figure 6* also shows the state debt incurred due to the payment of "old" work pensions. The literature often mentions the *implied state debt* hidden in pension promises—here this becomes transparent.

The compound result is of course negative, as this is where the same effect settles down. It would appear as current deficit in the pay-as-you-go system under an actuarially correct contribution rate. The pension asset accumulated in the "new" system is smaller than the state debt generated by the "old" system; the capital market feeding the economy does not win, but loses, just as it would lose

[2] This concern has already appeared in the literature concerning US 401/K accounts. (*Sheiber and Shoven* 1994, *Wayne* 1994).

in a pay-as-you-go system. The state budget loses even more as interest is payable upon old pensions financed from credit and this state debt survives even after old pensioners have all died.

The point of individual pensions

The socially acceptable system

In the first part of the article reference was made to the fact that all pension systems necessarily have a part which adapts fairly from the actuarial aspect to the period of (service) time covered by the contribution payment and the wages forming the basis of the contribution levying. This part is called the *work pension*, whether it is just one component serving as a calculation basis in a one-pillar system, or a separate pillar of a multi-pillar system. However, the inequality of the work pensions exceeds—several times—the inequality of work incomes (wages). This is because the inequality of years of service, and perhaps even that of different life expectancies, adds up to the inequality of incomes. This has to be counterbalanced since this system will be socially acceptable only if the inequality of pensions eventually comes close to that of work incomes.

In order to be able to discuss this numerically, it is necessary to choose an indicator from those available for measuring income inequalities. Following the example of *Atkinson and Micklewright* (1992), we have applied the indicator called *decile ratio*. In this people are arranged according to the size of their income, and the lower and the upper 10 percent are removed from the set. The ratio of the highest and lowest incomes of this truncated set is called the decile ratio.[3]

As an example let us examine how the requirement of social acceptability prevails in our current system. According to the wages counted, the decile ratio of new pensioners enrolled in the course of 1992 was 2.8, while that of their starting pensions was 2.48. In the same year the inequality of all (old and new) pensions was only 1.8. So while starting pensions are still close to the socially acceptable proportions, over time the inequality becomes unacceptably low. From this we can draw the conclusion that the task of maintaining the socially acceptable inequality of pensions is just as important for any pension reform as the fine-tuning of the rules for determining new pensions. The latter can be modified after a certain time if they result in disproportionality, but nothing can be done with a system damaged over a number of decades and distorted with *ad hoc* "improvements"; it must be left as it is.

[3] This income inequality indicator complies with Dalton's postulate: i.e. the addition of identical (positive) amounts to the incomes reduces the inequality.

There are several ways to get from the work pension to the (socially acceptable) final pension (from now on the amount "pocketed" will be referred to as the *pension* without any adjective). One way is: to correct the work pension through taxes and subsidies. We will term this proposal the *one-pillar* system. The other way is to introduce the basic state pension in addition to the work pension. This is how we get the *two-pillar* system. Supplementing the single pillar system with one element of the two-pillar one, we get the *one-and-a-half-pillar* system.

The starting pensions and the point system

The proposal to renew the system of pension determination aims to reach four, interconnected goals:

— it should make it *clear* for the insurees (during the period of their active insurance paying-in) what eligibility they acquire through the insurance and what they lose if the contribution is not paid upon the whole income. This is in contrast to the payment of taxes, where no personal interests are involved.) The clarity of the new pensions is important, especially in the one-pillar system where it is more difficult to distinguish the various components;

— the work pensions should meet the requirements of both *actuarial fairness* and *social acceptability*;

— it should be possible to carry out the *transition* from the old system to the new one in a couple of years;

— at the time of introduction of the pension reform it should be possible to transfer those who retired according to the old system into the new one without any perceivable change in their pensions. There should not be two parallel systems which carry on together for decades.

In order to meet these requirements simultaneously we found a "magyarised" version of the point system, introduced in Germany in 1992, to be suitable (described by *Rácz* 1992 and *Réti* 1995). This choice is also explained by the common (Bismarckian) roots of the Hungarian and the German social insurance systems, as well as the search for a solution that complies with European systems. (European conformity does not exist in this field for there are many systems among the respective countries. However, compared with the US system or with the systems created speculatively for developing countries, our system is still European.)

A condition for the introduction of the point system is to have an individual registration of the insurees for many years back and to record the years covered by their insurance, (that is, the *service period*) as well as their wages which serve as a basis for contribution determination (that is, the *contribution base*). We can consider ourselves relatively lucky since the basic data are available from about 1988. We can collect such details if and when funds become available. Given that the reform can hardly enter into force before 2000, by then we will have series of data on twelve years, which we find acceptable as a minimum. Therefore, from now on and without further anticipation (just to fix ideas) we will consider 1 January 2000 as *day X*, the day the reform is introduced.

The point system relies on wages and service times which serve as the bases for work pensions. These will be discussed below. The system is optionally supplemented with the consideration of the *retiring age* (i.e. age reached at retirement). The tools for this are the *age bonus and malus points*. From now on the one-pillar and the two-pillar systems will be discussed separately. First we discuss fully the one-pillar system and then return to the two-pillar system.

Pension formulae in the one-pillar system

The point system relies on the following, partly undefined terms, and unexplained relations (about which more will be said later).

Terms related to the active insurance period preceding retirement:

— annual points,

— registered period and service period,

— life points = (Σ annual points) $\times$ (service period : registered period),

— retiring age and age bonus/malus (optional),

— work points = life points $\pm$ age bonus/malus, (but non-negative).

Terms related to the period of retirement following the beginning of retirement (see formulae in the *Appendix*)

— forint multiplier,

— work pension = work points $\times$ forint multiplier,

— subsidy/income tax,

— pension = work pension $\pm$ subsidy/tax.

Insurance history of the individual: annual points and life points

The insurance history of individuals starts with the levying of the contribution. After that, all the periods when the contribution was paid and the individual contribution base (wage) was recorded are considered as *registered periods*. In addition to this, the *service period* also includes the period for which contribution was paid (i.e. before 1988), but the contribution base was not recorded.

In each year of the registered period we divide the individual contribution base (wage) of the insurees by the national average wage calculated in the same way. The ratio is called the *annual point*. Here details are not given about what must be considered in relation to the contribution base, but it is important to note for later that pre-tax wages will be taken into account. It should also be noted that we do not deal with the accounting of fractional years either. Of course, the annual points of individual insurees can be calculated in the course of the following year only when the average is known. Then, annual points are entered into the records and the insurees are notified in writing. In this way everyone can keep a record of his accumulated points. By comparing annual wages to the average wage as a *numéraire*, it is possible to add the wages of different years without having to struggle with interest rates and discounting, for in a pay-as-you-go system contributions are not capitalised. Thus the accounting of the points meets the requirements of clarity as well as actuarial fairness.

At retirement all the annual points gained up to the point of retirement are added. In the case of those who do not have any service period from before 1988 in addition to the registered period (and at some time all new pensioners will be in this category), the total amount of annual points gives the number of life points. However, now and for a long time in the future service years before 1988 will also have to be counted. This could be done by saying that "each year counts as one point", but it complies better with the principle of actuarial fairness if we project the average of annual points back to the total service period. The above formula of *life points* serves this purpose. We would gladly replace it by another formula if we could find a better method of estimation for individual wages before 1988. (Here we do not deal with the case in which someone acquired eligibility to a pension in the past, but does not have enough registered years.) As a favour, periods without employment (e.g. child rate, training) can be included in the registered or service period, if someone pays the relevant contribution.

Naturally, those retiring in 2000 might have a maximum of twelve registered years. This number will then increase year by year. When the number is high enough, it will be wise to modify the system by ignoring the same number of best and worst years for the calculation of the average. This would protect the insurees and the insurer from the inclusion of catastrophically bad and outstandingly good years.

Retirement age, life expectancy, age bonus, work points

With regard to the age limit of retirement, especially with respect to women, a political game has been going on for years and we do not wish to join this. Therefore our proposals related to this subject can be disregarded—thus the current age limits can remain or be changed in the old way. This is one of our reasons (others will be discussed later) for qualifying our relevant proposal as "optional"; even if it is rejected, this does not prevent the implementation of the other elements of our conception. In our proposal there is no positive or negative discrimination between the sexes, although the social acceptability requirement favours women.

In our current system two thresholds must be crossed in order to acquire eligibility for a pension: the age limit and the minimum limit of service period (and both must be met separately). In contrast we suggest that these two criteria be combined—namely, at a lower age a longer service period should be required for eligibility. For this, the medium value of the retirement age should be determined. As an example, let it be 64, and then a zone to the left and right from this, say between the ages of 58 and 70. A required minimum service period would correspond to the medium value (say 15 years). This would also prevail over the medium age of retirement. However, for early retirement, below the medium age the requirement increases—for example, by 3 years for each missing year. *Table 1* shows the combinations of retirement age and -service period necessary to be eligible for a pension.

Table 1

The age of retirement and the service period

Retirement age	Required service period
below 58	(no retirement)
58	33
59	30
60	27
61	24
62	21
63	18
64 and over	15

With this we have only solved the issue of the age of retirement from the aspect of the pension eligibility, but have not provided incentives for those who have become eligible for retirement to keep on working. In the case of those who retire younger, the present value of the expected pension flow (discounted to the moment of retirement) is, *ceteris paribus*, higher than for those who take this step at an older age. This related to the issue the longer *life expectancy*. Those who delay retirement not only pay the contribution for longer (and this is honoured by further annual points), but also renounce one or several years' pension income, and in the spirit of actuarial fairness the insurer must return this by increasing the work pension. Actuarial fairness requires that the expected present value of the work pension flow (for example in the 64th year of age) be independent from the age of retirement.

As has been mentioned earlier, we consider this part of our proposal optional (and thus dispensable). In other words, we are willing to renounce actuarial fairness at this point. Thus, three solutions present themselves, and we do not have sufficient data to qualify one of them as the best. The choices are the following:

— *to leave the retirement age out of consideration* (version zero). The following arguments can be mentioned to support this solution: 1. the promotion of continued work may be useful in the years of upswing, but during a recession it would increases the surplus on the labour market i.e. create unemployment; 2. it is useless to encourage the employee if the employer has a counter-interest; 3. the expected effectiveness of the proposal is difficult to estimate; 4. the difference of life expectancies would increase the inequality of work pensions and too drastic subsidy and tax rates would be needed to counterbalance this;

— *to take the retirement age into consideration in an actuarially fair way* (fair version). The main arguments in favour of this solution are: 1. at least the work pension should remain theoretically pure and therefore be less influenced by actual political interests; 2. it has been proved that inequality would increase at an unpleasant rate as a consequence of the fair version; 3. employers can be made interested in keeping the elderly employees who are able to work and discouraged from forcing early retirement;

— *to apply bonus and malus rates lower than the fair ones* (interim version). In this case, the arguments for and against are the same, but the good and the bad effects are moderated.

Table 2

Bonus and malus points

Denomination	Zero	Fair	Interim
Annual bonus points	0	4	2
Points gained 64–70	6	30	18
Annual malus points	0	–1.5	0.75
Points lost 64–70	–6	–15	–10.5

The effects of the three versions are shown in *Table 2*, where the numbers of annual bonus and malus points clearly indicate the effect of the retirement age. We arrived at the correct version by—for the sake of simplicity—calculating the average of the necessarily different correct points of the various ages. We started by considering the six-year average of the bonus points and the malus points separately. Thus the bonus/malus points have to be added purely (with their sign) to the life points. However, the six years' figures for gain/loss points include the effect of the change in the number of service years considering a person of average wage.

Comparing the figures of *Table 2* with the fact that the number of life points falls generally between 15 and 70, we can see how cruel the fair version is. It can also be seen in this definition that the extent of the prize and the penalty does not depend on the number of life points one has. Technically, a multiplicative solution (like the German one) could be elaborated instead of the additive age bonus; however, this would increase inequality in an even more direct way.

Even so, the age bonus/malus rates, irrespective of their actual extent, cannot be considered permanent forever. Without injuring acquired rights these rates may change at any time according to the status of the labour market: they can be increased when there is an upswing and decreased, even to zero, during a recession. Under the current permanent recession we would not be surprised to see few people voting for this element of our proposal. However, those contemplating pension reforms should contemplate the prospects of fifty years, not five.

Forint multiplier and work pension

Let us recall that the number of *work points* is the algebraic sum of the life points and the bonus/malus points. These, however, cannot turn negative, even after the deduction of the malus points. We get the starting *work pension* by multiplying the work points by a forint multiplier. Yet while the number of work points differs individually (albeit remaining the same right through the period of pension), the forint multiplier is the same for everyone even though it changes with time (in line with the forint). Thus we managed to separate the proportions (i.e. the inequality) of work pensions—which cannot be tampered with afterwards—from the general nominal level of pensions. The latter can be adjusted to the nominal value of average wages, i.e. to the economic situation. Yet while we are getting from the work pensions to pensions, a few more factors appear.

First of all, we calculated that value of the forint multiplier with which the average of the pensions starting in 1992 would remain the same under the new system (disregarding age bonus). The multiplier resulted in approximately 3,500 forints/work points annually. Otherwise, the size of the forint multiplier as determined by the stage at which we want to set the *replacement rate* (for the average of new entrants) or the *pension ration* (for the old ones). There always exists a forint multiplier value which creates a temporary equilibrium, and it can be calculated if the data are available, even if such calculation is by no means straightforward.

From the work pension to pension: subsidy and tax

On the path leading from the work pension to pension the first step is the income tax to be levied on work pensions. Although it might seem socially insensitive to present "poor pensioners" with an income tax bill, the proposal intends to deduct the income tax not from the pension, but from the—some might say fictitious—work pension. The latter has been calculated linearly (i.e. without the strict digression which at present burdens the service period and wages).

Martos (1994) demonstrated that the nominally not taxable pensions are in reality after-tax incomes where the deduction was performed according to twice the tax rate of active people. Thus pensioners, who are often considered as being dependent on society, bear a double public burden, albeit invisibly. According to our proposal they would pay tax just like all other citizens having an income. (We have defined the pension as after-tax income.)

Against the taxation of pensions reference should also be made to the increasing administrative burden: should all pensioners fill out a tax declaration? Those who have other incomes should, just as now. The income of the others could be arranged as simply as it is now, with the declarations being submitted via the employers, and managed by the Pension Payment Administration (PPA). We will revert to the clearing of accounts between PPA and the tax administration later.

In 1992 the contribution base (closing wages) of new retirees showed a decile ratio of 2.8, while their calculated work points and work pension was 6.9. The effective *marginal* income tax rates were as shown in *Table 3*.

Table 3

Tax rates

Annual income (thousand forint)	Marginal tax rate (percentage)
below 100	0
100–200	25
200–500	35
over 500	40

If we do nothing other than apply this tax table on the work pensions of 1992, then approximately 200 thousand forint will remain after tax from the 240 thousand forint work pension of the ninth decile. The approximately 35 thousand forint work pension of the first decile falls in the 0 percent bracket, so it does not change. Finally the inequality of the work pensions would be reduced from 6.9 to 5.7. This is still unacceptably far from the 2.8 inequality of wages, compared to which it should be lower rather than higher. The miserable 35 thousand forint of the first decile expresses better the prevailing absurdity, although it is difficult to recognise due to the abstract presentation. The solution we suggest is that, in addition to the work pension, a subsidy depending on the extent of the work pension should be paid to those entitled to low work pensions. In order to achieve this:

— the same authority which determines, and from time to time modifies, the tax rates and the corresponding income brackets (this is the Parliament now) should determine the income limit below which the work pension should be supplemented with a subsidy. This will be the lower boundary of the bracket of the 0 percent tax rate; this may be equal to the upper boundary, but preferably it will be lower than that;

— at the same time the marginal rate of subsidy should also be set. The maximum subsidy corresponding to the (perhaps fictitious) zero work pension is equal to the minimum pension. The amount of the subsidy is calculated using the following formula:

subsidy = (lower boundary of the 0 percent bracket − work pension) × rate.

We get the pension by deducting the tax from, or adding the subsidy to, the work pension. (A multi-bracket marginal subsidy rate is also possible. To date there is no need for that, at least according to our calculations.)

Continuing the previous arithmetic example: let the lower boundary of the 0 percent bracket be 90 thousand forint, (it should be taken into account that the upper boundary is 100 thousand forint!), and let the rate of subsidy be 67 percent. The minimum pension and maximum subsidy corresponding to the zero work point is: $90 \times 0.67 \cong 60$ thousand forint. In the subsidy zone the pension goes up to 90 thousand forint (this is what those having 26 work points get); then up to 100 thousand forint the pension equals the work pension. Above this, the work pension is taxed. According to our calculations almost 35–40 percent of those who became pensioners in 1992 would receive a subsidy, 10 percent would fall in the 0 percent bracket, and 50–55 percent would pay tax. The 35 thousand forint work pension of the first decile would be supplemented with $(90 - 35) \times 0.67 \cong 37$ thousand forint subsidy, so the pension would be 72 thousand forint. Finally, through the taxation and the subsidy, we achieved a situation in which the inequality of the pensions dropped to $200 : 72 = 2.78$, coming close to the 2.8 inequality of closing wages.

Figure 7 shows the work pension (full line) and the pension (dotted line) plotted against the work points, in accordance with the data of our numerical exercise. With respect to what follows, it is an important feature of the function that it increases strictly monotonically all along its domain of definition, so it can be inverted. The detailed formulae and the parameters corresponding to the numerical exercise for both the work point-pension function and the pension-work point (inverse) function can be found in the *Appendix*. We can get the diagram of the inverse function by projection to the 45° straight line.

By calibrating the parameters a situation can be achieved in which, at least at the start, the total of new pensions would be almost equal to that of the work pensions—i.e. from the deducted tax advances the Pension Payment Administration would be able to cover the amount of subsidy to be borne by the state budget at the final clearing of the accounts. Seemingly, the social insurance system lacks the coverage for "grossing" high pensions; in fact, this is compensated for by the transfer of the burden of the subsidy for low pensions to the state budget. Later a balance (that can be manipulated) can occur in favour of any of the parties, but legislators will always have enough "power" to be able to sustain the "break-even" situation.

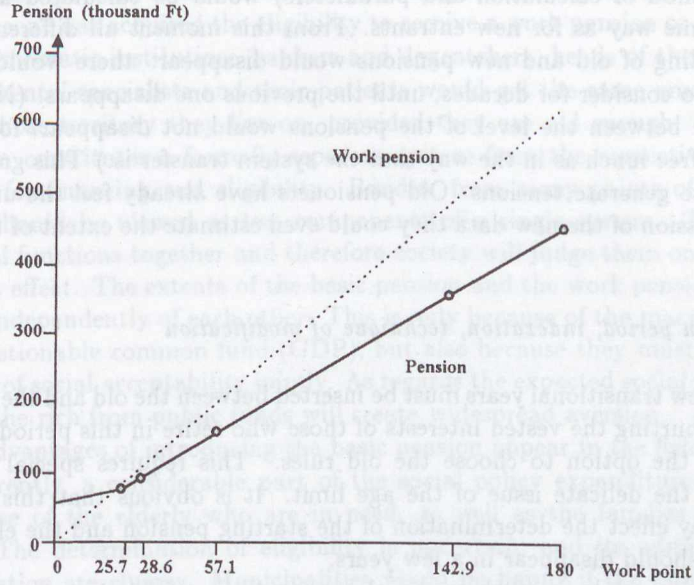

Fig. 7 Pension as a function of work points

Until now we have not mentioned the issue of the health insurance of pensioners nor the source of the insurance premium. Although the eventual decision concerning this issue changes the nominal size of the system parameters, here it is not necessary to go into detail.

Transferring old pensions to the new system

We want to fit the old pensions into the new system in order to leave the actual pensions of day X unchanged (or if we–the state–are rich enough, we can increase them evenly in order to improve the public mood). Then for each insuree we calculate that number of work points (*implicit work points*) according to the parameters determined in the new system which would generate the actual pension.[4] They are informed of the latter, and then from the day of receiving this information each element of their pension (work pension, subsidy, tax advance,

[4] This is where we use the inverse of the pension function mentioned above. The inverse is not defined for pensions lower than the maximum subsidy. To these we assign 0 work point (instead of a negative number of points). According to the 1992 data this would have resulted in an increase of 1000 forint monthly for 3 permille of the pensioners, with a cost effect of less than 5 million forint annually.

their method of calculation and parameters) would be calculated and disclosed in the same way as for new entrants. From this moment all differences between the handling of old and new pensions would disappear: there would not be two systems to consider for decades, until the previous one disappears. (Naturally, the difference between the level of the pensions would not disappear, for this would not be a free lunch as in the way that the system transfer is.) This great openness would also generate tensions. Old pensioners have already feel the unfairness. In the possession of the new data they could even estimate the extent of this inequity.

Transition period, indexation, technique of modification

A few transitional years must be inserted between the old and the new systems to avoid hurting the vested interests of those who retire in this period. They must be given the option to choose the old rules. This requires special attention in handling the delicate issue of the age limit. It is obvious that this duplication, which may effect the determination of the starting pension and the eligibility to a pension, should disappear in a few years.

We do not have much to say about regular annual indexation either, which now effects the forint multiplier only. In our view the *principle of following the average wage* should be sustained. At most, the retroactive method should be improved and, most of all, the adjustment should be made automatic. It is not reasonable for this administrative issue to become the subject of political debates twice a year.

The modification of the parameters related to taxes is a different issue. Obviously, the tax rates and, similarly, the subsidy rate could be changed in acts, but automatic valuation rules should be applied on the relevant income brackets. However, this already trespasses across the boundaries of a proposed pension reform.

In our proposal we have not dealt with the allowances of the dependants of pensioners nor with the pensions of survivors. It is obvious that these payments should be included in the point system. Whether, in addition, their current rates should be changed can be decided later, after the fundamental issues have been cleared up. The issue of disabled people is more complex. Below the age limit they are provided for not within the pension system, but the health insurance. However, their switch to the pension insurance system will certainly raise some questions, the answer to which is not ready yet.

The two-pillar and the one-and-a-half-pillar systems

The introduction of the two-pillar system (the basic pension) serves the same goals and principles that we presented at the beginning of the chapter and one goal more. The basic pension is also a tool for providing for the elderly, irrespective of whether someone has acquired the eligibility to receive a work pension or not. This is a quite democratic institution: bankers and dogcatchers, heads of the mob and policemen, mental specialists and their patients would get the same amount from the state, whose territory they live on, provided they are old enough. Thus the basic pension constitutes a formally separate system from the respective aspects of the rules for financing and eligibility. Besides, from many points of view the two pillars should be viewed as two components of a single system. They fulfil certain social functions together and therefore society will judge them on the basis of their joint effect. The extents of the basic pension and the work pension cannot be decided independently of each other. This is only because of the macroeconomically unquestionable common fund (GDP), but also because they must meet the requirement of social acceptability jointly. As regards the expected social reception, subsidising the rich from public funds will create widespread aversion.

The advantages of introducing the basic pension appear in the field of social policy. Currently, a considerable part of the social policy expenditure serves to support those of the elderly who are in need, as well as the families providing for them. The determination of eligibility is uncertain, and its administration and organisation are clumsy. Municipalities would be happy if the basic pension could free them from at least a part of this burden (even if they had to renounce some money). Another kind of favourable effect would be enjoyed by the system of work pensions, which will become considerably simpler as it becomes clearer. Finally, the two-pillar system is backed by the fact that this solution is operated successfully in several Western European so-called welfare states. I would explain its favourable domestic reception in 1991 (by the Parliament) as being due to the latter consideration. However, I consider it is not the task here to formulate a moral-political opinion for or against the two-pillar system, but to consider how it can be implemented, what are its disadvantageous consequences and to what extent they can be averted.

If the true goal of the two-pillar system were to help old people in need who are outside the social insurance (and not a carrot dangled in front of us to lead us to the privatisation of social insurance), then this previous goal could be achieved by a small modification of the one-pillar system. It is in this light that the one-and-a-half-pillar system is conceived. We have nothing else to do other than extend the subsidy—which corresponds to zero work point (60 thousand forint in our numerical example)—to those who have not acquired eligibility to receive a work pension, but have reached a specified higher age, e.g. 64 years. From the other aspects everything could remain as it is in the one-pillar system, except the service year requirements, as shown in *Table 2*. A new table should be prepared instead but the arguments and details will not be discussed here.

Basic pension formulae, dilemma of the age limit

If, as we have assumed, we want to operate the basic pension in the framework of a point system too, then it is wise to determine its extent also in points (*basic points*). Hereby we ensure that this component moves along the work pension in time and that the actual forint multipliers are the same. So the number of basic points and the starting value of the forint multiplier are closely dependent on the structure of the work pension; therefore our first task is to examine in what way the work pension component of the two-pillar system should differ from that of the one-pillar system. Two relevant formulae need to be taken into account:

basic pension = basic points × forint multiplier,
pension = basic pension + work pension.

Compared to the previous pension formula, it is clear that the basic pension stepped into the place of the subsidy and tax in the case in which somebody is eligible for both.

With respect to the work pension we suggest the following changes:

— the requirement of a minimum service period must be neglected. This was necessary only to restrict eligibility to claim a subsidy. So, in the two-pillar system, everyone who has ever been insured and becomes eligible by age will get a work pension in accordance with the number of work points. The latter may be very low or, due to the age malus, even zero;

— the age bonus/malus remains an optional element of the work pension. The fair version has again a quite distorting effect, but even the malus part of the interim version is questionable, as we will see.

Here we stop for a numerical detour as we continue the exercise of the one-pillar system. Let the number of basic points be 26. As the average number of the work points is 35, the forint multiplier must be reduced to the proportion of 35:61 so that the average pension remains the same. (The average is interpreted by calculating it only for those receiving a work pension, and this includes all of them.) Thus the forint multiplier changes from 3500 forint to 2000 forint, and the value of the basic pension is $26 \times 2000 = 52$ thousand forint. The latter can be compared with the 60 thousand forint minimum pension of the one-pillar system. The first decile's pension is 72 thousand forint (as earlier), while that of the ninth decile is $(70 + 26) \times 2000 = 192$ thousand forint (instead of 200 thousand forint). The decile ratio is: $192 : 72 = 2.67$; although it has diminished it is still socially acceptable.

From this calculation it is clear that in the two-pillar system it is much simpler to create pensions of proportions similar to those of the one-pillar system, preserving the linearity of the work pension, eliminating the complex subsidy and tax system, and reducing the pension contribution by approximately 40 percent.

(And, as there are no miracles, the tax burden is also forcefully increased.) All this sounds quite acceptable, but there is a problem which has not yet been mentioned.

It is a quite general opinion that, also due to the cost effects, the age limit of the basic pension should be considerably higher than that of the work pension. Yet then the possibility of a flexible age limit for work pensions disappears. It is impossible to imagine the introduction of a pension system where an individual can retire at the age of 58, but then for 6 years he must make a living on a fraction of the final pension, the work pension, and wait for his income to rise when he reaches the age limit of the basic pension. This system excludes those who do not have other incomes from the beginning of retirement until they reach the age limit of the basic pension.

It is possible that there exists a method for bridging the period between the two age limits; however, I have not found any solution which could fit into any of the two pillars without contradictions.

If the work pension remains within the scope of social insurance, then the inclusion of the old pensioners into the new system and the adjustment of the forint multiplier can be solved equally or even more simply than in the one-pillar system. Thus there is no need to discuss them again. Among the former pensioners those who have not yet reached the age limit of the basic pension may have to wait a few years until their enrolment, but this delay is not really disturbing. If the work pension system is managed in a funded private system, then, of course, the possibility of fitting old pensioners into the new system disappears. In fact, in the funded system there is no pension formula. In this system the pension amounts to what is covered by the assets accumulated on an individual's account until the point of retirement. In a lucky situation this may be large, but it could also be very small.

Conclusions

We have to recall that, due to the absence of elaborated reform proposals, our calculations, with the exception of the basic data, are based on arbitrarily specified assumptions and parameters. What we have presented here may be only a minor exercise for future, more detailed calculations and "effect studies". These will require thorough and persistent team work, without which the introduction of a pension reform would be a jump into nothing.

Despite this weak point, we have tried to throw light on some of the fundamental relations which will also prevail under other specifications of the assumptions and parameters. These are what we try to summarize now.

The proportion of elderly people in the population is higher than the weight of old age in the life path of the cohort. This is already a fact now and it will remain so for the greater part of the next century. Therefore the *effective contribution* *rate* necessary for the cross-sectional balance of the pension system is higher and this will not only be persistent through the decades—albeit with fluctuations—but will remain higher than the *actuarially correct rate*. This would ensure longitudinal balance (zero heritage) along the pension path of the cohort. This cannot be changed by the administrative increase of the age limit nor by the financially promoted, spontaneous increase of the age centre. This is because longer contribution payment periods and shorter retirement periods reduce both rates.

Under such conditions there are two ways to sustain the stable self-financing of a social insurance pay-as-you-go pension system:

1. the actually applied contribution rate should strictly follow the effective rate—i.e. it should change year by year (this is how the German pension system operates for example). The advantage of this is that it enables "fine tuning", but the disadvantage is that it unfairly disfavours or favours the different active cohorts, as at a certain time they must pay more or less, depending on the demographic fluctuations generated 60–80 years earlier;

2. in a period which is relatively favourable from the demographic aspect, the legal rate is fixed at a higher than necessary level. Thus, cross-sectional surpluses are generated and this enables the stockpiling of reserves in preparation for demographically critical periods (this is the practice in the social security system in the USA). The advantage of the procedure is that the legal rate can be left unchanged through a long period and the load on successive generations is even. On the other hand, it is a disadvantage that even the most thorough calculations may be wrong with respect to future mortality. Moreover, without constitutional guarantees, the ruling government might be tempted to seize such attractive reserves for its own purposes.

A *funded and actuarially correct* pension system cannot have recourse to the first method, but it does not need it either. When the system matures, it then behaves automatically according to the second system. The difference is that not only a small bridging reserve, but also the whole pension asset accumulated in the maturing phase cushions the effect of cross-sectional deficits.

In the demographically critical periods, from the aspect of the economic consequences, there is no difference between either of the two systems, or the two forms of financing. According to the first procedure the higher contribution finances current consumption—i.e. it reduces the possibility of accumulation; the second method, whether in the framework of social insurance or private insurance, involves the withdrawal of previously invested capital, which has exactly the same effect.

Thus it is self-delusion to hope that any transformation of the pension system may, in the 21st century, eliminate the impact on pensions of the demographic fluctuation resulting from the mortality and birth history of the 20th century. There exists no number of pillars or financing forms which could overwrite the laws of demography.

However, the pension system depends not only on demographic, but also on economic changes, it has to adapt to them too. Through a few more decades the number of active earners "sustaining" pensioners will depend not on the demographic trends or the number of pensioners, but on the *labour absorbing capacity of the economy*. We may adopt any other assumption in this regard; but under the *given* assumption it will always be true that the reduction of the number of those who are retired—whether by raising the age limit, or by financial incentives—will either reduce the employment opportunities of young and middle aged people, or increase the elderly population dependent on social care. Therefore, all proposed pension reforms that neglect the interrelations between the pension system, the labour market and the social relief system are irresponsible.

Even if the awaited economic restoration actually takes place and employment moves from its current unprecedented low rate, future *cyclical economic fluctuations* still have to be reckoned with. The pension system cannot be immune from these fluctuations unless it applies a type of automatism which keeps *proportions* and not absolute levels stable.

In the Hungarian pension system the average pension level has been gradually decreasing over several decades in comparison to real wages. The Swedish pension system has encountered serious problems because, in contrast, it preserved the real value of pensions with price indexing. This carried on in Sweden even through a long period of recession when real wages were decreasing. Both distortions cause considerable changes in the income proportions between the different generations. However, the financial and social stability of a pension system can only be maintained if the generations suffer together in a recession and benefit together in an upswing. All this can take place without permanent legislative debates and negotiations in order to reconcile conflicting interests.

In this article we have used the current average gross wage as *numéraire*—i.e. as a general unit of calculation. This is not a mere technique, and it is not one of the usual tricks that a model builder uses to facilitate his or her task. It is true, though, that we have avoided making unfounded assumptions about the future development of the GDP or other economic indicators. However, this cannot be done when designing a *real-life, future pension system*, for the stability of the latter must not be made vulnerable from the start due to uncertain forecasting stunts. All the key elements of a pension system—i.e. the measure of claims acquired by paying the contribution, the starting pensions, and the maintenance of already determined pensions—must be determined on a *relative* basis, in terms of the current average wage.

Within the *scope of social insurance*, from this aspect there is no difference between the one-pillar and the two-pillar system. In both cases the relative calculation can be performed, the income proportions between the generations can be preserved and, if necessary and possible they can—occasionally but not frequently—be corrected.

Also, no fundamental difference can be made between the two systems with respect to which one is better for meeting the requirements of social acceptability. As far as the calculations in the third part reflect the real proportions, it turned out that the desirable inequality of individual pensions can be reached in the one-pillar system by applying the tax rates applicable to other incomes and a single moderate subsidy rate. The same proportions can be reached in the two-pillar system too, in such a way that the basic pension reached almost the same size as the minimum pension in the one-pillar system. The postulated linearity of the actuarially fair work pensions could have been preserved in both cases.

In the case of a *privately managed capitalised work pension*, however, the relative calculation is technically impossible and the maintenance of the income proportions between the generations is not a goal. The absolute level of individual annuities depends on the contribution paid through the earning period and the return on the investments. At the age of retirement all these are factors rooted in the past, and the level of the pensions cannot be harmonised with the actual income level of active generations. This may seem attractive to self-confident young people who believe that they know this to be the way in which to make a better deal. However, from the social aspect a wealthy pensioner class next to a young pauper class in a recession is just as undesirable as elderly poor mass on the fringe of a booming society.

Finally, an important factor affecting the social acceptability of a pension reform lies in the possibility of connecting the past and the future. We have proved that *in the scope of social insurance* the old and the new pensioners can be integrated immediately in the uniform system, whether it be a one-pillar or two-pillar system. Although this does not help the relative financial status of old pensioners in comparison with the new pensioners or the active generations, it at least prevents further deterioration of this relative situation. Thus it is impossible to squeeze the old and the new pensioners separately, or to turn different groups of pensioners against each other.

In contrast, proposals promoting the *capitalisation* of the mandatory work pension generally do not bother about those who are already retired (or who will retire soon) when the reform enters into force. Something will happen to them, and this has always been the case. This approach projects two systems operating in parallel over several decades. One of them is just developing, and therefore it requires special attention, and the other one is dying out, so it requires no further attention.

To put it more correctly, it requires attention inasmuch as it represents a burden to public finances, so the reduction of its costs must be accelerated. We have proved that if such an unfair acceleration does not take place then the resulting state debt exceeds the capital accumulated in the funded system; the capital market does not win and the state loses. If the acceleration is carried out cruelly, then the generations already retired or close to retirement will pay for the new capital accumulation, although they have amply contributed to the resources of a long growth period.

To summarise: in the case of a two-pillar system the capitalisation of the *mandatory* work pension and its private management are not suggested. The quotation of Latin American examples does not prove its assumed positive effect with regard to revival of the economy. At the same time its individual, social and budgetary consequences seem clearly negative. We are certainly not against *voluntary*, supplementary private savings. These are desirable and should be encouraged, but not at the expense of the taxpayers or as a charge on social insurance.

In the scope of social insurance the two-pillar system is favoured by its relative simplicity and greater clarity. However, the fact that the general availability of the basic pension would probably moderate interest in so-called "self-provision", the acquisition of eligibility for a work pension speaks against it. The dilemma of the age limit centres upon the following: during the period between the optionally selected age to start to collect the work pension and the age limit of the basic pension, the work pension is not sufficient to make a living. This can be seen as an even greater problem. If an acceptable proposal to solve the dilemma of the age limit is not elaborated, then the intention to preserve the uniform social insurance system, coupled with the positive moral effect of taxing and subsidising work pensions, turns the scale in favour of the one-pillar system.

Appendix
(to the section "The point system of individual pensions")

Notations:

- i: index of a bracket
- x: number of work points
- y: annual amount of pension
- ϕ: forint multiplier (3500 forint/year)
- m_i: lower boundary of work points' bracket i
- p_i: lower boundary of pension bracket i
- c_i: slope of the ith line segment ($\gamma_i = c_i^{-1}$)
- b_i: y-intersect of the ith line segment ($\beta_i = b_i \times \gamma_i$)

The pension as a function of work points:

$$y = c_i \phi\, x + b_i, \quad \text{if} \quad m_i \le x \le m_{i+1}, \quad i = 1,2,3,4,5.$$

Bracket index (i)	Work points' bracket	c_i	b_i	Pension bracket (thousand forint)
1	0 – 25.7	0.33	60	60 – 90
2	25.7 – 28.5	1.00	0	90 – 100
3	28.5 – 57.1	0.75	25	100 – 175
4	57.1 – 142.9	0.65	45	175 – 370
5	142.9 –	0.60	70	370 –

The work point as an (inverse) *function of the pension:*

$$x = \phi^{-1}(\gamma_i y - \beta_i), \quad \text{if} \quad p_i \le y \le p_{i+1}, \quad i = 0,1,2,3,4,5,6.$$

Bracket index (i)	Pension bracket (thousand forint)	γ_i	β_i	Imputed work points' bracket
0	0 – 60	0.00	0	0
1	60 – 90	3.00	180	0 – 25.7
2	90 – 100	1.00	0	25.7 – 28.5
3	100 – 175	1.33	33	28.5 – 57.1
4	175 – 370	1.54	69	57.1 – 142.9
5	370 –	1.67	117	142.9 –

The critical values of the pension function
(thousand forint/year)

Number of work	Single (one and a half) pillar system		Two-pillar system	
points	work pension	pension	work pension	pension
No eligibility	∅	0(60)	0	52
0	0	60	0	52
10 (1st decile)	35	72	20	72
26	90	90	51	103
29	100	100	57	109
35 (average)	122	117	70	122
57	200	175	114	166
70 (9th decile)	245	200	140	192
143	500	370	286	338
180	630	458	360	412

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FROM QUOTAS TO HARD CURRENCY

Company views on the post-Soviet barter period at the beginning of the 1990s*

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The so-called "barter period" at the beginning of the 1990s was the result of special circumstances. Barter contributed to the *survival of international trade* among the transitional economies in an era when inter-state relations were shaken by political factors and the pain of change had upset established inter-company connections. It follows that, with the development of normal trade, the role of barter will *revert to being marginalised* and the exchange of goods, as of necessity, will be replaced by the use of modern financial instruments. However, in the conditions of the so-called "Wild East", neither the tendencies nor the required duration of this process are clear-cut. This article aims to record certain general features of what can be called the post-Soviet or CIS (Commonwealth of Independent States) barter period. It is based on a series of interviews conducted among a number of companies. Actual experiences have enabled us to analyse the underlying causes of the barter period as well as to examine the factors behind the reduction in significance and the falling out of fashion of counter-trade deals.

It is widely believed that following the collapse of COMECON barter was a "necessary evil" in the trading practices of East European countries and as such was merely a *temporary* phenomenon. Its popularity was basically due to the fact that financing opportunities were rather narrow between 1991 and 1993. This was because the CIS countries lacked a banking infrastructure and easily accessible sources of hard currency, which itself was generally in short supply.[1]

In this text the term "barter" is used for all deals (linked deal, counter deal, repurchase deal, exchange of goods, compensation, contingency agreement, etc.) (*Törzsök* 1993) where the parties effect financing by part or full compensation of the value of the goods, or provide financing via counter provision of other goods, irrespective of the number of participants in any particular deal.

Barter turnover is not truely reflected in customs statistics since it is not obligatory to provide the coding for the types of deals on the customs certificate.[2] The *tangible segment of barter turnover* is decreasing year by year. This was confirmed by companies during the interviews which were carried out. It is due to the

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[1] It was not only in the CIS area that barter existed. However, most of the barter was undertaken with that region in the period of time under examination. Products received from Poland in barter trade often proved unsellable. However, Slovak barters were popular and often provided items directed to CIS countries, such as canned goods, knitware and footware.

[2] See research work undertaken by Ágnes *Nagy*.

fact that partners in CIS countries can more or less readily obtain hard currency and licences at present, whereas previously either one or the other was difficult to obtain. For these and other reasons, there is simply not much point these days for companies to engage in the tiresome processes of barter trade.

We can only assume that the remaining barter sphere, as with the early phase of barter, is a rather muddy area of foreign trade and that, due to its "maffia" nature, barter is today *even less tangible* than a few years ago. Thus real information about barter turnover is quite significant. The significance, however, is not merely the result of the "excitement" and fog surrounding it.

Barter as a form of financing is not likely to peter out fully and finally, although both statistics and empirical experience clearly show that by and large *the special barter trade among the CIS countries* belongs to the past. Its disappearance, however, is not complete and is on shaky ground. Barter in certain fields is still a means of trade.

Due to various imbalances in the post-Soviet economies and the variety of their problems in the supply of goods and financing, it is difficult to draw final conclusions—anything can still happen, even reversals. The commodity and currency markets may evolve in such a way that barter becomes advantageous due to the appearance of a relative glut of goods which can be sold in response to a traditional demand for trade in these goods. At the same time there is a local shortage of hard currency and an insistence on dealing with the same partners. However, the demand for barter could never reach the level it was in the special "barter period" at the beginning of the 1990s. It was a period that can be described as one which witnessed the "privatization" of the commodity turnover of inter-state quotas. Central organisation fell into disarray when previous entities ceased to exist, albeit certain personnel remained in place.

At that time barter trade was vital to transition. Barter maintained relations otherwise destined to cease, making up for what was absent in order to continue trading. In disorganised trade barter thus provided an element of consistency and became the minimum resource necessary for survival or indeed for the appearance and strengthening of new, upcoming organisations. It follows that barter has lost its importance with the birth of new economic and social structures. Barter, however, is varied. What is petering out, as normal trade relations are formed, is so-called "enforced barter" (though, of course, it is still too early to describe relations in the CIS markets as "normal"). Yet barter may still be required even when hard currency is available.

Barter is a *living form of trade* and, however strange it may seem, it is even used in the West. Therefore, research into barter trade is useful, despite the final (or maybe temporary?) disappearance of the CIS barter era. There is some point in the exchange of goods, even under modern trade conditions, because it is money-sparing and can be made multilateral with relatively simple accounting using the trading house form. Barter is important not only because it still *exists* in certain spheres of CIS trade, but also because it is primarily *non-monetary accounting* in this part of the world and it will not take a back seat for a long time, given the existing interest rates and conditions of export financing.

It is also timely to take a look at barter since Western brokers specialising in the trade have appeared in Hungary. The first such specialised barter company—a joint venture in Hungary of Austria's Barter-Clearing-International (BCI) network—began operations in September 1995. In addition, the necessity of conducting agreements on a non-monetary basis has even been raised on a state level (SAAB project). The current barter deals, however, are very different from the legendary deals of the CIS barter era, considering their level of profit and indeed extra-profit, their character, economic content and background motivation.

Companies that could be traced via customs barter statistics were not very willing, to say the least, to provide information about this activity. This reflects the fact that *the area in question touches on the "invisible" sphere and approaches the category of, if not entirely "black", then the "grey" economy*. This is supported by the fact that a large number of companies which had engaged in significant barter trade in 1994 could not be traced at the end of 1995, either on the basis of the official address list or via the telephone book.

It most cases barter exports and imports are incorrectly recorded on paper and in the statistics. The arrival of barter goods may often only be confirmed if checking quantities and values reveals a very unreal price per unit. Furthermore, if one or more foreign parties are involved, one or all sides of the trade may not appear in the Hungarian statistics.

Traders are unwilling to label deals as barter partly due to lack of understanding of the matter, and partly so as not to generate the interest of the customs authorities. Experience shows that what differs even to a minor extent from normal business deals will inevitably attract the attention of the authorities. Barter has clearly interested the authorities, especially in the period of legendary profits, i.e. in 1991–93.

The method

The information is based on the experiences of the companies questioned and thus reflects only a small part of reality. Real barter turnover involves immense variety. The interviews allowed us to look at characteristically different entrepreneurial circumstances, which, with some exaggeration, could well be called separate types. Although the whole range was impossible to cover, the reports given are instructive, while maintaining the *incognito* status of the companies. Thus this article employs the following method: the individual stories themselves are published with some comment in the belief that the pieces of the mosaic will finally make up a few decisive elements of a rather colourful picture.

The participants

The most simple form involves barter between two participants on the basis of complete compensation, but since bringing this into being involves searching for a partner, which is not easy, further participants usually join in.

So-called "tri-partite barter" involves the participation of a third party on either the import or the export side. The majority of CIS barters were doubled on the Hungarian side; in most cases the user of the imported product was not the exporter. In classic cases, the counter lot was generally supplied by the foreign producer, who also received the Hungarian commodities.

If the receiver of these CIS goods was not the Hungarian exporter, then either a Hungarian company or a foreign, usually Austrian or German user, stepped into the business. In such cases, any of the three parties—the exporter, the Hungarian/Western importer, or the CIS supplier—could take the initiative.

A third party most often joined in where the exporter who wanted to place a Hungarian commodity on the CIS market (e.g. a large Hungarian enterprise with a traditional interest in the old Soviet market) searched for a partner who would receive the counter goods. One particular type of large state-owned company was closely interested in CIS imports due to their raw materials content (chemical plants, ore users, energy importers, etc.). These were the ones who often looked for domestic partners whose products for exports were in demand in the CIS. Experience shows, however, that in most cases it was often a Western mediator or broker who skimmed the special profit of barter. The interest of the Hungarian party was largely determined by the sales opportunities on the blocked market.

If the export and import sides of barter were separate then accounting was very varied, depending on the degree to which participants were working on their own account or on commission. Accounting could have been in hard currency or forints and risks and profits varied widely according to the nature of the power relations.

Since in 1993–94 Western businesspeople were not at home on the CIS markets, and since Hungarians often played a mediatory role in the barter import of cheap, large volume bulk goods, much of the turnover appeared as re-export on the imports side.

The goods reached the Western buyer often without reloading and repacking and avoided both Hungarian customs and customs statistics.

A fourth, fifth and other parties often joined in the barter deal. The mediator(s) of a barter chain may have formed a whole chain themselves. From then on the route of the commodity, VAT accounts and export subsidies could not be traced by an outsider.

Between 1991 and 1994 both small and large entities, limited companies and state-owned large enterprises participated in barter if they wanted to sell on the former Soviet market. Both producers and businesspeople took part in barter, yet there was a surprising difference between the small and the large companies. Not all the small companies were clever and were thus unable to take advantage of the existing opportunities. However, among the large enterprises questioned there was not one—and it cannot be accidental—which would have used this structure for anything more than sales (for example, gaining outstanding profits), although at that time a lot of profit could be made in this business. The large companies participating in barter joined in to maintain their presence in their old markets and it was enough for them to find a third Hungarian party to receive the raw materials arriving as payments for the exported goods (medicine or buses in the case of some of the enterprises questioned). On these occasions the business was concluded at world market prices due to the fixed price of the Hungarian counter goods.

The business philosophy of a small unit was often completely different. Of course, among them there were some whose primary interest was also to sell (for example, a distributor of dental laboratory units, a producer of fish feed, or a telephone network installer). While the special profit of barter proved to be a fortunate side product, it did not really motivate the business in the beginning. Real barter traders were, however, moved by the business itself. These entrepreneurs tried to match every pair for exchange where money was to be found and they traded with everything. The opening of sudden opportunities for this special business attracted them with its extra profit during those three or four years.

The participation of banks raises a separate problem. Although at the time of inter-state agreements accounts held by banks were used, as the period of prompt collections ended. Banks (losing their initial enthusiasm while simultaneously becoming aware of the risks) withdrew from barter trade before they had really got into it. The principle reasons were the lack of readiness and lack of ability of the banks to take and bear risks, and the low level, or in many cases the non-existence of banks in the CIS. Practising businesspeople often complained of the non-functioning of the banking infrastructure. In many cases they blamed the failure of possible business deals on precisely this. Although Western companies in barter often agreed to search for partners in principle and agreed to organise the accounts, they were not able to solve the problems of barter in this field because they were afraid of doing. This was because they did not have a network of contacts in the CIS countries at the time.

One feature of the barter era was that *business deals were executed with primitive methods*: the truck left and came back, it was unloaded and loaded without using a forwarder or insurer, at own risk and with the weaker party's advance delivery. The latter was the Hungarian party in the 1980s and generally the CIS party between 1991 and 1994. This fact made small firms lacking large capital prefer this form. The size of the transport was determined by the firm's risk-bearing strength and skill, as well as its working capital. After 1993 even CIS partners would not supply in advance without guarantees, and this was one of the reasons for the decline in barter turnover.

Characterisation of the CIS barter era

The barter wave of the 1990s was the product of a specific period. Barter existed before 1991 and it has existed since 1994. The four-year period between 1991 and 1994, however, can be described differently from the preceeding and the present years.

Barter today is the privilege of a few. It is no longer an easy option for new traders and "knights of fortune" trying to make money nor can it be the touchstone of their enterprising ability and courage. It is not the "game" of many as it was earlier.

The deals of this era were different from the barter deals of the 1980s. They were quite different from the direct exchange of goods which characterised the earlier inter-state quotas, and also different from the barter agreements of companies in the COMECON era at the end of the 1980s. These antecendents are, however, very important because they involved *stability for the participants when there was no other way of maintaining relations*.

The *national economic significance* of the barter era, therefore, was to ensure the continuity of inter-company relations in a market which was extremely important and decisive for the Hungarian economy: in effect it was *a vehicle for the change of system in trade*.

As with every transitory formation, it also displayed all the anomalies of a confused era. The barter trade which today survives to a lesser extent bears the marks, albeit *in a mature way*, which differentiate this special, characteristically "Wild East" type of natural exchange from "civilised", modern trade.

The most important features of the barter era were as follows:

— natural exchange with the concomitant exclusion of money circulation and its institutions;

— neglect of the product characteristics and quality standards of the exchanging pairs;

— exclusion of specialist services participating in the technical execution of trade (forwarding, insurance, financing, distribution of risks, etc.);

— trust;

— good or occasionally outstanding profits;

— complicated transactions stimulated by profits, large volumes and natural chain relations;

— the overlapping of legality and illegality with the aim of taking unlimited advantage of domestic preferences and loop-holes in the regulations;

— obtaining the rights to the disposal of typical barter commodities irrespective of whether the resources necessary for this are available;

— a trend towards the criminalization of barter trade.

Roots of the CIS barter era

A compensation deal is usually concluded if one party is interested in obtaining goods at the other party's disposal. In this case the products are complementary. They are related to each other in some vertical line of production, or they feature in a specialised trader's range of goods (they may be semi-finished or finished goods and/or may increase the range of goods). If barter is not used primarily to facilitate the supply of vertical needs or to take advantage of financial or other comparative advantages, but is something *dictated by necessity*, it is characterised from the start by a potential to disappear when the original determining circumstances cease to exist. This is what happened with the CIS barter deals.

In reviewing the following companies, we will take a look at some other, even more important issues.

Inter-state quotas

The system of agreements with regard to the exchange of goods was common. Participants were familiar with it and it was an obvious necessity for them to maintain the turnover of various pairs of exchange adjusted to their needs.

One company was among the first to obtain the right to conduct foreign trade on its own behalf. Although it was known as a *user of textiles*, it had already traded in various commodities, such as canned food and wheat, and it had stable relations on the Soviet markets. It conducted barter deals from the middle of the 1980s because its Russian partners could not pay. At first it was possible to include the counter goods in the quota, but later these deals were concluded separately. In this situation, its partners were always happier to pay with goods, but in time the Hungarian company also insisted on barter.

According to one manager of a *trading company*, machine industrial firms used to account for 80–90 percent of industrial exports because the majority of these exports were part of a network of deals. Today, in his opinion, exports have slackened because there is no state coordination. In the past, Hungarian machine industry products, backed by state credit conditions, were competitive and thus were exported to places such as Libya or Brazil. Inter-state quotas were secure.

Many of the companies questioned, particularly the large ones or the small ones closely connected to the large ones, spoke about the former inter-state quotas with some nostalgia. The deals were looked after by the state and they involved the use of bank accounts.

One Hungarian manager commented:

"The loss of markets for Hungarian *bus manufacturing* was partly caused by the state spectacularly withdrawing from the companies. Meanwhile Turkey, for example, in its trade with CIS countries has managed to arrange that a part of its gas and oil imports is counter-balanced by the supply of buses. This is also true for the Czech Republic, albeit to a lesser degree. In addition, the Czechs are 10–15 percent cheaper than us due to subsidies. South Korea has also appeared on the CIS market and in no way can we compete with their credit arrangements. The ministry under László *Pál* tried to introduce some state organisation, but it resulted in failure. True, the minister signed an agreement in Moscow, but it doesn't work in practice. The Ministry of International Economic Relations under *Kádár* didn't want to see commodities balanced against commodities, while the current ministry doesn't have any preference in this area. The Czech are in a better position since the state hasn't withdrawn from companies so clearly as is the case with us."

"Barter may be used with Vietnam or China, but without the support of banks or the state a small firm cannot penetrate such markets. What would be required is state barter agreements copying the old inter-state quota arrangements. However, GATT bans these, yet bilateral exchange could still be organised using the mediation of banks. Ministries should get involved in organising something since several post-CIS countries will be unable to conduct normal trade for some time and our products are needed there as much as we need theirs. Small trading companies are unable to finance the stocks and the organisation on their own. Singapore has been able to set up a semi-nationalised trading house—we should be able to do something similar."

Lack of hard currency

In 1991 when, from one moment to the next, the Soviet budget could not provide enough hard currency for the republics, barter became an obvious form of maintaining trade relations.

"Barter came about because the Russians were insolvent", says one Ukrainian-born businessman who, as sales executive of a Hungarian company, trades mainly with his native country due to his knowledge of the market there. "As the situation improves, so barter decreases. Traders were suddenly faced with a free market. This was one of the reasons for barter since businesses were scared of trade—they were no good at it. Old Russian traders were not really businesspeople, but bureaucrats who handled affairs. They knew each other but were afraid of others. They were the ones who had an interest in barter. They established private companies but didn't know anything about business or means of payment apart from barter."

"At that time licences didn't exist. In the beginning they paid with raw materials, but they realised quite early that such goods could be sold for hard currency in the West. At that time the major shortage was not in hard currency, but in licences. The biggest participants in barter still engage in it, though they are much richer than before."

In 1992 the Soviet Union collapsed and its largest market, Russia, banned barter. In 1993 barter was again allowed, but was taxed. Finally, in 1994 barter further declined for various reasons which will be discussed later.

Permanent exchange parters

Barter contacts, which started in the mid-1980s, mainly ceased to exist with the disintegration of COMECON and the changes in the partner companies—however fruitful they had been. This in itself signalled that *barter is a business based on trust, which is always related to certain persons. If the latter for some reason disappear* (for example, due to the disintegration of a former nationalised enterprise), *the deal is over*. The well-oiled system in most barter arrangements is a stabilizing factor.

One wholesale company questioned owes its existence and development to a Soviet barter deal. Its only starting product was a type of fish feed called "Tetra", which could not be sold in the West. However, it sold well in Moscow shops due to its low price and its quality.

In the period 1987–90 when barter existed, the partners were identical and turnover value quadrupled. The *counter product* was also fish feed, which the small company would have been unable to purchase for dollars. Several compensation possibilities were available—*dried fleas*, crab, other animal feed, etc.—and the company, which was involved in the *pet wholesale business*, needed to utilise them all. The company developed steadily due to this very peculiar barter.

"Products are special, partners are lasting and reliable, the counter lot is given and everyone has an interest in the business which generates significant profits", noted a representative of another company. "The majority of partners get involved through *personal contacts* and not by chance. In this profession *everyone knows everybody*, therefore risks are not too big."

"Experience shows that to conclude a deal with people you know is difficult but it's possible—with people you don't know it's easy, but you shouldn't. The old hands have already got what they want, don't want to rob you and are better at it." (According to the interviewee, this also holds true for Hungary.)

"We supply telephone network equipment (imported from the West) to the CIS and in exchange workers from there (actually ethnic Hungarian from the Sub-Carpathian region) go to Arab countries where they work alongside Hungarian engineers and technicians. Our barter arrangements with Slovakia are of a similar nature only in reverse—our experts go to Slovakia and products from there are used or distributed by us."

In the case of raw material/manufactured product exchange it is easy to find partners and maintain permanent contacts, and thus barter is an obvious option. This type of relation is usually fair and allows for risk-free business practices. However, it was difficult to track down examples of vertical barter among the larger companies questioned since setting this up *did not become a strategic aim*, even in the CIS barter period. Although the empirical evidence is not sufficient to generalise fully, it can be stated that the period in question was characterised more by spontaneity than any form of demonstrable strategy.

"The *pharmaceutical works* experienced its most difficult period in 1992. We didn't go into barter directly ourselves at the time, since it was easier to participate in others' barter deals. We did have our own barter deal once, in 1993–94. It was coordinated by our Moscow representative office by comparing the supply of and demand for basic materials on the part of the factory and the republics. In exchange for some medicines, we managed to obtain from Ukraine some basic material which we had previously purchased from Scotland."

The exchange pairs

There were both typical and special barter items. Cheap Soviet raw material imported in large volumes was the most commonly traded commodity in exchange for Hungarian foodstuffs and consumer goods.

"Large quantities of different types of raw material would come in—cotton, wool, crude oil, plastic, metals, logs or sawn timber, or part-manufactured goods. In exchange consumer goods were nearly always sent—clothes, foodstuffs, wheat, flour, canned goods, knitware, textiles and footware." The company developed its wheat business such that it set up its own warehouse for the purchase of corn. It still manages this on its own account and deals in large quantities.

The company had fairly large deals in oil—50–60,000 tonnes on each occasion at a value of HUF 200–300 million. "In oil circles that's nothing, still it was big business for us. Very simply, it was done within a few hours. You only had shift the papers around and results appeared nicely. It doesn't happen these days because the old contacts are gone."

"If there's a profit of two fillérs we'll do it, risking a lot. The lack of expertise has sometimes caused problems, but it's not characteristic. Meat and tinned vegetables, clothes, footware, knitware, wheat, flour and corn can be sold by anyone—you don't need a lot of expertise. We used to deal in these goods exclusively with barter, but no longer. We still export wheat, flour, pasta and corn if required, because you can't stop from one minute to another due to the lack of subsidy. And we used to import non-ferrous metals and semi-precious stones—and we could do it. There were times when profits were very low, but we never experienced losses."

"In 1991 it was easy to find counter goods—several items could be obtained for *buses*. Half of these goods could be sold on the domestic market, the other half was sold to Austria. Domestic sales did well as others could not obtain the goods. Commodities like cotton, anti-freeze, salt, coal and ore were easy and cheap in the former Soviet Union, and exports were not tied to licences. There were some special counter goods, too, like bicycles, paper, garlic and sardines. We got involved with a wide range of things then, because the factory had to sell."

At the start of the 1990s *pharmaceuticals* were still a strategic commodity. They could have been easily exchanged if the factory had used barter at that time. In 1992 the Hungarian company appeared to have lost the market, but later it managed to gain some ground with hard work.

In 1992 Vnieshekonbank owed USD 48 million to the industry. Half of that was owed to the factory in question. The dominance of Hungaropharma was lost at that time. Old traders no longer purchased goods and new ones had not yet appeared. Turnover dropped both on the domestic and the most important CIS markets, where, due to the outstanding debt, the will to supply was absent, while at the same time demand was low since imports were no longer centrally coordinated. All these factors resulted not only in disappearing trade, but also in the near disappearance of the pharmaceutical plant itself at the peak of the barter era in 1992.

Although the demand for medicine in the CIS countries continued to exist and several Hungarian companies recognised the opportunities presented by pharmaceuticals exports, tri-partite barters to the tune of USD 20–30,000 could not make up for tens of millions of dollars of lost exports. At that time much of the barter involving pharmaceuticals was conducted by foreign (German, Swiss and Finnish) brokers, who thereby creamed off the profits. At least ten percent of all pharmaceuticals exports sent to CIS countries in 1993 was handled by Western brokers. Although the products of the Hungarian company were in demand, the company on its own had not been able to obtain the hard currency without Western partners.

In barter it is not only goods that can be exchanged for goods, since goods for services can also be exchanged, or even services for services. In these cases the deal is stimulated by the necessity to export or maybe the different pay levels of the two countries. With the above-mentioned pharmaceutical company, the partner in the CIS may organise an exhibition or engage in marketing in exchange for medicines. The telephone installation company sold sent goods in exchange for services. One trading company did some marketing for a German partner in exchange for repair technologies or reconditioned spare parts.

One barter, which is currently underway and which will extend into 1997, is valued at approximately HUF 200 million and is part of a one-and-a-half billion forint deal. The company has already supplied the *telecommunications* equipment to Ukraine and in return Ukrainians will participate in installation work in Arab countries for four years. The market could bear much more than this, but the Hungarian owner (which enjoys a monopoly in telecommunications) is not really interested in the Ukrainian market and in fact the business came about almost independently of the owner.

A Ukrainian-Hungarian joint venture regularly participates in tenders of oil-producing countries. It often wins installation contracts in which the Hungarian company is a partner. The latter supplies Western goods necessary for the installation and the Ukrainian workers do the installation on location. The Arabs pay in dollars and Western imports are financed from that. No goods enter or leave Hungary itself.

Reasons for decline—in general and in particular

The decline of barter turnover is a *general tendency*, according to both statistical data and empirical evidence. Apart from the normalisation of bilateral trade, it is explained by *factors of both a domestic and foreign nature*. The trade in large volume products, with its attractive super-profits, has become overrun by "mafia", whereas the less profitable barter has "found its place".

Besides the political changes and the effects of transition in the former Soviet Union, *central measures directly* affecting trade have also played a role (e.g. the banning of barter, then later taxing it).

Barter turnover started to fall sharply in 1992 due to the *deteriorating economic situation*. Production dropped and partners found it difficult to offer goods for exchange.

"Former textiles partners have disappeared; big factories stopped working. For example, our Belorussian joint venture was idle for half a year. We always sold yarn—not now. Living conditions have become so bad that people can only afford to buy food. Our joint ventures are operating at a loss, continuously using up their assets."

Another reason for the absence of export goods is the over-valuation of the rouble with respect to the dollar and to the purchasing-power parity, which draws the goods to the domestic market.

"The rouble exchange rate is absurd in Russia. A dollar is worth 7000 roubles at the moment, but it should be at least 10,000. Russian raw cotton costs two dollars on the world market, for example. If it's sold on the domestic market the seller can convert the price to three dollars. Therefore the producer is not interested in exports. What happens is that we export goods there for dollars. They want to keep goods in the country for the time being, at least that's the case with basic textile materials."

Besides the above, several explicitly *trade factors* have affected business deals adversely. A few important factors are discussed in detail in the following.

Changes in the CIS commodity markets

Where there is demand for Hungarian goods, any *shortage* of such goods creates multiple *price increases* and thus the increase in free, hard currency sales have changed the strategy of CIS businesspeople.

The *company dealing in animal feed* used to buy crab for roubles worth HUF 300 and re-exported it to the West for HUF 500–550. The profit amounted to 10–15 percent. Today the Russians export it themselves for hard currency at a value of HUF 1000–1500. Customs duties can somehow be avoided in barter, but purchases for hard currency are taxed and subject to customs duties, so it is no longer economical.

In recent times both the *organisation of trade and trade policy* have changed significantly in the former Soviet Union. The distribution of goods used to take place via a single central channel. When that went, all the components of sales changed. The new regulations began to take effect as early as 1993 and in the bigger cities many people were replaced. New wholesalers appeared, new sales channels opened and working capital is now also available in some places. The old system of connections changed to a new type of system based on confidence and interest. The peculiarity of selling in the post-Soviet market is that the further away a town is from Moscow, the more difficult it is to discover the interest-related connections.

The popularity of barter in these countries is limited since the profitable barter goods are difficult to obtain. A new, special right to certain export goods has evolved, which represents a type of sales monopoly. The maffia often holds the monopoly, or sometimes foreign capital does. West European companies have built close connections with manufacturers and monopolised the sales of certain products in Western Europe. Typical barter goods require licences.

"What grows or is produced there is taken out of the country by them. We quit. They pay better, finance the economy better", complained one interviewee.

"A region, for example, may have had the right to sell copper in return for Hungarian medicines, but the commodity is no longer at the region's disposal. It is the factory which can dispose of the copper and it will say it doesn't need medicine, but something completely different—perhaps an assembly line. There's a new wholesaler, but the factory won't sell the goods to it either, because only the "select" may trade in such items. On that market, where there are too many regulations and only a few have authority over "strategic" goods, barter is a dying practice."

"With the *bus barter* the buyer is a public transport company or the local authority which the company comes under. The factory providing the products in return may be only very indirectly interested in others getting vehicles for its products. The opportunities for direct exchange are slim and trading buses can be undertaken only within a limited circle. A city with a population of one million would need 50–100 buses to a value of USD 5–6 million. Given the value, goods in exchange would mean raw materials, primary materials, ore or metals and their market is quite regulated in the former Soviet Union today."

The central licence requirement for raw materials reduced the possibilities for bartering buses because the goods were no longer available to the Hungarian manufacturer's usual connections. Low-value sales added together could not compensate for what was lost. It proved impossible to maintain the earlier level of exports using either barter or hard currency. The regional or republic management in charge of free goods obtained and sold the raw materials on the basis of confidence. It no longer purchased buses in exchange, but food, clothing and other general consumer items. The circle of buyers has specialised and narrowed to towns and public transport companies, where experts are involved in purchases.

Changes in the financing systems in the CIS republics

In the hey-day of the barter era the factories themselves purchased goods in return for their products. However, since 1995 the currency supply is realised in a form of tax system—the factory pays tax to the town and the town purchases goods in exchange for the dollars it has obtained by changing a part of the tax. Immediate cash payment is dominant both in Hungary and in the former Soviet republics. These days, Hungary's crawling peg system of devaluation also stimulates prompt payment. Among our examples, one company (the telecommunications firm) insisted on advantageous terms of payment.

"Everyone pays in advance. Long-standing partners may be able to pay by transfer later, but it's rare. Supply without prompt payment has disappeared. We insist on receiving at least half of the invoice value in advance. The rest should be paid in 15 days, but actually it usually takes 30–40 days.

"You can obtain our kind of goods only for cash. In 1995 Hungarian mills sold flour only against prompt cash. They didn't accept bank transfers because prices of corn were changing so fast that the time taken to effect a bank transfer was too long."

Special import limitations; changes in purchasing policy

Buses were no longer exempt from import, customs and tax duties in 1993. The exemption was reintroduced for public transport companies at the end of 1994, but by then the regulation had already reduced purchases. Import limitations grew for other products, too.

"Today it's not demand but licences that limit sales in the *pharmaceuticals industry*. A copper producer may ask for medicines in exchange, but they will not get the licences. A general import licence for pharmaceuticals, a domestic distribution licence and a separate licence for each transport are required. Obtaining a licence through the official channels takes several months. We have had a consignment warehouse for two years, but our partners have been unable to obtain the general licence... Pharmaceuticals suppliers in the provinces find their way around the non-official channels in Moscow with difficulty. There is a one million dollar limit, which is not much for a serious wholesaler. As soon as he gets one licence he has to start lobbying for the next. A trader who deals in everything from primary materials to medicine requires so many documents that they may cause paralysis!"

The direct exchange of goods has also fallen due to *changes in the Hungarian supply*.

The fall in the competitive nature of Hungarian goods

The vulnerability of Hungary's traditional industrial structure was based on the fact that the majority of products were manufactured as a specialisation within COMECON, were developed for the vast Soviet market, were produced in enormous quantities and were unsellable in developed market economies. The barter which followed the inter-state agreements was ended by the import competition which opened up with purchases for currency in the CIS markets. Medicines have been mentioned, but others such as bus production and the machine industry were similarly affected.

"Hungarian *pharmaceuticals* have lost their costs advantage because Western companies launch their products at introductory prices, below the domestic ones. We also had to compete with cheap, poor quality medicines from India, Turkey and Cyprus. In 1992–93, when anybody could export to CIS markets without any licence, plenty of "con-merchants" appeared and made huge profits. Although the latter have been squeezed out because of quality considerations, the price competition resulting from Western imports has injured Hungarian medicines."

After 1990 trade with Russia changed. People left partner companies and set up their own businesses. A type of "adoration of the West" also began. When new Hungarian entrepreneurs wanted to establish a joint venture they could barely compete with Western firms, which sometimes gave away cars as presents or provided other advantages. This is how the company dealing in animal feeds lost its Moscow market.

The winding-down of domestic industry

Companies squeezed out every product that could be exported for the last time in 1992. The winding-down of Hungarian industrial companies began in 1993 and was completed in 1994. Industrial exports decreased and demand for imports increased resulting in a severe balance of payments deficit. Reducing production capacity was sometimes accompanied by liquidation of the sales organisation.

The *export of machinery, equipment and spare parts* and the import of related technologies decreased considerably with one company we questioned, since its supplier factories (Láng Machinery Works, Industrial Equipment and Machinery Works and the former Pest Regional Machine Factory) either went into liquidation or now manufacture goods not up to export standards.

Bus sales might have been easier if overseas representatives of the bus company had been better. However, in 1993 the bus company already had significant problems and due to financial cuts organisations abroad had to be reduced. The technical staff were recalled and a year later, when no results had been achieved, the business staff followed. The company maintained trade representative offices only in Moscow, Saintpetersburg and the Ukraine. Local personnel were appointed to replace those who had been called back. The idea was to introduce incentives based on results, but the outcome of it all was rather ambiguous.

The increasing financial problems of domestic producers

Since the Russians do not supply in advance, neither manufacturers nor businesspeople have sufficient working capital to finance exports in large volumes. At the same time, if they offer Hungarian supplies in advance they run various risks. Exporting for hard currency is much simpler. Re-exporting is no alternative because of the financing obstacles. Export credits do not exist in practice, because banks are unwilling to shoulder the risk. There are few bank connections with the former Soviet republics apart from Russia because there are few banks. Although a Hungarian party could give guarantees for the advance supply of the foreign party, that would further reduce profitability, which has already suffered a lot. Producers have sometimes tried to apply complicated solutions to these problems, but without much success.

Given the financing problems of *bus exports*, sales were to be connected to items required from CIS countries, provided the Hungarian importer (perhaps re-exporter) financed the business. The aim was to conclude an annual block contract, with an occasional price check. Only small companies with personal contacts got involved. The majority had been earlier involved in manufacturing. The counter item is usually wood. The problem, however, is that normally the lots are small, being the equivalent of one or two buses. Dunaferr was the only large firm with which it was possible to cooperate in practice. Large importers such as Mineralimpex or MOL (the Hungarian oil company) have no interest in the direct exchange of goods as they can realise better prices using cash turnover.

The difficulties of finding a partner

It has become increasingly difficult to find business partners since old trade relations have disintegrated, enterprises have changed, the private sector has emerged and the Soviet Union has fallen apart.

"Since they began calculating everything in dollars and nearly every retailer buys on his own account, there are no serious wholesale exchange partners. In the *small animal feed trade* it's the maffia that rules OK!"

The cleverest among those we interviewed, a tiny plc. located in the empty headquarters of a former large company, does business in everything that promises profit. Previously they had their own man abroad but the old contacts disappeared, as with the other companies. "If you want to do business today you have to visit the enterprises there and bribe the new managers, otherwise it is impossible to buy or sell." The company's three top executives are continuously travelling to the CIS republics on the basis of the information they receive from their representative office.

Since Western businesspeople have ventured into the CIS the majority of sales have been conducted in hard currency and barter has become rare. One specialist barter company operating in Hungary also made no attempt to spread its network in the CIS. The biggest problem obstructing the use of their services is that they are forced to insist on the purchase of West European goods in order to keep the account.

A specialist barter company from Munich contacted the *bus factory*, but it would have involved price increases of approximately 10 percent in both directions. The factory assembles the buses from part units and changing the suppliers is rather difficult given the existing complicated system of specialisation.

The factory set up a barter team to increase *bus sales* at the end of 1992. They launched a heavy campaign of advertisements and circulars in distant republics and cities, then delegated their own people to industrial centres and capitals to demonstrate the products. The results were rather mixed, but there may have been some subjective reasons for this.

The biggest obstacle to increasing the export of *dentistry units* is that partners cannot be found to take the offered counter products. A ten-fold export volume could have been achieved if someone had taken on these goods. Metal plates, which seemed sure of a market, were offered by a small town in the Urals, but no buyer was found.

Subjective reasons

The businesspeople interviewed mentioned the following as being among the subjective reasons—lack of business expertise; weak Hungarian business activity on location; traders leaving their jobs following the transformation of commercial organisation, resulting in the lack of concrete expertise; change in the owner's attitude or indifference following privatisation; lack of people speaking foreign languages; and "adoration" of the West. Most of these factors characterise the Hungarian parties as much as those in the CIS.

"*Hungaropharma* was not on top of things because of problems of a subjective nature as well as faulty evaluation of the situation. They didn't think that the Soviet market would collapse. They just thought there would be some temporary confusion. It was at this time that they did away with the barter section, dismissing the employee who dealt in barter. In the *pharmaceuticals factory* there was only one person dealing with Soviet relations at the department of former "socialist" exports. He couldn't cope with discovering the new patterns despite the fact that those on location were also on the lookout for new contacts. The factory could only export if it accepted the initiatives of a third party."

The risks of barter deals

Any product on the CIS market is quoted at world market prices, yet this does not make trading easier in this part of the world. The supplied goods are sometimes not up to the level of the samples. Delivery dates are unsure and unreliable. If the seller takes on delivery, he may not obtain the means of transport, the licence, etc.

The professional hospital planners and dentistry experts were competent perhaps in domestic matters. That limitation of experience would have represented a disadvantage in normal times, so it was a miracle that the company stayed on its feet in the confused conditions of the transition period. Barter did not produce any profits—it was too complicated and more expensive than they had thought.

The company supplied 20–25 dentistry units to the CIS market. Seventy-five percent of the deals involved barter. Given the problems, it now tries to effect sales for hard currency. The third party to the barter was the Hungarian buyer in the CIS republic and it was he who got the deal underway. The story is as follows:

The Peremarton Chemical Works (PVV) wanted to purchase copper sulphate. Its Russian partner wanted dental surgery and laboratory equipment in return. On paper this meant three business deals: the import of copper sulphate for PVV, the dentistry company supplied PVV, and the latter paid in forints and exported any additional dentistry materials for hard currency. Calculations were made in dollars without using banks.

This adventurous barter lasted four years. Then Peremarton went bankrupt and could not pay for the counter goods. They tried to sell the copper sulphate for a year, during which time the owner in Moscow changed and the new one delivered the product without a concrete buyer. Warehousing caused packaging losses and deterioration in quality.

Meanwhile the dentistry company was organising the lot for delivery with huge physical and financial sacrifice. The Moscow partner found a Hungarian buyer for the copper sulphate, but by then, in the game of "who's responsible for what?", delivery costs together with quality and quantity losses amounted to HUF 2 million. The company had to take on a half a million forints of this as well as grant half a year's delay for payment for the delivered goods. One and a half years was not enough for the factory in the CIS to be able to complete preparations for receiving the equipment. In addition to the loss due to deteriorating materials, significant warehousing costs were also incurred since a laboratory and its equipment designed for special requirements could not be sold to someone else. The original quotation was long out of date, but no price rise could be effected.

After Peremarton, the chemical industry passed the company from one place to another. An unsuccessful attempt was made with TVK. Then it concluded four barter deals with the Ongotrade company of BVK, which imported primary materials in exchange for dental and laboratory equipment. The company delivered in forint accounts. The goods were delivered, as suggested by Ongotrade, in line with the consignments sent in lots from Russia to BVK. It was always the Ukrainians or the Russians who got advance deliveries. All this was comfortable and risk-free, but the profit, if any, was not realised by the dentistry company. Each deal was delayed, partly due to internal BVK problems and partly due to deficiencies in receiving the goods. There was always a delay of 2–3 months between delivery and accounts being sorted out, so profits were lost mainly because of devaluation.

The same company also concluded some business with Metrimpex. Lada spares were imported in exchange for dental equipment. Yet once the car factory accidentally sent an invoice amounting to the domestically accounted value; however, Metrimpex did not complain, so it received HUF 6 million less than the contracted value. The difference between the domestic Russian price and the amount the accounts stipulated was 45 percent.

Methods of risk reduction

Avoiding advance delivery

In the 1980s Hungarian advance delivery was still normal.

"It was always us who delivered before the other party", one wholesaler recalls, "although it was never higher than 10–15 percent in quantity. We avoided risks by starting with small consignments and, depending on how the goods in return were delivered, we increased the exported quantity on a monthly basis. The Russians were always slightly in debt, but it was insignificant, partly because they were all right as partners and partly because we are a small concern and we don't run high risks—although they still owe us half a million forints. However, we couldn't avoid delivering in advance because one professional team faced a state-owned company and our partner couldn't have legalised the deal with the centre otherwise."

Between 1992 and 1993 the Russians were willing to deliver in advance in exchange for customary, suitable Hungarian goods. Thus the financial burden of exports was born by the barter imports. This facilitated the participation in barter of small companies which otherwise would not have been able to finance the usual quantities.

"We imported it, sold the goods and made a profit. Then we bought what we wanted, exported it, made a profit again and used their money for months. They found it hard to find a realiable partner, so it was OK for them, too. There were times when they had several hundred thousand dollars over here. Sometimes we were unable to sell the goods and we were the losers. Sometimes we financed them, but that wasn't usual. The counter goods were bought only when delivery was due. We mainly chose counter goods (such as textile products, suits or food) which could be purchased quickly and didn't require either warehousing or working capital."

Interest in barter changed after 1993 and barter deals would have been difficult to conclude without Hungarian advance deliveries.

"Everything's changed there in recent years. Everyone is scared. They all want the other to deliver first. The old hands have left and set up their own companies which lack capital. They can do something only if we deliver in advance."

Another company recently tried a barter deal amounting to USD 50–60,000. Half of the required Hungarian food was delivered and the offered polyamide granules in exchange were awaited. The aim was to sell the latter after delivery. Since demand had previously been large for military purposes, it was not thought it would be difficult to sell two or three wagon loads of the goods. Attempts were made, both at home and abroad but the product, although first-class, could only have been sold at a loss due to price cuts which had taken place in the meantime. The deal showed a minimum profit on the export side and a 15–20 percent loss on the import side. Deliveries had to be stopped to see if the partner would pay.

In 1995 the same company hardly bought any goods on the CIS market, although it still exported products there. It sold Hungarian goods and Western machine parts with a minimum profit, taking advantage of the fact that the Russians could not pay cash in advance to the German or Austrian machinery manufacturers. The company delivered because of old contacts and gave credit of one or two months.

Bank guarantee

With inter-state barters prior to 1991 (including quotas with Turkey, Greece and other developing countries) a bank kept records of bilateral deliveries, and also recorded private commercial barter agreements. The National Bank of Hungary took the risk and provided the guarantee to the Foreign Trading Bank. Since these "barter deals" were organised by the Foreign Trading Bank, demand could be matched with the product range of different companies.

At the beginning of the 1990s Hungarian banks were making attempts to keep accounts. They concluded agreements with individual republics, but these never functioned in practice. (*Lamberger* 1992) One agreement between Commercial Bank of Hungary and a bank in Moscow survived the longest, but the turnover recorded on the account barely reached USD 8–10 million.

"A bank is needed if delivery by the partner cannot be relied on for some reason. For example, one business connection had just started with a cable export to Ukraine and the value of the consignment was large. Information was required regarding which Ukrainian bank guarantee was worth obtaining. We were given valuable advice, the deal was concluded, although profitability decreased somewhat due to the increased costs. Since everything went smoothly, later on the bank guarantee was no longer required."

Hungarian banks no longer participate in the turnover—they do not shoulder the risks. They are prepared to work with a few banks in Moscow, but know little about others far away. For the time being they are reluctant to accept a guarantee or trust the readiness for payment of these new banks, even in the case of cash deals. In most cases they are not prepared opening a letter of credit with other banks and accept only cash transfers.

"According to the latest tender, buses should have been sold to Vilnius with a five-year credit and to the value of USD 6 million. The Czechs were able to take on a five year credit. We couldn't because no Hungarian commercial bank would have accepted the guarantee of a bank there for five years."

Businesspeople in some cases are inclined to accept their partner's bank guarantee, but it would be a legal nonsense. Such a guarantee could not be effected in case of non-payment because the matter is correctly an inter-bank affair.

The *pharmaceuticals factory* would be willing to open a factory in the Far East, given the guarantee of a local bank. Since no Hungarian bank would back the deal, the factory either does it itself or does not open the warehouse. The partner factory does not have sufficient working capital itself to have a trustworthy foreign bank to guarantee the deal for them.

The low opinion which companies have of banks is general and widespread. The companies we questioned did not use banks because they did not regard them as suitable for their activities (they are too careful, have no idea what is going on, are expensive or slow, they hinder or prevent deals, were common responses).

The sources of barter profit

When turnover was calculated in roubles, the "world market price" was never mentioned in connection with barter deals. There was a huge *"re-evaluation" opportunity* in the rouble-dollar exchange, which remained for a few years in the period of transition to a free currency. However, these opportunities were not used by everyone to make super profits.

Compensation took place according to a special calculation, using a jointly-formed accounting price in one of the really honest barter deals which took place at the end of the 1980s. "If there was a higher-than-expected profit gained from the sale of the imported product, the Russians got the exchange goods at a cheaper price. The volume was managed according to a five-year contract whereby we checked the prices and the range of goods every year. Rouble faced forint without a bank. We didn't use hard currency as a guide for exchange purposes—we didn't know then that it didn't meet the legal regulations on currency at the time."

The main benefit for companies which sold their goods virtually exclusively to eastern markets, and whose existence basically depended on COMECON, was *that they could maintain the level of sales*.

"The Russians couldn't get over the shock that there weren't enough *buses* while public transport was deteriorating. Barter was good business, even when we had to stick to world market prices in exports."

"We supplied machinery spare parts in exchange for raw linen and cotton waste. Deliveries were determined according to how the counter product and licences could be obtained. The barter was initiated by the Russians and organised by a permanent representative office with changing partners. It was the *opportunity to effect machine industry exports* that attracted us and not the higher-than-average profit. That is why we took on the painful process of selling the goods that were delivered in return."

Barter profit did not primarily originate in the difference between "calculated" and "real" prices, although there could be huge profits in that. Barter provided the *only possibility of development* for several small Hungarian companies. Those deals did not produce profits counted in millions, but the results were not negligible either. Alongside the fish food barter, the case of the company specialising in dentistry exports can be mentioned here.

Prices per unit in barter deals are different from hard-currency prices due to the character of the business. Gaining a market for, and selling the goods received in exchange involves real extra costs, especially when a market is depressed. Over-invoicing, however, sometimes surpassed all imagination. Special "accounting prices" helping to make up *unit prices which lacked any relation to reality* and which were intended to hide profits and to obtain preferences that foreign trade offered.

"In 1991 one company (not us) imported linen from Ukraine and sold sports shoes. The two sides could be balanced if a pair of shoes amounted to one-and-a-half dollars. You can imagine how much the company made on the linen if such prices had to be put down. This doesn't happen any more. Prices have shot up so much there, that they are higher than in the West!"

A Slovak telephone post would have cost HUF 10,000 in normal trade. In barter it was no more than HUF 6,500. The difference derives from the different pay levels in the two countries. No way would we conclude deals at world market prices! Everyone does well—we share the profit!"

Since re-export, frequent in barter, was not seen by the Hungarian authorities, *price manipulation* was relatively widespread. The size of the invisible barter sphere was increased by the dubious opportunities to make super profits, not to mention the significant lack of business expertise at the time.

One company had a barter deal which alone made a profit of a hundred million forints. Super profits were made with the re-export to the West of metals and other bulk products from the CIS. "This frequently occurred, especially when the origin of the goods could be cleverly masked with repackaging and reloading. A large part of an imported consignment could be re-exported. Copper and aluminium manufacturing waste, spare parts for aeroplanes, dismantled military equipment, good quality metals, etc. were easy to sell in Western Europe. Some customs duty was added, which we paid and got back when we exported the goods. Previously the imported goods didn't officially enter the country but were stored in customs-free zones, thus saving expenses. There were times when the consignment was sent abroad as transit goods, but transit was much more expensive compared to unloading, warehousing and loading onto another means of transport for forwarding. This can no longer be done."

Trade in foodstuffs, significant in barter, was also a source of high profits due to the Hungarian regulations.

In 1996 one company exported a large quantity of flour in barter before the subsidy was withdrawn. "The price of flour sharply rose in the two months the contract had to be fulfilled. Then the HUF 14 per kilo subsidy was withdrawn with the stroke of a pen and even the valid, signed contracts were not taken into consideration. The final consignments made a loss, but some profit was made on the whole deal. We couldn't have anticipated what was going to happen. In a normal regulatory environment it's absurd to withdraw subsidies from one minute to the next."

Various forms of manipulation were widespread in obtaining export subsidies. It can only be assumed that *VAT abuse* was probably an everyday phenomenon in this field.

"If there was some cunning aspect to a barter deal it was always related to a subsidy. They didn't say that the goods were something different, but that the price was different—especially when the subsidy was due for a certain amount of dollars. With barter it was easy to say that what is one is not one, but one-and-a-half. A litre of wine could not be priced at USD 4, but 10–15 percent could be added and no one noticed. This could be done even up until quite recently. Last year a subsidy was paid for natural measurements, i.e. kilogrammes. Really, the price per unit didn't matter. If nothing but the subsidy was gained on the business then it was worth it, though we got it later as the consignment was first sent out and the payment for it came in. The application for subsidy was only made then and it took 2–3 months to get, but it was still worth it. It worked like VAT. Both VAT and customs duty were paid back, but customs was more difficult because the accounting was more complicated."

It was partly *large quantities* and partly the prices and invoices adjusted to domestic financial bridges (customs, export subsidy) which produced the profit. Maximum profit obviously resulted where customs duties were low and export subsidies were very high. The duty was repaid in the case of re-export. Exchange products made it possible to apply the old business rule of buying cheap and selling dear. This was especially true at the beginning when few Western businesses acted as brokers due to their lack of knowledge of the market. In the late 80s and early 90s the clever ones *made money on both the import and the export side of barter*. Later on it was satisfactory if just one side of the barter was profitable. Profitability fell sharply partly because more players were involved and partly because the supply of products that could be exported from the CIS was gradually decreasing.

"The advantage can be seen—money, unlike with a letter of credit, need not be tied down and a bank doesn't have to be paid. Two percent interest can be saved a month with this, and with no bank charges and an average two months execution the saving is 3–5 percent. A modest profit gained on the deal can be added, and if both parties can obtain credit on the goods because the connection is good then the price margin may even reach 20 percent."

"Then there were the export subsidies and VAT refunds on foods. The paperwork can say one thing, but what was loaded on the lorries was a different matter... Or take the oil. Most of it came in barter. Metal or alcohol—there's so much profit on these goods that out there it's only the mafia that deals in them. They won't let anyone else near."

"We could have done it financially in such a way that we under-invoice on both sides in order to save on customs and other duties, but it could not be done because of our partners out there. The licences had to show the exported quantities in lots. Approximately 10 percent could have been gained due to the bureaucratic administration in those countries and for that it was not worth risking under-invoicing."

"If we're talking about subsidised goods, the recipe is under-invoicing for here and over-invoicing for out there. The profit will be at least 50–60 percent and should the partners cheat on each other the maffia appears and shoots. Huge sums of money are moved and clients often do not know what they are letting themselves in for. Various items imported in exchange for Hungarian canned goods could be included here."

A few words about present barter deals

Four segments of the remaining barter turnover at the reduced level seem to be present:

a) criminalised raw material barter deals—nothing is known about them except for their existence;

b) barter relations formed in the CIS barter era which seem to be lasting for some reason;

c) exchange deals for money-sparing purposes and executed by specialist Western barter companies keeping the accounts;

d) inter-state quota deals.

Even without any detailed analysis of these types of barter it is worth publishing some interviewees' doubts and comments about the future. The two comments below also present a suitable ending—they express the fact that in barter what may happen is "all or nothing".

"Inter-state barters bear a greater significance, for example the SAAB deal. But the Swedes will not purchase their exchange items here, even if the lists or agreements induce Hungarian products, for example buses. They will find quality, price, etc. excuses. There was a contract signed in Moscow. The Moscow City Council managed to compile the list for exchange goods, still nothing came out of it in the end."

"Barter trade with us amounted to over USD 50 million in 1991 and was 25, 15 and 7 million dollars in 1992, 1993 and 1994 respectively. It came to only USD

2–3 million in 1995. There is reorganisation going on and the trade section will also be transformed. Privatisation is underway and the buyer will determine what happens to the barter team. They may remain, since many businesses do alright with deals of USD 2–3 million... But they may not!"

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REVIEWS

HUNGARY'S EXPORTATION AND EXPORT TRENDS EXPRESSED IN TERMS OF PRODUCT MIX

A. K. SOÓS

The intention of this article is to provide the reader with some insight into the recent past, current trends and short term prospects of Hungary's foreign trade endeavours. Under the expression "recent past" I am referring to the period around 1990 (certainly nothing will be said about exports conducted before 1988); by "short term prospects" I am referring to mere generalities of export trend predictions projected into the next two or three years ahead, at the most. I would like to mention here that, just like the customary sound practices and attitudes of other governments towards mercantilism, my analysis will mostly extend to exports dissected into groups of countries and groups of products.

One of the most obvious and drastic changes connected with Hungary's exports is their change of direction. Up until 1988 some 51 percent of Hungary's total exports were directed to the (at that time) socialist countries; within this total about 27 percent went to the Soviet Union. By 1992 trade with the East had dropped to 23 percent of the 1988 level, followed by a marginal increase to just above 24 percent of the total trade of Hungary.

It is quite obvious that the single, most important factor concerning the drastic decline of Hungary's economic performance is directly attributable to the sudden decline in trade with the former socialist countries. Even though this is difficult to prove adequately by an appropriate set of statistical data, it is not too difficult to imagine the impact that such drastic curtailment of export sales made on the Hungarian economy. Of the enormous drop—amounting to 11.9 percent of Hungary's GDP in 1991—a mere 2.5 percent could be attributed to the loss of trade with the former socialist countries. It is obvious that other factors also contributed to Hungary's considerable decline of GDP in 1991, such as a drop of GDP in the previous years due to the decline of trade with countries east of Hungary. Likewise, an important factor leading to Hungary's decline in GDP must have been the drop of imports of inexpensive raw and base materials in 1991. Yet another factor was that some companies, particularly those which were previously highly dependent on eastern exports, were either forced to curtail their production quite drastically or were forced into liquidation.

Considering the future, it can safely be stated that the previous high level of eastern trade will never be fully restored. Árpád Hasz, a Hungarian Marxist-Leninist economist, once expressed that when the socialist revolution is victorious

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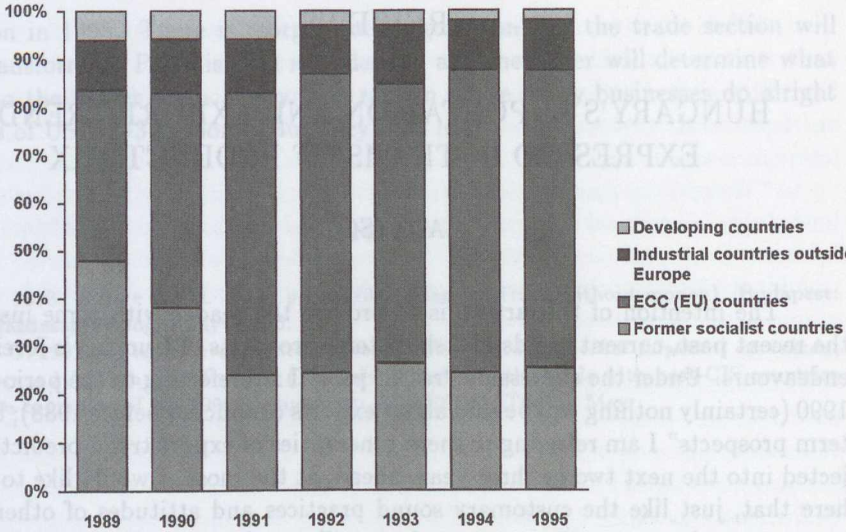

Austria, Finland and Sweden are included in the "EEC (EU) countries" group in the period 1989–94 too.

Fig. 1 Commodity pattern of exports by groups of countries

in the advanced capitalist states this event will bring about social-economic changes such that the western type of industry would no longer suit the new, evolving social-economic circumstances. As a direct result of this, it would be necessary to restructure the entire socialist industry. In fact, the reverse came true. No socialist revolution took place in the West—instead a capitalist "revolution" is sweeping through the East. Yet, Hasz was right in one respect, because the old economic structures of the east have, indeed, collapsed and ceased to exist. Entire, previously substantially important industrial bases have had to close premises in Hungary. It suffices to refer to Hungary's high series bus manufacturing, for instance; this almost entirely relied on the large scale orders placed by Gosplan of the Soviet Union *via* a cash on delivery arrangement. At the time Gosplan's ideal trade constituted large, single orders put for items, such as buses—presumably suitable for climates as different as those of the arctic circle and sub-tropical regions respectively. There are many economists who still think there are ways and means to explain and to reverse Hungary's economic climate and they search for ways to revive eastern trade, to some extent at least. One of the fundamental problems and the essentially true explanation for the situation is that investment endeavours have drastically declined in Russia and the CIS countries in general. Yet, one must go a step further and think more realistically along these lines and also realise that the cash payment system is unlikely to return, even if a decision is carried by the CIS countries to place substantial orders for buses with Hungary sometime in the near future. Future exports and, hence in our example, the output of the bus company will very much depend upon the ability of the bus manufacturing company to provide and sell goods on credit. Thus the previous comfortable cash payment system is unlikely ever to return. From this it follows that it is most unlikely that the previous large series bus manufacturing will ever return. Some of the economic decisions in Russia and the CIS countries, just like anywhere else, are now passed down to a lower level of decision-makers. Each city, each township, or each county will now place orders for public transport vehicles that they see best suited and fit for their own purposes and requirements. They are likely to shop around the globe and select the brand which they think will suit their purposes the most and may even require special changes and alterations (as stipulated in their future orders). This indicates that the majority of the old markets have well and truly gone—"vanished into thin air"—and will never be regained by Hungary. Their places have been taken by new, more competitive markets.

A closer look at Hungarian exports directed to, and conducted with the CIS countries (and Russia in particular) reveals that Hungary's exports to Russia increased slightly in 1995, while Hungary's exports to CIS countries increased even more in that year.

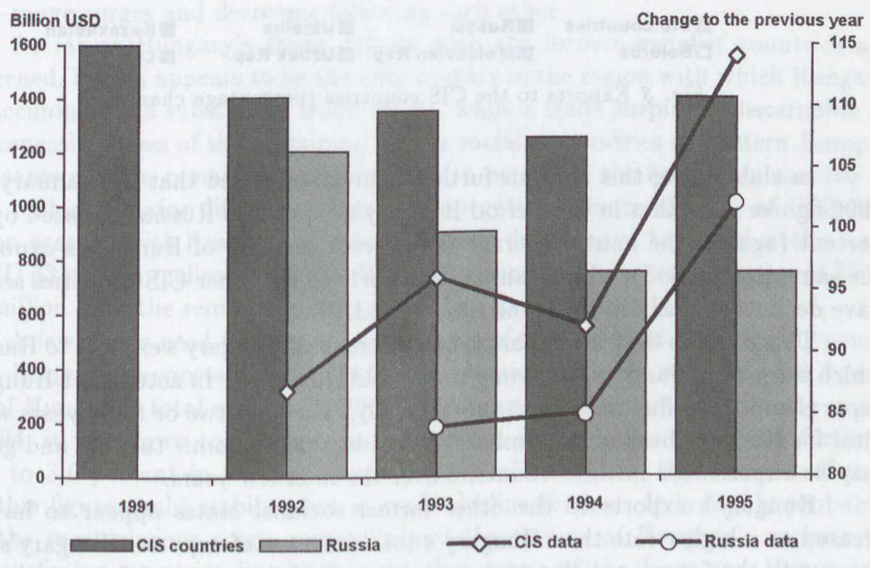

Fig. 2 Exports directed to the CIS countries and Russia

On the other hand, this relatively rapid 15 percent increase of exports took place at a time when the value of the U.S. dollar was falling and it lagged behind the annual average 21.5 percent increase of Hungarian exports. This means that Hungarian exports to the east have, relatively, declined even further.

By dissecting Hungarian exports directed to the CIS countries in order to look in more detail at individual countries, it becomes clear that Hungary's exports to some of the CIS countries—such as the Moldavian Republic, The Ukraine and the Uzbek Republic—have increased at a rapid rate.

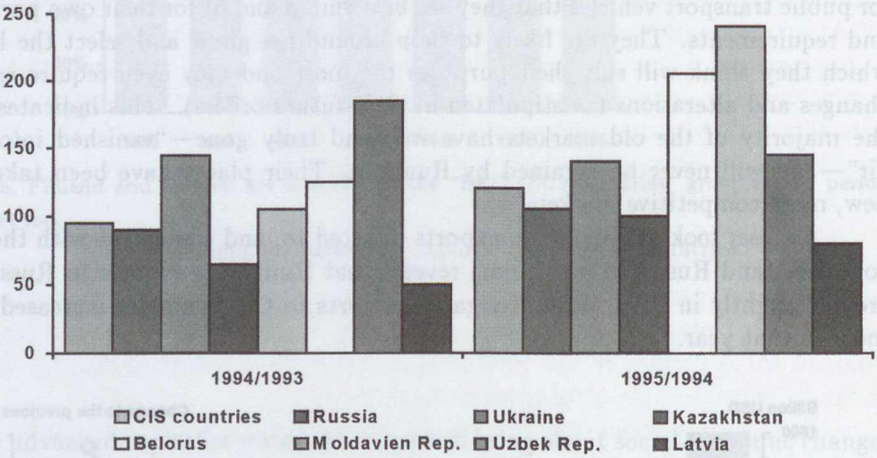

Fig. 3 Exports to the CIS countries (percentage change)

In elaborating this analysis further it must be added that the January–July 1996 figures show that in this period Hungary's exports to Russia increased by 10.2 percent (against the annual average 5.2 percent increase of Hungary's exports in the same time period), while Hungary's exports to the other CIS countries seem to have declined slightly in the same time period.

This signifies that the apparent overall trend of Hungary's exports to Russia—which show a regular decrease—might not hold true at all. In actual fact Hungary's exports appear to fluctuate quite substantially. The next two or three years will be vital for Hungary because, presumably, considerable economic turn-up and growth may be experienced in these countries over the next few years.

Hungary's exports to the other former socialist states appear to have increased at a higher rate than Hungary's total increase of exports. Hungary's total exports to the former socialist states constituted 13.6 percent of the total imports of these countries in the first seven months of 1996. Compared to exports of the corresponding seven months of 1995 this was an increase. This same trend seems to have persisted unequivocally and consistently in more recent months. This may have been brought about by the beneficial effect of the regional free trade agreement—i.e. the CEFTA Agreement—concluded between the Czech Republic, the Slovak Republic, Poland and Hungary. Romania and the Slovene Republic are not members of CEFTA. In the respective cases of these two countries general trends of rapid and substantial export growth by CEFTA with them seems to show some reversal of the results of previous years. Due care must be exercised in judgement since Hungary's export growth is by no means due to the CEFTA Agreement alone. For example, it should not be construed that the sudden decline of Hungary's previously rapid growth of exports directed to the Slovene Republic is entirely due to the fact that the Slovene Republic is not yet a full CEFTA member. A closer look at Hungary's exports directed to Romania against the previous year figures shows that there has been a decline. However, this is due to one single factor alone—namely, the occasion of a single, large volume export order of cereals delivered by Hungary in 1994. In fact, Hungary's exports to Romania increased by 70 percent in the first seven months of 1996, indicating a substantial and continuous increase, regardless of the one-off cereal export. It stands to good reason that the apparent decline of Hungary's exports (by 17 percent) to the Slovene Republic compared to the same period a year before, is rather difficult to interpret. However, it seems most unlikely that this is due to the fact that the Slovene Republic is not yet a member of CEFTA. It is obvious that the volume of trade between CEFTA members is, undoubtedly, on the increase in the long term, albeit with periodic, short-range surges and decreases following each other.

As far as Hungary's trade deficits with the former socialist countries are concerned, Russia appears to be the only country in the region with which Hungary has accumulated a substantial trade deficit, while a trade surplus is discernable in the respective cases of the remaining former socialist countries of Eastern Europe. This same pattern remained and continued to persist in the first seven months of 1996, with one major difference: Hungary's negative balance of trade of USD 588 million accrued with Russia (and a further trade deficit must be added to the tune of USD 83 million realised with The Ukraine). Hungary has a trade surplus of USD 220 million with the remaining former socialist countries.

A few words need to be said on the topic of trade with the developing countries. Hungary's exports directed to the developing countries constituted 8.6 percent of Hungary's total exports in 1988. This figure has dropped consistently until, in 1994, it was down to 3.9 percent. In 1995 it seems to have dropped further, down to 3.6 percent in the first seven months of that year. By the end of this year this figure could stabilise but it could decline further. It is highly probable that the most obvious single reason behind the decline of Hungary's exports to the developing countries lies in the fact that many of the large size Hungarian state export agencies have either been restructured or wound up. These business entities were not replaced by other, financially sound companies willing to assume higher business risks. Other factors of lesser importance which possibly contributed to this decline are the financial difficulties experienced by some of the large size state-owned manufacturing enterprises and suppliers. The decline in the volume of exports to third world countries is particularly true with respect to countries of North Africa and the Near East. On the other hand, it appears that Hungary has managed to maintain a tiny, but firm foothold on the Far East markets. Hungary's exports to the Far East have never really been substantial. This is a most unfortunate situation as far as Hungary is concerned, particularly in view of the fact that the most dynamic economic growth anywhere in the world is taking place in the Far East region. Hungary's volume of trade with this region is still small.

In cases of the developing countries and the CIS countries trade credit, insurance provisions, economic diplomacy and so on, all constitute important considerations requiring the involvement of the state. Likewise, considerable efforts are required to attract capital from the Far East. It is not likely that Hungary's trade will increase to any substantial extent with the Far East in the near future. However, it is believed that it would be possible to attract capital and induce capital inflow into Hungary from the Far East. This is what happened in the case of the United States. The volume and value of trade between the two countries are not all that impressive, although the capital inflow from the United States to Hungary is, in fact, quite substantial. This should eventually generate greater trade between the two countries.

Hungary's exports to the countries of the European Union amounted to 62.8 percent of Hungary's total exports in 1995. This means that the EU is Hungary's number one trading partner by far. Yet it is a statistically difficult task to extract meaningful figures to demonstrate growth of trade until a decision is made about how to dissect and group these countries and how to account for the recent increase of membership of the European Union. By ignoring the new member states of the European Union for statistical reasons, the growth of exports to the 12 countries amounted to 17.0 percent in the period between 1991 and 1994. This represents a higher rate of increase of exports than Hungary's total growth of exports of 7.3 percent in the same period. Other factors should also be duly considered concerning the above time period. For example, in 1993, in the first year following Hungary's signing of Associate Membership with the EU, Hungary's trade was effected most unfavourably. Hungary's exports to the EU declined in 1993 by more than 22 percent, while import growth was 6.5 percent in the same year. Hungary experienced the same effect as Portugal, Spain and others following their entry into Europe as full member states. Thus the abolition of customs and tariff barriers must mean increased competition, manifesting itself in reduced exports and increased imports. In Hungary's case this was exacerbated at the time (i.e. held back Hungary's export growth potentials) because it coincided with an economic slump in the EU. Hungary must be prepared for the possibility that the same thing might happen again in the future (i.e. when Hungary attains full membership status of the EU).

Thus for all practical purpose all trade barriers will be abolished. In accord with the current Associate Membership Agreement all tariffs will be abolished prior to Hungary's entry to the EU; however, the customs procedures will be abolished only upon entry into the EU. This is, as far as Hungary is concerned, likely to result in an immediate increase of imports. This possibility should be considered and reckoned with.

Let us return now to the analysis of recent trade figures. Following the unfavourable trade trends from Hungary's point of view in 1993, figures indicate that in 1994 both Hungary's exports and imports grew at around the same rate. This resulted in a proportional increase of the trade deficit. The deficit reached USD two billion in 1994 but dropped to USD 1.5 billion in 1995. The expectations are that Hungary's trade deficit will shrink further in 1996 (USD 809 million at present). Based on first half-year trade figures for 1996, perhaps it is possible that Hungary's trade deficit could decline by a further USD 0.5 billion. The above trend is encouraging, particularly when one considers the great importance and weight of the EU for Hungary as far as its total trade is concerned. Hungary's trade with Germany requires a special mention because it represents about half of Hungary's total trade with the EU (if we also include the trade realised between the two countries via the free trade zone also). (With respect to free trade zones, due caution is required since these free trade zones came on stream relatively recently and their current performance is not yet possible to compare with previous years' figures simply because no previous figures exist.) Hungary's trade with Germany has increased in comparison with the rest of the EU countries in spite of the economic slump that has been experienced in Germany. Given the possibility of an upswing of the economy in Germany, Hungary can be mildly optimistic about the future in this respect.

Now I would like to turn to the trade product mix.

Imports of raw materials, intermediary products, machine and equipment parts have increased into Hungary since 1993. This is in line with the increase of Hungary's GDP following reversal of the slump in the GDP in 1993. Many critical comments have expressed that Hungary's production structure is all wrong, meaning that Hungarian production is excessively material, and thus it is import-demanding. I would like to place doubt on these critical comments. This is by no means unusual. Since the entry of international and multinational companies into Hungary solid evidence exists that the majority of the increase of raw material and component imports into Hungary are directly due to the activities and interchange of such products flowing from one country to another, exchanged between various branches and plants of the same international company. It is necessary to take a closer look at how many new companies have been established on either side of the respective borders of Austria-Hungary. The typical division of labour shows that some of the more refined manufacturing processes are carried out on the Austrian side of the border while the less refined and more labour intensive jobs are carried

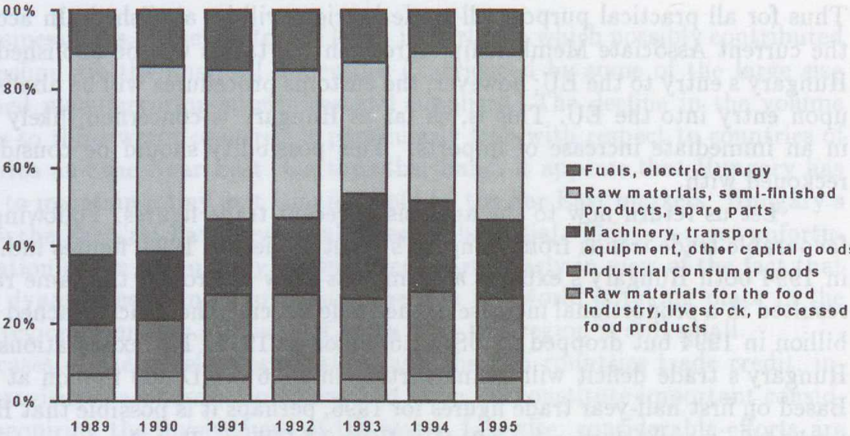

Fig. 4 Import by main commodity groups

out on the Hungarian side. Such arrangements appear increasingly more "fashionable", popular and make perfect economic sense. (These are the very companies which exert considerable pressure and lobby the relevant Hungarian government institutes and offices, trying to persuade Hungarian officials to accelerate the customs procedures in order to permit more easy entry and exit of goods, intermediary products and parts across the border on a daily basis.)

One form of division of labour is the often, understandably, criticised contract work.

The figure above shows the extent of the importance and weight of contract work according to the various branches of industry (expressed as gross value and thus including the value of the material and/or the intermediary product). In the light industries this figure is substantial, with a similar discernible increasing trend, particularly in the field of machine industry. Contract work could be construed as being useful to Hungary. It contributes to technological increases and contributes to employment. On the reverse side of the coin the disadvantages are that technological improvement is derived from sources external to the country. Another disadvantage is the inevitable higher extent of dependency and uncertainty of the Hungarian economic units which take part in the business. A third disadvantage reflects the low and suppressed wages and salaries paid to Hungarian employees. It would not only be possible, but, indeed, desirable to reduce this dependency and give greater independence to the economic units engaged in contract work. It is rather short-sighted to be critical of this situation; instead, greater attention should be paid to finding out what factors hinder such moves. Two factors seem to constitute major impediments. These are: the insensitivity, the "could not care

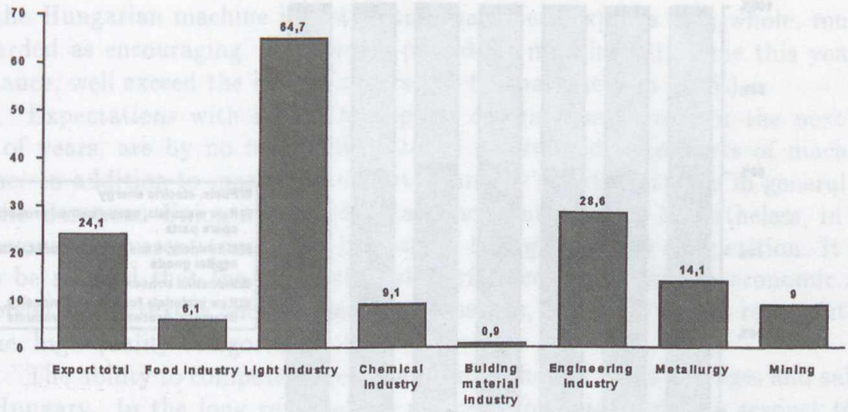

Fig. 5 Weight of the gross value of the outwards processing in the various branches of industry

less" attitude of the owner (in the majority of the instances the state) of these economic units; secondly, the lack of capital to do something about this situation. One obvious solution would be to enhance and accelerate the processes of privatisation. This would virtually force the given economic unit to act like an economic unit should in the circumstances of a true market economy.

Once again, as far as the product mix is concerned with respect to exports, it appears that a discernible trend exists. This indicates an increase in the export of raw materials, intermediary products and machine parts, while the export of machinery and equipment is tending to decline.

However, the situation is not as bad as it seems. A closer look shows that the increase of raw material exports represents a smaller proportion of the total—i.e. the majority of the increase is due to increased exports of intermediary products and machine parts. This is primarily due to increased trade within the same company across borders, as a matter of division of labour. For example, Belgium's exports are almost 10 times higher than those of Hungary. This is, obviously, also due to movement of enormous volumes of intermediary products and parts across borders. Hungary seems to be heading in the same direction and there is nothing wrong with that.

It is not a favourable development that machine exports have declined. However, several explanations may be given for this phenomenon. It is obvious that the advantages flowing from joining the European Union, as far as Hungary is concerned, is least likely to manifest itself in increased exports of finished machinery and/or complete vehicles. These advantages are more likely to be expressed in terms of increased exports of intermediary products and machine parts. The Associate Membership Agreement forged between the EU and Hungary includes pro-

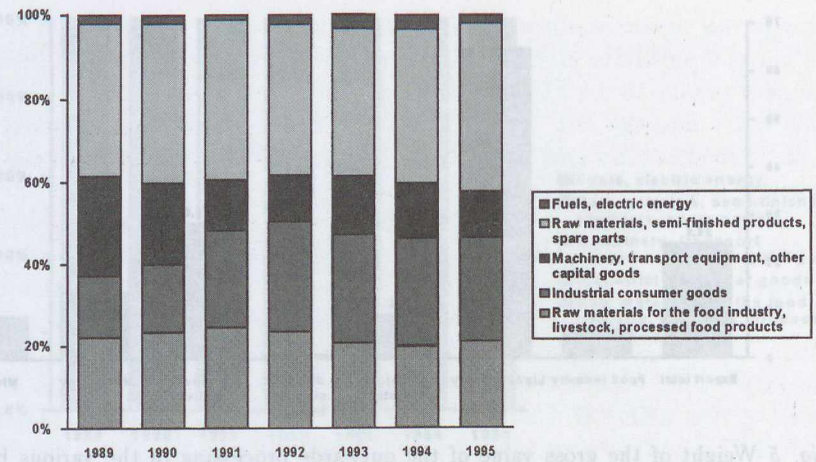

Fig. 6 Export by main commodity groups

visions for halting and punishing dumping practices and preventing other market disturbances. The export and import of items such as raw materials, intermediary products and parts, particularly within the same company, however, is least likely to disturb the existing market than the export of items such as finished products, machinery and equipment. In Hungary this is reflected in the general retardation in the expansion of enterprises producing for exports. This is especially true in the case of companies manufacturing complete finished products. Instead, production concentrates more on partly finished products and this is likely to continue at least until Hungary becomes a full member of the EU. Still, economic progress can be achieved by manufacturing and exporting a greater proportion of intermediary products and machine parts in a framework of division of labour. In other words, this type of production should not be regarded lightly.

The main user of intermediary products and machine parts is, naturally enough, the machine industry. Investment in the machine industry seem to be increasing at a rapid rate and is contributing substantially to export growth. (Note: the value of investments in the machine industry amounted to a 61 percent increase on the previous year in 1995, followed by a further increase of 6 percent in the first six month of 1996.) One of the favourable economic trends in Hungary includes a production output increase of 12 percent in the period January to June 1996. (It should be pointed out, however, that in spite of the fact that exports of machinery and equipment appear be increasing at a higher rate than Hungary's total exports, a certain caution must be exercised because exports from the tariff-free zones are not, as yet, indexed. However, if exports from the tariff-free zones are also considered the increase in machine exports would still probably be in excess of 10 percent. Without a shadow of doubt, however, the current trends pertaining to the Hungarian machine industry, and machinery exports as a whole, must be regarded as encouraging. The orders placed for machinery in June this year, for instance, well exceed the level of orders put for machinery in 1995.)

Expectations with regard to exports covering next year, or the next couple of years, are by no means likely to be determined by exports of machinery alone. In addition to machinery exports Hungary's textile exports in general, and to the European Union in particular, are most substantial. Nevertheless, in spite of favourable current trends this industry is facing enormous competition. It must also be realised that the contract work performed by Hungarian economic units involved in the textile and the clothing industries, as a rule, do not represent high value, high quality categories.

The ability to compete largely stems from the low levels of wages and salaries in Hungary. In the long run there is no room for optimism with respect to the Hungarian clothing and textile industries—at least not in the next couple of years. Similarly, the co-operative contacts previously fostered in the chemical industry and the pharmaceutical industry also seem to have declined. Some prospects of growth do exist for the chemical industry in the next couple of years, but this is unlikely to be matched by prospects of growth in the pharmaceutical industry. In the absence of substantial investment in these two industries no substantial increases are likely to be realised. Unlike the machine industry, the chemical and pharmaceutical industries are unlikely to attract investments necessary for growth. This may be due to the fact, at least to some extent, of either late—or the absence of—privatisation of these industries.

Given the analysis, what are the prospects in the short term? As far as the 1997 year is concerned there is not much point in making any prognoses at the moment. For 1997 the best source of information is a study of the sizes of incoming orders received to date. Indeed, the value and volume of incoming orders in the manufacturing and processing industries in July exceeded the levels of the previous year by 6.2 percent (the latter year itself had a substantial increase of 37.9 percent over the corresponding figures for the previous year). The best approach seems to be to quote the volume of exports realised in 1996 (an increase of 8 percent till end of July), expressed in terms of volume of trade. This is because the expression of volume lends itself for ready extrapolation, as distinct from expression in monetary terms. The reason for this is that, in the latter case, it is not possible to predict the exchange rates, barter ratios for the following year.

As far as the two-directional cross section analysis of exports is concerned it would serve a good purpose to concentrate our attention on double digit predictability only. In the analysis concerning the CEFTA countries the weight of this group of countries is highly likely to increase further, and will probably exceed 10 percent growth. However, there is a possibility that it could exceed the 10 percent mark quite substantially particularly since the entry of the Slovene Republic to the CEFTA is imminent, while the entry of Romania is highly probable. By casting our eye on the product mix the most spectacular increase in a particular category of export is likely to be achieved and realised by the Hungarian machine industry and the vehicle industry; this includes increased exports of intermediary products and exports of parts. Increase of exports in these two industries will almost certainly exceed the 10 percent benchmark in 1997. Based on the incoming orders received, none of the other Hungarian industries are expected to achieve exports exceeding 10 percent in 1997. As far as the rest of the decade is concerned it is unlikely that Hungarian export growth will exceed 10 percent in more than one or, perhaps two of the remaining years of the decade. This must mean that from the point of view of the Hungarian economy, and Hungarian exports in particular, no spectacular rapid growth is expected to take place. Instead growth, certainly at first, is likely to pick up at a slow rate. Later on, this will perhaps accelerate, helped by the realisation of some of the ideas expressed at different forums. This would provide opportunities to discuss such topics as investment incentive provisions, further liberalisation of trade and the economy, accelerated privatisation processes, and more favourable external economic conditions. In this way further progress can be anticipated.

THE WEIGHT OF BLACK TRADE AND BLACK SERVICES IN THE NATIONAL ECONOMY

I. BÓC–M. KLAUBER

The authors assess the percentage of the black economy in terms of its share in household spending, and the assessment is based on responses to a questionnaire. The responses indicate that the proportion of non-registered shopping expenditures as a percentage of the registered spending is 16 percent, while in the range of the assessed services the proportion of non-registered spending is 69 percent. Along with the changing of the system and with the expansion of the conditions of the market economy the dimensions of the hidden economy have also expanded to a considerable extent. However, this is not primarily a result of the market economy; the market economy has only provided new opportunities. Since the expansion of the black economy has been generated by inflation and by over-taxation, any repression of the black economy would most probably be easier through the elimination of the circumstances that stimulate it (i.e. over-taxation and high inflation), rather than through increased application of administrative and police actions.[1]

[1] This article has been written on the basis of a study in Hungarian by Imre Bóc–Mátyás Klauber–István János Tóth: "Numerical estimates concerning certain segments of the black econ-

Introduction

Kopint-Datorg Inc. has been conducting research on various segments of the black economy. According to our findings, retail trade, household services and foreign currency transactions linked to tourism are of outstanding significance in this context. In the course of a process of data collection from the population—carried out by TÁRKI between 27th November and 8th December 1995—non-registered purchases were included as elements of the shadow economy. Non-registered purchases refers to those purchases that occurred in the street, in markets, from "ad hoc" sellers, in retail shops—and all without the sellers giving receipts or vouchers.

Empirical data were collected from the users (consumers) and these data directly pertain to the phenomenon in question. The surveys were based on questionnaires in which consumers were asked about certain limited segments of the market of consumer goods and services. The results of the empirical research were not combined with the economic background and therefore they were not suitable for drawing conclusions which can be viewed as valid at the level of the macro economy. Given the results of our surveys, the main objective of this study is to estimate the weight of the black economy using proportions and volumes that can be interpreted at the level of the national economy, and that are characteristic of non-registered goods and services.

The GDP generated in the black economy can, as revenue, be most readily realised in the form of cash through the black trading of goods and services. Our research suggests that any attempt which expects to reduce the black economy quickly and noticeably by a policy of economic restriction is over-optimistic. In our view reduction can only be achieved in the long run, through substantial tax cuts and through concerted action, supported by the society as a whole, against the black economy.

We considered markets to be the main venue for black trading, but with respect to foodstuffs, a significant portion of the traditionally legal trading of goods is also carried out in markets and thus we were not capable of realistically evaluating the black trading involved with this group of goods. Consequently, we forego detailed estimates concerning foodstuffs, but for the sake of providing a complete picture, such data will be included in the summary tables.

The proportion of the black economy is substantial in the area of enjoyment goods (i.e. alcohol, tobacco, coffee—ATC for short) and in that of goods which are subject to excise duty. Despite the tightening of excise control the black economy never stops looking for (and finding) new ways to avoid the controls. In the total turnover of tobacco products the black economy is estimated to represent between 15–20 percent, while in the turnover of alcoholic beverages the figure is 20 percent.

omy" (Kopint-Datorg 1996). The study was prepared on assignment by the Prime Minister's Office.

This results in a tax loss of some *HUF 14–18 Bn* (HUF 8–10 Bn in the case of tobacco products and HUF 6–8 Bn in alcoholic beverages).[2] The two major channels of black trading involve the smuggling into Hungary of counterfeit brand products, and the pretended exporting of locally made cigarettes which are then re-imported for illegal sale in Hungary.[3]

As a result of increases in the taxes on tobacco and alcoholic beverages—which came into effect on 1 January, 1996—about two-thirds of the price of *cigarettes* is tax. Tax rises of this nature proved to be a failure in 1994, they resulted in a 21 percent drop in sales in 1995, and owing to these tax increases the market continued to contract.[4]

Following the introduction of the strip stamps (duty seals) *counterfeit strip stamps* appeared in the market. Domestic finished goods are also faked.[5] Part of the excise duty increase implemented in 1996 is "pocketed" by the producers of spirits, but it is still a question as to whether the tax rises will result in an increase of tax revenues or it merely facilitate the expansion of the black economy. According to experts the tax loss due to black trading in the market of spirits is HUF 10 Bn, in the tobacco market it is HUF 6–10 Bn, and in the wine market it amounts to 1–1.5 Bn.[6]

Besides the HUF 13 Bn of taxes paid by the *brewing industry*, there are "home breweries" which are difficult to control. According to estimates they failed to pay in almost *half a billion HUF*.[7] The tax content of the beer price is over 70 percent and beer's share of the black market is at least 30 percent; the tax loss in 1995 has been estimated at HUF 10 Bn.[8]

According to Nestlé the black economy in connection with the confectionery industry—with the black trade of coffee included—makes up about 30 percent of the total turnover.[9] Nestlé reckons that around 20 percent of the coffee market, with a total of HUF 20 Bn in turnover, is realised in the black market. This is because the customs duty, the 20 percent excise tax, the 25 percent VAT and

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[2] *Napi Gazdaság*, 10th June, 1995.

[3] The black trading in area of cigarettes has reached a level which has prompted manufacturers to resort to demonstrative measures. For instance, the Pécs Tobacco Factory, in order to break black trading, reduced its prices—from March 1995—by up to HUF 10 with regard to its most popular products. The factory also intended to use price-cutting to put pressure on the government to make it adopt more efficient measures against the black economy, since the factory's own policy also results in a drop of tax revenues for the state. Even so, the revenue loss of the factory was about twice as large as that of the state (*Világgazdaság*, 3rd March, 1995).

[4] *Népszabadság*, 16th November, 1995.

[5] *Népszabadság*, 13th December, 1995

[6] *Népszabadság*, 5th January, 1996

[7] R. Sz.: Home breweries difficult to control, *Népszabadság*, 16th November, 1995

[8] *Népszabadság*, 7th December, 1995

[9] Customs duty cut against the black economy („Feketegazdaság ellen vámcsökkentés"), *Világgazdaság*, 16th April, 1996.

the strip stamp put up prices to unreasonable levels. Even in smaller shops there are products priced 30–40 percent lower than local products, and these may have originated from illegal sources. Nestlé cannot compete with such a situation and so it intends to withdraw from the coffee roasting business.[10]

One of the characteristic methods of black trade is when the principal of the forwarder certifies customs clearance with a counterfeit stamp. This is done for the forwarder, on the basis of the TIR card, at the points of loading. This is primarily worth risking in the case of products with high tax contents (e.g. cigarettes, spirits). When at a later stage it turns out that the TIR card of the forwarder has been abused by the principal, the company involved in the deception disappears or is made to go bankrupt (but the goods would already have been sold a long time before). In such cases the foreign customs authorities start proceedings against the forwarder, innocent though he has been. On a lorryful of cigarettes the customs duty of DM 2 million can be "saved". This sort of manipulation started back in 1992 and was spotted for the first time in 1993, when the documentation for the goods which arrived through the border and the documentation for those cleared were found to be different.[11]

Purchase of manufactured goods

According to the results of the questionnaire survey, non-registered purchases account for a significant portion of purchases, but the percentage thereof strongly varies by commodity group. We assessed the percentage of cases in which the sellers in retail shops had not given a receipt, and the case examined was the sale of used clothing items. *According to the results of the survey no receipt or voucher had been issued in 11 percent of the purchases of clothing items in small retail shops. The respective figures were 7 percent for purchases of other manufactured goods in shops, and 32 percent of the cases of shops selling used clothing items.*

We assumed that the share of non-registered turnover varies by commodity group and so we assessed this proportion within purchases in shops, by commodity group. 23 percent of the total expenditure on *clothing items* was spent on goods bought in the street or markets from *ad hoc* sellers and another 2 percent was spent on used articles. *Non-registered purchases accounted for 27 percent of the total turnover of clothing items.* Most of the non-registered turnover is accounted for by products bought from *ad hoc* sellers, in streets and in markets. In the underwear category this share is close to 40 percent while in the case of overwear it is near to 30 percent, and in the case of shoes it is almost 22 percent. *Given the*

[10] *Népszabadság*, 27th December, 1995

[11] Gábor Ferencz: Tax-free importation using a fake stamp („Vámmentes hamis pecséttel") *Népszabadság*, 7th July, 1995

Table 1

Distribution of value of industrial commodities (percent)

	Large shop	Small shop	of which non-reg.	Street, market seller	Used items	of which non-reg.	Total	of which non-reg.
Underwear	38.1	27.1	2.5	34.4	0.4	0.0	100	37.0
Overwear	36.9	34.6	4.0	24.7	3.8	0.9	100	29.6
Shoes	47.0	34.2	3.3	18.5	0.3	0.0	100	21.8
Cosmetics, parfumes	57.4	28.8	0.8	13.7	*	*	100	14.5
Detergents	54.5	34.9	0.8	10.6	*	*	100	11.4
Sports goods, toys	47.9	37.4	0.3	14.7	*	*	100	15.0
Tools	57.2	35.1	2.0	7.7	*	*	100	9.7
Plastic-, glassware	52.4	38.0	0.6	9.6	*	*	100	10.2
Video, audio cassettes	76.1	18.7	0.5	5.2	*	*	100	5.7
Batteries	43.7	48.3	2.0	8.0	*	*	100	10.0
CD's	53.9	44.3	4.0	1.8	*	*	100	5.9

*No such answer applicable to industrial articles

lower prices of non-registered goods, the volume percentages must be even higher than the value percentages given above. If it is agreed that black market prices are at least one-third lower than legitimate ones, the statement may be ventured that over half of the underwear purchases, almost half of the ready-made clothing items and about one-third of all pairs of shoes sold are procured in the black market.

The survey, on account of the limitations of the questionnaire method, only reveals the non-registered purchases of end-users. *Non-registered trade, however, is not limited to retail trading for it accompanies each of the phases of the course of the commodity*: i.e. from the producer, or crossing of the border, from the importer, through wholesale and retail trading, to the customer. Indeed, *the goods may cross sectors several times, from registered into non-registered, and back.*

The aim of retailers is to avoid paying the various taxes. For them, it is immaterial which goods they sell without issuance of certificates. Their primary target is to find the largest volume of goods, the illegitimate selling of which results in the saving of the largest volume of taxes, without attracting the attention of the tax authorities. In their procurements they often mix up legal and illegitimate sources, and in selling they also alternate in the giving of a receipt or not. Having stated this, the source and the course of most of the goods may be traced, or at least estimated.

In the case of underwear the legitimate and the illegitimate goods are, in the majority of cases, not distinguishable. The majority of the items come from the Far East or Turkey; these cannot bypass customs on account of their large volume and low unit value. However, in the customs documents the price indicated is remarkably low, or the goods and the volumes are declared false. This is indicated by the fact that the prices of underwear items sold in markets are lower than the realistic procurement price plus customs duty plus VAT. Accordingly, a certain quantity of the underwear stock that are customs cleared and sold with a receipt include "black" elements. Even underwear items include smuggled goods in the classical sense of the term ("importing stuff in the luggage"). For instance, belonging to the latter category is the Romanian underwear sold in streets and markets by illegitimate vendors. When all things are considered, in the case of this commodity group (similarly to the case of clothing items) *the results of the survey can only be regarded as the lower limit of the non-registered trade turnover*.

In the case of *ready-made overwear items*, the assumed high proportion of non-registered local production is a new element, in comparison with underwear. In this category the portion of Chinese and of used, bulk items is high.

In the category of *shoes* Italian, Turkish and Chinese goods dominate non-registered trade, but again, there is a high percentage of Romanian "luggage imports".

With regard to the other manufactured articles considered in the research 56 percent of total sales is purchased in large stores, 33.5 percent in small shops and 10.5 percent from street and market vendors. Accordingly, the share of non-registered trade is also less significant than it is in the case of clothing items, the latter being a mere 12 percent.

The non-registered turnover of *parfumes and cosmetics* accounts for some 15 percent of the total turnover. Counterfeit and/or smuggled parfumes and cosmetics that do not meet domestic health standards account for a substantial part of this 15 percent.

Of the turnover of *detergents* some 11 percent is black, most of it being manufactured in Hungary. It is put into circulation by the manufacturer or the wholesaler in a legitimate form, accompanied by vouchers. The retailers then transfer some of this stock to vendors selling without receipts, at prices which are even lower than the procurement price plus VAT. In this way their profits are hidden. The gains of such transactions are realised through re-claiming VAT on the ostensibly unprofitable business.

The commodity group comprising *sports articles and toys* is highly diversified and the share of non-registered trade is relatively high here, being about 15 percent.

In the category of *dry batteries* (non-registered trade indicated as 10 percent) there are brand names and no-names as well, and there is some "import in the luggage". The non-registered trade results in a loss of, respectively, VAT, customs duty and also the environmental product charge.

The 6 percent share of non-registered trade of *CD's* is a modest share, even within the commodity group. This product is still something of a luxury item in Hungary, and those who do own a CD player are not motivated to buy on the black market.

Some 6 percent of the turnover of *construction materials and fuels* showed up in the research as non-registered. In 1995 short supplies of certain construction materials were observed and this also contributed to certain distributors favouring buyers who did not want receipts. However, purchase without receipt also occurs in a situation of over-supply as well for then the constructor cannot or need not charge (book) the costs of construction. It must also be noted that the survey was limited to household procurements, therefore it did not cover public and institutional procurements that account for a substantial portion of the turnover of this segment.

We performed a separate survey of procurements and issuance of receipts for certain *manufactured goods*, the black turnover of which we assumed to be significant.

Table 2

Share of non-registered purchases of certain manufactured goods (percent)

	Black sales as a percent of the number of purchases	Portion of value of products sold in the black market as a percent of the total turnover	Average black market price as a percent of the legitimate market price
Wrist watch	41.3	23.1	45.5
Gold, silver jewellery	20.8	11.5	51.8
(Pocket) calculator	38.7	14.3	32.8

In 1995 over 40 percent of those who bought a *wrist watch* were not given a receipt, or a certificate of warranty. Since all wrist watches are imported it can be assumed that there is a good deal of smuggling. The average price of wrist watches sold in the black market is somewhat less than half of the price charged in legitimate shops (HUF 1,596 as opposed to HUF 3,510). As a result of the price difference, those buying without receiving a receipt accounted for a far lower percentage in terms of HUF spent (23 percent), than their portion in terms of watches bought. This, however, does not mean that the price levels in the black market were significantly lower than those for watches sold accompanied by receipt, since it can be supposed that there are a lot of cheap, poor quality and, in some cases, counterfeit goods sold in the black market.

Over 20 percent of those individuals who had bought *precious metal jewellery* reported that they had not received any receipt at all upon procurement. Since in the legitimate shops only the sale of hallmarked goods is permitted, it is assumed here that the non-registered purchases were, in the majority of cases, made up of goods smuggled from Turkey, Greece or Serbia. These watches had been illegally sold for a fraction of the legitimate Hungarian price. The average price of jewellery bought in the black market is hardly over half that of illegitimate goods. However, this does not allow conclusions to be drawn concerning price levels, since the survey indicates the average price of the total purchases. At any rate, it is clear that the value of black trading accounts for some 12 percent of the total turnover of this category.

Almost 39 percent of the turnover of the market of *pocket calculators* is realised in the non-registered sphere. The proportion of the black market in terms of value accounts for only 14 percent of sales. This difference indicates both that prices are lower in the black market, and that this is where the majority of the poor quality bulk goods are sold. All of these goods come from the Far East, therefore it is likely that there are a lot of smuggled goods among the total stock.

With regard to *durable consumer goods*, according to the results of the survey, the buyers were given certificates of warranty in about 78 percent of the cases. The question pertaining to the certificate of warranty was asked in order to find out something about the frequency of illegitimate sales. The frequency varied by item. In the cases of articles where there is a significant difference between the local and the foreign price (e.g. computers, VCR's, radiophones), the percentage was higher than in the case of those commodities (e.g. washing machines, microwave ovens) where the prices charged locally are not, or only a little higher than the prices at which such commodities are available abroad.

In the turnover of *entertainment electronic goods* (e.g. television set, radiophone, walkman, VCR) the sales in the black market, and within these the sales of smuggled goods, account for quite a high percentage. Although households are well supplied with these articles, the rate of replacement is quite high due to obsolescence.

It seems that the decline of the living standards does not restrict the market of precious metals, since the acquisitions here serve the aims of profit retention. The share of the illegitimate trade of gold jewellery in Hungary is estimated to represent 40 percent, according to traders involved. However, the survey only proved a small portion of this figure.

The taxes and other payables on imported gold amount to about 150 percent. Therefore traders bought gold from the National Bank of Hungary and then exported it—mostly to Italy. It was then processed and re-imported as lease work for sale. Taxes could be saved and substantial profits could be made in this way. If more gold was imported in the form of jewels than exported unprocessed, the tax gap between the significantly lower foreign price and the higher local price could be earned, as a further substantial profit.

The proportion of illegally imported artefacts made from gold is extremely high from countries where gold is inexpensive. Since there is no Hungarian hallmark on such goods these are hard to sell. Therefore, smuggled goods are more and more frequently sold with a counterfeit hallmark. The authorities have confiscated some 20 kg of gold jewellery with fake hallmarks over the past three years. Nev-

Table 3

Breakdown of purchases of durable commodities according to registered and non-registered source

	Frequency of non-registered purchases (percent)
Washing machine	5.9
Television	11.6
Computer	44.4
Camera	0.0
VCR	33.3
Microwave oven	5.0
Sowing machine	50.0
Heater	13.6
Furniture	21.0
Percolator	35.0
Hand mixer	37.5
Multifunction mixers	7.7
Toaster	30.0
Radiophone	37.5
Walkman	22.2
CD player	25.0
Other electrical appliance	13.7
Durable consumer goods, total	21.6

ertheless, according to estimates, the volume sold illegitimately was several times more. According to the head of the controlling department of the Institution for the Verification of Precious Metals the only efficient means of reducing the level of counterfeiting would be to lower taxes on gold so that these taxes approximate to the European levels. A reduction of taxes would not only reduce black trade but it would also increase the revenues of the treasury.[12] This has been tried in Slovenia where taxes on precious metals were cut for a year, on a temporary basis. The traders of precious metals undertook to pay the difference if the revenues of the treasury declined over that period. They did not have to pay, but the legitimate traders re-gained their market and the state got its revenues.[13]

[12] Zoltán Gaál: „Hamis fémjel az arany ékszereken" (Fake hallmark of gold jewellery). *Magyar Hirlap*, 14th March, 1995.

[13] *Népszabadság*, 22nd May, 1995; *Népszabadság*, 15th December, 1995

Services

Almost half (42.5 percent) of the respondents used *technical services* without asking for a receipt. The non-invoiced portion of such services, however, only accounted for about 30 percent of the total expenditure on these services, of which the tips accounted for 1.4 percent. The latter related primarily to services provided and accompanied with an invoice. This significant discrepancy indicates that, as in the case of other manufactured articles, in this range the values of the non-invoiced items tend to be far lower than those of the invoiced ones. This is also due to the fact that the users of such services charge these expenses to their businesses, on some account, and claim varranty on such services.

Table 4

Frequency of purchase of certain services, and the percentages in terms of non-registered incomes (percent)

Type of service	Non-registered purchase as a percent of the total of procurements	Proportion of non-invoiced value*	Peaks of the respective totals of procurements*
Repairs of household appliances	32.5	28.8	2.5
Painting, wall papering	67.3	32.9	0.9
Water and gas supplies, repairs of	32.9	10.4	2.0
Electrical repairs	69.2	22.2	0.2
Bricklayers, joiners	73.5	44.3	1.7
Car repairs	32.9	19.4	1.0
Forwarding	45.0	46.2	0.8
Technical type services, total	42.5	29.5	1.4
Hairdressers, beauticians	56.6	54.2	2.3
Shoe repairs	54.2	40.2	0.1
Laundry	10.3	23.8	0.0
Tailor	69.8	71.4	0.1
Personal services, total	57.2	52.3	1.9
Dentist	67.1	52.0	–
Physician, homeopath	94.6	76.7	–
Hospital	96.9	95.8	–
Health services, total	89.3	62.9	–
Training/education services, total	69.0	46.4	–

*Not weighted, scaled up for a whole year

The proportion of black services *vis à vis* household repairs (except for water and gas repairs) is exceptionally high, representing slightly more than two-thirds of total turnover. The exceptions to this tendency indicate that the official regulations may restrict non-registered use of services.

The proportion of non-registered services in *personal services* is exceptionally high—with the exception of laundry services. The use of the services of hairdressers, beauticians, shoe repairers and tailors by the population is over 50 percent in terms of frequency. The proportion of tips, however, is negligible, and cannot even be found outside the categories of hairdressers and beauticians.

This indicates that where there is no receipt issued, from the point of view of the customer the tip is not separated from the rest of the amount paid. This is especially true in the case of *health services*, the majority of which are available free of charge due to the provisions of the social security system.

The unofficial moneys given in exchange for health care services were seen by the respondents not as tips but as gratuity money for the service. Accordingly, in 90 percent of the cases they report non-registered cash movements. This percentage was highest in the case of hospital care (96.9 percent), which amounted to 95.8 percent of the total hospitalisation expenditures. An exception to the general trend is dental services, where registered payments account for one third of the cases and only half of the costs of treatment go unregistered. This is an obvious sign of the fact that the majority of dental services have been taken off the list of those health services which are free of charge.

According to estimates of the profession, tips in the health care services may amount to some 0.6 percent of the GDP, or HUF 13–30 Bn. No more than about 10–20 percent of these tips are stated in the tax returns.[14]

In some two-thirds of the cases the *educational services* were used without asking for receipts. The prices of organised teaching/training forms are far above the level that has developed in the non-registered market. This is indicated by the fact that about half of the expenditures fall into the non-registered category. The survey also revealed that, where a teaching method does not require any special material facilities (such as language teaching at home), the non-registered use of the service is far more extensive than in cases where facilities are required, such as sports or use of computers.

The survey did not cover financial services—e.g. banking, insurance—the frequency of which cannot be assessed using the questionnaire method.

Macro-economic consequences

The data for each commodity type obtained from the survey were scaled up for a year's period. However, before doing this the results were summed up and weighted. The number of the sample was multiplied by the total number of families. In this way the total value of the assessed goods and services could be macro-estimated.

[14] *Népszabadság*, 13th October, 1995

Our estimates of the black economy are primarily aimed at establishing proportions. The actual development of the black economy can only be monitored through repeated performance of empirical surveys of identical or very similar methods. It is these surveys which can show the dynamic of the changes of the proportions of the black economy in the various sectors of the economy. The distortions of the results yielded by such repeated surveys (arising from the methodology of the survey) are identical. Therefore the results indicate changes with no significant distortions.

The *non-registered expenditures* indicated by the survey *include goods purchased and sold for the purpose of tax evasion, along with such services rendered for payment of gratuity money, tips and the whole of the turnover of the food sector*. With respect to the last category, only a small proportion is seen as serving purposes of tax evasion. This is because the obligation of agricultural producers to pay taxes and issue receipts is much narrower than that of the rest of the actors of the economy.

In the market, the buyer occasionally receives a receipt, especially in units which operate in markets as shops. Here, the range of the total turnover was not assessed—i.e. car purchases, fuel purchases and, among services, residential construction and catering were not included in the questionnaire. The latter two items would be very difficult to separate on the basis of the statistics. In the case of turnover included in the retail trade but not assessed, we assumed proportions similar to those of the assessed turnover. This has resulted in a slight distortion of the final results.

The assessment of manufactured articles does not cover the whole of purchases made. Questions were asked about manufactured goods which have a higher than average proportion in the black economy. This has also resulted in some distortion of the results, but distortions in the opposite direction are also possible.

Using the proportions yielded by the survey we made an estimate of the non-registered turnover not included in the assessed turnover. The basis of the estimate is the assumption that, as a result of the survey, we received relevant information on the non-registered turnover of certain products. This information also accounts for substantial sections of the black economy, and on the black use of certain services.

In order to calculate this, first the amount of the 1995 turnover of the assessed commodity groups had to be defined, within the total expenditures of households. This was calculated by projecting the 1995 turnover of retail trade at current prices, on the basis of the 1994 annual and the 1995 January to November data. Also, we assumed that the total range of the expenditures of households is better assessed by household statistics than by a single questionnaire assessment. Therefore the structure of the registered sales turnover of the retail sector was calculated on the basis of household statistics.

Table 5

Estimate of the assessed segments of the shadow economy, from the aspect of the national economy

	Expenditure structure of households percent	Estimated registered expenditure HUF Bn	Estimated non-registered expenditure HUF Bn	Breakdown of non-registered expenditures, by expenditure group	Expenditures, total HUF Bn	Non-registered turnover as a percentage of the registered turnover
	1	2	3	4	5(2+3)	6(3/2)
Foodstuffs and ATC net of catering	34.5	1.096	177	20.6	1.273	16.1
Clothing items	7.7	244	84	9.8	328	34.4
Other manufactured goods	29.0	920	256	29.8	1.176	27.8
Retail turnover, total	71.2	2.260	517	60.2	2.777	22.9
Services	15.5	492	341	39.8	833	69.3
Total surveyed range	86.7	2.752	858	100.0	3.610	31.2
Catering	6.8	–	–	–	–	–
Residential construction and acquisition	6.5	–	–	–	–	–
Total	100.0	–	–	–	–	–

Source: Household budget 1989–1991 (CSO 1993); Retail trade, catering (CSO 1995/10); Statistical yearbook, 1994. (CSO 1995)

By breaking down the retail turnover (of the) main commodity groups in this way we developed the estimated total values of non-registered turnover, using black market ratios. The same procedure was followed in the case of services.

In the evaluation of the proportions it should not be forgotten that these are value ratios, which cover far larger volumes as a result of the lower prices prevailing in the black market.

The estimated non-registered expenditures amount to 31.2 percent of the registered expenditures—i.e. shoppers spent about one-third of their respective total expenditures in the shadow economy in the assessed range of goods and services (compared to expenditure in the legitimate economy).

Within the various main groups of expenditure the proportion of the non-registered turnover compared to the registered turnover is between 17 percent and 69 percent, and these figures show large differences. The survey revealed that in the case of food and ATC purchases, which account for the majority of the expenditures of households, some 14 percent is non-registered, while over one-third of the total "black expenditures" are on foods and ATC.

Non-registered turnover is 34 percent and 27 percent of the markets of clothing items and of miscellaneous industrial products, respectively; the shares of these groups are over 14 percent and 16 percent of the assessed non-registered turnover, respectively.

The proportion of non-registered expenditures compared to registered expenditures is highest in the area of services (69 percent). Services are not linked to the movement of goods, therefore the possibility of tax supervision is limited. As the share of services in total expenditures is increasing—in line with world-wide trends—so too is there an increase in their weight within the shadow economy. This trend is intensified by the fact that some of the formerly "free of charge" services in the Hungarian economy have been transferred into the range of services to be paid for. According to the survey, services account for about one-half of the total assessed shadow economy.

The shadow economy was already present in the Hungarian economy prior to the transformation of the system. Indeed, even though its dimensions were smaller than those existing now, it may be said that under the conditions of a shortage economy, support came from the hidden economy. The latter, in terms of its forms, differed from the existing one, as a matter of course. At that time it was not recognised that the hidden economy could be restricted by eliminating the causes, rather than resorting to administrative means.

Along with the transformation of the system, with the expansion of the market economy the dimensions of the hidden economy have also increased considerably. However, this is not primarily a result of the market economy; what the market economy has done is to provide new opportunities. *The expansion of the hidden economy is primarily a result of inflation and over-taxation.* With the inflation of wages and other incomes (and the reduction of real purchasing power) the stratum of the society which can only just make ends meet if it buys in the black market is increasing; over-taxation is a cause due to the fact that the high rates of VAT and personal income tax make the gains of bypassing legal channels substantial and especially attractive.

Most of the GDP generated in the hidden economy is generated in the private sector. According to the already cited GKI study (calculations by *Árvay and Vértes* 1994) this proportion is almost 90 percent.

The greatest part of the black economy is realised in monetary processes. People are spending much more than they earn, officially. This is also reflected by the generally acknowledged high proportion of non-registered turnover of the retail trade and services.

Legitimate, illegitimate and semi-legitimate activities are completely mixed up in the economy. They are inseparable in such a way that it is hard to recognise the individual components. Although the choice of the methods selected and their characteristics may seem to be of an *ad hoc* nature, it is without doubt important to study this segment of the real economy. This is what we have made an attempt to do.

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OBITUARY

In Memoriam Professor József Bognár

The lifetime of Professor József *Bognár* stretched across one of the most difficult and contraversial periods of Hungarian history. Born in 1917, in the last stage of the Austro-Hungarian Monarchy, he grew up in the nationalist atmosphere of the 1920s and 1930s. As a student he joined the anti-nazi political groups and this brought him into the movement of those people who actively fought for the democratic transformation of Hungary before 1945. He was not merely a bystander or an analyst of events, but in many ways played and active role in influencing them: as the youngest mayor in the history of the Hungarian capital, as a member of parliament for about 45 years, as a minister, as a deputy premier, as a university professor and as a scholar (who, until the very end of his life, remained an active researcher). Like many other well-known economists, József Bognár came to the field of economics from another field—from that of humanities; he moved to the academic world from the sphere of politics. He maintained, however, his fundamentally political approach in economics, even after his decision in 1957 not to accept any high post in government. He understood better than many other Hungarian political figures or economists, that the role of external factors, international political processes and global economic changes had a major influence on Hungary. Therefore, in order to avoid complete and unilateral dependence, Hungary must understand and formulate clearly its national interests and goals, and always assess its scope for manoeuvre in the complex web of the international environment. As an economist, he was an open-minded pragmatist, who remained free from the traps of the different economic and political dogmas. Bognár's pragmatism was based on his system of values: first of all, humanism, democracy, a belief in human interests and rationality. He was also a strong and devoted advocate of the interests of Hungary. He looked at the different schools of thought from the perspective of their relevance, relations to realities, and the soundness of their recommendations for supporting human interests. It is not easy to summarise the contribution which József Bognár made to the progress of economics. He firmly believed in the necessity of cooperation between the different scientific disciplines, and as a scholar, he introduced multidisciplinarity into his work. He probably did more than any other Hungarian economist to show the complex interactions between political and economic processes, and internal and external factors in "real", functioning systems. He explained and analysed the causes of the different socio-political conflicts which emerged in the process of changes related to economic development. He also searched for ways and means to make such changes manageable. He revealed the patterns of consumer behaviour in the system of central planning and he also introduced the idea that market research is indispensable, even in a centrally planned

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system. In his work —which in fact was the subject of his doctoral dissertation at the Academy of Sciences—Bognár emphasised that the system of central planning and the scarcities created by it, may enforce certain consumption patterns. However, in the final analysis, disregard (on the part of planners) for the preferences of consumers and their deeply rooted habits is the main source, not only of the accumulation of unsold goods, but also of popular dissatisfaction. As a political figure, scholar, and research manager, he promoted the opening of Hungary to new ideas and diverse schools of thoughts in social sciences.

He started teaching the "Economics of Internal Trade" at the Karl Marx University of Economics in 1951. At that time he was a Minister of Internal Trade. Bognár's lectures introduced the critical analysis of Hungarian realities to the media (which at that time was dominated by ideology and dogmatism). I was one of the students invited to come and work with him in carrying out empirical surveys in the state trading companies. This was at that time a unique practice in the university. As a minister, he firmly (and in a few areas successfully) resisted pressures to nationalise everything and he protected a number of small private ventures in services, and particularly in catering.

While József Bognár was always interested in international relations and issues, he had to deal with them directly and actively. When the ministries of Internal and External Trade merged he became responsible for both. As a minister, he was a strong supporter of the ideas of, first, the Imre Nagy government in 1953. He was also a member of the second government of Imre Nagy, in 1956, during the Hungarian Revolution. After the crushing of the Hungarian Revolution, already as a full professor of the University of Economics, József Bognár became a member of the short lived Committee on Hungarian Reform, chaired by the famous Hungarian economist, István *Varga*. Bognár firmly believed in the necessity and the feasibility of reforming the economic system. He was the co-founder of the Hungarian Economic Association, which was initiated mainly by the reform group of Hungarian economists. In the 1960s he was one of the initiators (and an active member) of the group of those experts and politicians who elaborated the main ideas and programmes of the reform which introduced in 1968, under the name of the "New Economic Mechanism". He considered the reforms as instruments for the improvement of the living conditions in Hungary. He never agreed with those who dealt with issues concerning the reforms in isolation from improvements in competitiveness and the economic and technological performance of Hungary. He also understood—and in a way anticipated—the strong resistance to the reforms by the Soviet Union, and also by some Hungarian politicians, yet he was convinced that the setbacks will be only temporary.

In the early 1960s, the emergence of the "Third World" in the international system directed the professional interests of József Bognár towards global development processes. He was probably the first person in the profession to understand the causes and the consequences of the similarities between the transformation process in the developing and socialist countries. His first essay on the issues of development and their possibilities and limitations as a deliberate political and economic process, made him known instantly to a number of important leaders of the developing countries. In particular, he was important to those who were interested in the experiences of the socialist countries and in the lessons which could be drawn from their successes and failures. One of those leaders, the African Kwame NKrumah, invited Bognár to serve as an adviser and entrusted him with the elaboration of the first five year plan for Ghana. For this purpose Bognár brought together a small group of Hungarian economists, and the team, working with local experts, did a very good job. The plan became a long-term strategic document and it served as the foundation for the economic policies of a number of different regimes in Ghana during the decades after 1963. The programme's recommendations for self-sufficiency in food, the diversification of the economy in such a way that it would not need to give up the "cash-crops" of the country, the radical improvement of the educational system, and the better incentives for the farmers are important components of the policies even of the present government.

The experiences in Ghana, and further work in Burma, India, convinced and encouraged Bognár to "institutionalise" formally the research group which had dealt with the problems of the developing countries. This was not only based on his professional interests. He was convinced that the developing countries could become important economic partners for Hungary and other countries. The Afro-Asian Research Centre of the Hungarian Academy of Sciences, established in the mid-1960s, became an internationally recognised institution on development issues, unique in its objectivity and rational approach in the former socialist countries.

In the late sixties, József Bognár became the President of the Institute of Cultural Relations, a government agency dealing with the international cultural and scientific cooperation of Hungary, particularly with the Western countries. In this capacity, he initiated the first fellowship exchange programme with the United States, through the Ford Foundation, which facilitated the visits and studies of almost 300 Hungarian social scientists in the United States during the 1970s and 1980s. A new form of international cooperation in social sciences, particularly in economies, and regular roundtable meetings between British and Hungarian, and U.S. and Hungarian scholars was also his initiative. This form of cooperation served as an example for other countries. The roundtables functioned for about two decades and involved almost 50 economists from both sides respectively.

Bognár was one of the first economists not only in Hungary, but also on the international scene, who came to the conclusion in the early 1970s that the oil price explosion was not just a cyclical event, but it reflected major, long-term structural changes in the world economy. He also understood that the changes required not only new policies in the field of energy, but also major structural changes in the Hungarian economy and a much more profound knowledge about the international environment of the country. Bognár's initiative in helping to establish the Hungarian Council for the World Economy—a semi-governmental consultative body, with the participation of leading government officials, government and academic experts—aimed to advise and influence the formation of the economic policy of the country. The establishment of the Institute for World Economics of the Hungarian Academy of Sciences in 1973, which was also his initiative, served as a background institution for the Council. It also served as a new centre for non-partisan, objective research on issues vitally important for Hungary: e.g. on the main trends in the world economy, the expected longer term changes in the economy of Hungary's main trading partners, and the possible consequences of those changes for Hungary. He was the director of the institute for fifteen years.

During the 1980s he became the head of a group of economic advisers which was an important and influential body for the support of the new reform efforts. After the systemic changes, he confined most of his work to the Institute and the Academy of Sciences. His most important goal was to help the adjustment of both the Academy and the Institute to the needs of the new era, and to save the valuable achievements of the intellectual life of Hungary. He maintained special interests in the most important global issues and he turned to study the problems of global food security. In this area he organised a small, interdisciplinary group for a research programme just before his death.

Professor Bognár's merits were recognised and honoured in Hungary, with his full membership of the Academy, with State Prize and with an honorary doctoral degree from the Budapest University of Economics. He was also honoured internationally. In 1980 he was elected to the membership of the Club of Rome; in 1982 he became a member of the World Academy of Art and Science; in 1983 the Social Prospect Academy honoured Professor Bognár's achievements with membership. He was nominated as a Special Fellow of UNITAR, and in 1985 he became a member of the Council of the United Nations University.

With the departure of Professor József Bognár Hungary has lost an outstanding scholar and a public figure of international importance, and a great humanist.

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BOOK REVIEWS

BEKKER, ZS.: *Rendszerválság. Alkalmazkodási folyamatok a kelet-európai országokban 1970–1990 között* (Systems in crisis. Adaptation processes in Eastern Europe, 1970–1990). Budapest: Aula Kiadó. 1995. 309 p.

This book is a highly valuable contribution to the empirical research already done on ex-socialist countries. Drawing on a very wide range of facts, it compares the respective economic performances of four East European countries over a period of 20 years. The aim of the study is to throw light on the spectacular collapse of the socialist economic system and the problems which have been inherited from that system. These problems continue influence the scope of our progress and thus limit our "freedom".

The author has focused her attention on the ability (or inability) of the former socialist countries to adapt; she analyses their inaptitude for renewal with the background of the crisis and fall of the socialist system. In fact, she is still vexed by the problem which motivated her to write a book 17 years ago (*Növekedési utak, dinamikus pályák* [Paths of growth, dynamic routes] Budapest: Közgazdasági és Jogi Könyvkiadó. 1978),—namely, what sort of economic strategy may lead late-developing countries to success. Research on this topic started in the mid-1980s, no doubt influenced by the foreboding of an inevitable fall; it tried to explore why the respective attempts of socialist countries to break out of their plight were doomed to failure. Such research may also offer an answer to the obvious question of whether it was worth investing such an amount of energy into comparative research of the socialist era. Yes, it definitely was. Our only hope for progress is to thoroughly analyze our past mistakes and failures, to get to know the heritage we are dragging about and to understand what sort of change in economic strategy we need.

According to Bekker's starting point "radical changes in the late 80s had been all but the end game of a long-simmering process". Reforms and attempts at adaptation were applied as remedies for weak performance and operational troubles, Bekker says, but worsening performance and shocks from outside led, by the 1980s, to inoperability. Based on these assumptions, the author sets out to measure and prove the worsening of performance and its socialist features in an empirical, and not simply theoretical way. Her examination looks not so much into the mechanism of the guiding and operation of planned economies but rather into their quantitative achievements and results from the growth period of the sixties until the collapse of the system. This was the period when it was mostly the ability to adapt to changes in the world economy, to globalization and to technical renewal that decided if a given economy would lag further behind or catch up.

While studying performances and their factors, the author is in fact asking about the strategic orientation of economic policy: is it growth or efficiency-oriented, is it closed or open? Reform attempts as well as economic policy dilemmas were mostly related to just these questions and so were debates and fights among reformers and dogmatists: do we have, in order to prove the superiority of socialism, to speed up the pace of growth at any price or is it better to increase efficiency? Do we have to close in even more tightly from the capitalist "enemy" and turn even more intensively towards the Soviet Union and other CMEA countries, or do we open up to the world economy? Various countries and various periods produced different answers to these questions although, the Soviet Union tried hard to dominate and coordinate the economic policies of the camp.

The study deals with the adaptation reactions of four Eastern European countries—Bulgaria, Czechoslovakia, Poland and Hungary—and collates them with those of four industrialized countries: Austria, Finland, Portugal and Spain. It lists four kinds of reactions to outside influences: (1) drawing on outside resources, (2) boosting exports, (3) import substitution, (4) and slowing growth. It examines the path and characteristics of the economic policies of the various countries and pe-

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riods, as measured by the above four reactions.

The author luckily combines and applies the methods of two eminent Hungarian economists, notably the trend concept by Ferenc Jánossy and Béla Balassa's method of analyzing reactions to outside shocks. Accepting Jánossy's evolution thesis in which the stability of long term economic growth comes from the slow change of professional knowledge, it measures differences and the particulars of the adaptation process alongside the trends of growth. Balassa's method breaks up differences in disparities measured against actual changes, and the prolongation of the progress of an earlier period or other countries' growth according to answers given to "what if"-sort of questions. Bekker compares actual progress partly with the trend of the given country at unchanged conditions, and partly with the development achieved by other countries or regions over the same period. It is a well-known fact how difficult it is to carry out an empirical study of efficiency in international comparison. Therefore the author has approached the problem by using flexibility indices: rather than any absolute measure. This has enabled the measurement and comparison of changes in time and space. The research examines the export and import flexibility of the GDP as well as its sensitivity to accumulation and consumption and, from these, tries to read the underlying changes in economic orientation. The analysis openly concentrates on the real sphere, neglects financial processes (this is obviously a continuation of traditional planning approaches) and does not include the impact of non-economical changes—i.e., political, military, diplomatic. However, these latter factors have, in the past, to no small extent influenced economic policies as well as adaptation processes.

Besides introducing methods and the 1960s as points of departure, the backbone of the research comprises an analysis of the external economy. Incidentally, the understanding of complex concepts, notions, relations and measurement methods made more difficult by the fact that the author mentions, but does not explain, them within the text. (Definitions without explanations and equations representing correlations can be found in an annex only.) It would have been better to bring formulas and explanations together. There is another serious deficiency that may perplex the reader throughout the book: neither methods and research themes nor findings are positioned within the literature. We do not get to know if this or that is the author's opinion, with whom she is arguing or where her conclusions differ from those of others.

The good points: Bekker presents in a novel and expressive way the losses in the terms of trade suffered by the countries under review and caused by global economic changes following the 1973 oil shock. We not only learn how wrong and misleading the official line of the socialist countries was—i.e., that they could fend off the negative impacts of the price explosion—but we also get to know that, in fact, they had to book even greater and more prolonged losses than market economies, especially the more advanced ones. It is mentioned that this was partly due to the so-called Bucharest pricing principle of the CMEA (by which countries of the region formed their export prices based on a five-year average of world market prices), but we are not told what the reasoning behind this principle was. It is true that the price explosion was, at first, not so devastating; however, it weakened the pressure to adapt to it and consequently it became one of the main causes of much heavier cumulated losses than in industrialized countries. The latter were, in a relatively short time, able to compensate for their losses caused by the steep rise of imported raw materials by raising their export prices for processed goods. Bekker reckons that this did not happen in socialist countries, although their losses came not so much from their trade with market economies than from within the CMEA. At this point, the author should have dealt with the international dispute on the questions of for whom, and how much price proportions within the CMEA were favourable.

An indisputable merit of the study is that it refutes the widely held opinion which believes that the losses were caused by the price explosion alone. Instead, it emphasizes the drop in the volume of global trade. This is all the more important since this debate on economic policy dates back a long way: i.e. is it better to overcome difficulties by growth, acceleration, improved efficiency or perhaps by slow-down? Most illuminating is the author's claim that over the two ten-year periods between 1970 and 1990 the Hungarian economy was afflicted by two external trade shocks of similar magnitude: the price shock in the 1970s was bigger, while in the 1980s a slump in demand had a more serious impact. It must be noted that the notion of "external trade shock" is somewhat misleading. It seems as if countries were totally unable to influence their foreign trade prices and market share, respectively. Yet this was certainly not so: there is only a relatively small proportion of deals in which prices are unchangeable and given and where the bargaining power of the parties plays no role (that is, one or the other is a "price taker"). Similarly, it depends largely on internal factors such as, for instance, the way in which changes in the volume of exports are related to changes in external demand—i.e. if the market share of a given country would grow or shrink.

After treating external shocks, Zsuzsa Bekker turns to the aforementioned four kinds of adaptation reactions to see combinations characteristic of a given country's economic policy in various periods. She correctly states that in itself, drawing in external resources is neither right nor wrong; the issues are: what are loans spent on, and how far does their investment serve a change of structure and competitiveness? In other words, how far does it create the conditions for smooth repayment? However, she fails to stress that indebtedness in Hungary and elsewhere (e.g. in Poland or in many developing countries) cannot be simply blamed on an inadequate economic policy. The worldwide and extremely serious debt crisis cannot be explained from the demand side only. The huge supply of cheap loans created by the oil shock was just as responsible for the accumulation of practically non-returnable loans. In an economic sense, it is obvious that the fault for bad investments lies both with debtor and creditor. This is true even when a loan is raised by governments or central banks (who are much less likely to report bankruptcy than private enterprises are).

Bekker's comparative study shows that in the 1970s Bulgaria and Poland drew on much higher levels of external resources than Hungary did, and by the 1980s this process turned into an outflow of resources.

There is an interesting deviation in the slowing down of growth between planned and market economies. The latter immediately reacted to the oil shock by slowing down growth, curbing imports and introducing energy austerity measures; whereas, somewhat paradoxically, Eastern European countries experienced a six-year long boom. In other words, their answer to dramatic changes in the global economy was acceleration instead of slowing down and this naturally resulted in increases in their import and trade deficits.

Bekker's method becomes most enlightening when she examines the four reactions together. In this way she is able to measure how the adaptation reaction to external shocks was distributed among the various economic policy opportunities. It turns out that in the Hungary of the 1970s both reactions were positive; export growth and import substitution dominated and the drawing in of external resources and slowing down of growth played, respectively, smaller roles. On the other hand, the dominant reaction of the 80s was the slowing down of growth, followed by export expansion and import substitution; the drawing in of external resources was replaced by an outflow.

The parallel survey of the four planned economy countries shows clear regularities. Bekker calls the drawing in of external resources and the slowing down of growth "passive reactions" and points out that they moved in a contrary direction with time; the aforementioned regional boom of the 1970s was accompanied in all four countries by trade deficits and indebtedness. This, however, lasted no longer than the late 1970s when they were forced to switch over to a balance restoring policy. This policy, without requiring structural changes was possible by slowing down growth only. The policy of export expansion and import substitution—which Bekker calls "active reaction"—could not really become dominant. In respective cases of the four Western countries in the comparison, the drawing in of resources was combined with export growth: that is, with a change of structure. This was one of the engines of their later success.

Bekker contrasts the policies of export expansion and import substitution as synonyms of opening and closing up. This is often, but not always, true: a policy to develop competitive export industries automatically results in import substitution. This is because new and competitive export products may at the same time replace imports: developing countries with successful industries are a proof of this fact.

With regard to the ties between Eastern and Western countries, the vehicles of adaptation were different in all socialist countries, but the four under review may be grouped as this: Czechoslovakia and Bulgaria opened to the East and closed to the West in the 70s; thus they turned to look for outside resources, too, to the East. Poland and Hungary, on their part, drew in resources from the West and exported a sizable amount of capital, in the form of investment contribution, to the Soviet Union. They were confident that growing raw material imports from the East and an opening towards the West might considerably increase their export possibilities (which would help to lower their respective trade deficits). Yet just the opposite happened: due to soaring Soviet demand—caused by a change in the terms of trade—and to the recession in the West, the Soviet Union virtually drained off all their exports. At the same time, opening to the West resulted in exports containing more and more Western parts, and this again widened the deficit of trade done with Western countries.

Of the production factors, Bekker first examines the characteristics of labour management. She points out that the implementation of full employment was actually a specific feature of the socialist system, not only in the sense that the level of employment was higher, but mainly in that the proportions of employment were modified by the extensively expanding socialist sector. Beside apparently full and stable employment, the change in productivity in fact became unrelated to the workforce since this was a more or less constant figure; therefore, the apparent change in productivity became dependent on changes in production tendencies. This became a most deceptive phenomenon: the boom after the mid-1970s seemed to bring about growth in productivity—i.e. it suggested that the economy was progressing along an intensive path. However, the production tendencies of the Eastern European countries broke in the late 1970s: it was then that the illusion of improved productivity vanished and it became clear that there had been no intensive phase at all.

Comparison with the development of industrialized countries clearly shows the differences: there, changes in tendencies were followed by adaptations in employment policies, and it was not the workforce but the trend of productivity which was stable. Looking at the long-term tendencies of productivity, we see that the indices of the four Western countries are usually better than those of their Eastern European counterparts. At this point it must be noted that Bekker deals with the productivity of work alone; she has not dealt with the productivity of the other factors of population. Moreover, nothing is said about the fact that, when the number of those employed does not follow changes in production, then actual employment—that is, inter-company unemployment and the intensity of work, respectively—should change. Anyone who ever visited a factory during the period of state socialism knows this.

As there are no reliable and comparable data on capital stock, the author studies this through the development of investments. As a consequence of the growth-oriented economic policy of socialist countries they had a relatively high rate of accumulation; policy-makers and managers alike were permanently trying to raise the volume of investments. By keeping the price of capital goods artificially low and channelling investments into heavy industry and new projects, they distorted the structure of capital and this inevitably led to a slowdown in growth. Bekker indicates that the accumulation rates of Eastern European countries were higher than in the industrialized, and even than in the developing countries. However, she fails to point out that, given that this went on for decades, it was senseless to speak of a shortage of capital (as our economists did) since it was in fact a waste, and not a shortage, of capital that characterized socialist management.

In analyzing the data on net fixed capital accumulation in Eastern European countries one sees no sign of a switch-over to the so-called intensive phase, i.e. to an improvement in the use of capital. From the late 1960s onwards investments rose and this tendency was still evident in the late 1970s. The attempt to step-over the extensive phase (when the drying up of resources and the slump in revenues was already felt) urged policymakers to drive up the volumes of accumulation even more forcibly instead of improving the quality and utilization of investments. In spite of considerable efforts, the formation of fixed capital was, in the long run, faster in the four planned economies under survey than in Eastern Europe in general because, as Bekker writes,: "... management trying to avoid squandering resulted in quicker capital formation accompanied by a lower accumulation rate".

In analyzing the accumulation cycles of the four Eastern European countries, the author takes an original point of view in the debate on the causes of the cyclic quality of planned economies. Without arguing with those researchers who believe that the reason for the cycles was the indigenous bargaining process (Bauer) or the campaigns (Soós) of socialist economic management, or with those who attribute it to inept regulation (Bródy, Jánossy) or to political cycles of management (Ungvárszki), Bekker offers a fresh explanation. In comparing the actual process of accumulation to the respective accumulation trends of the individual countries, she finds a large degree of joint movement and sizeable swings in the behaviour of all four Eastern European countries. She attributes the sudden shift to belated economic political reactions; these occurred when the loss of balance demanded immediate interventions. Imbalances were of course induced by the nature of the system but, as Bekker writes, "a dominantly doctrinaire economic policy of a clumsy and tardy system" could handle these "in leaps and bounds only".

Within the analysis of the factors of final demand, the development of consumption plays a pivotal role. The author points out that ideologists declared the improvement of living conditions to be an ultimate goal; still, whenever they had to choose between consumption and investment, they invariably opted for the latter. She noticed the changes of the 1970s but failed to mention that they were to no small extent triggered by the 1956 revolution and its after-effects. Fear of explosive popular discontent dictated that personal consumption must not dwindle but should slowly and steadily grow. Bekker correctly separates the population's consumption from the so-called "collective" one that included and, as such, grew at all times quicker than consumption in general. Therefore, there is more to it than a simple conflict between investment and consumption. Wantonly generated investment and consumption induced by power and political consideration were here opposed to consumption as defined by actual social needs.

While, in general, consumption is a stabilizing factor, accumulation is highly sensitive to boom and bust. No other data is more informative on the downward tendency or "collective collapse" of the eighties, as the author calls it, than the rapid fall in the volume of accumulation in all Eastern European countries. The consumption flexibility of the GDP had been systematically lower, and that of the accumulation higher, in Eastern European countries than in industrialized countries. In other words, consumption in the East was only to the fruits of growth. In saying this the author provides a definite answer to the charge—a small extent based on often cited "from above" even now—that the cause of the difficulties was our "excessive" consumption: "... if for the purpose of qualification we use the share from unit economic product as the point of departure, ... then the decisive factor is not so much excessive consumption but excessive accumulation that actually ... masks inefficient and unreasonable utilization".

The last chapter of Bekker's study is entitled "At the threshold of changing the system". This is a summary of the author's views on future development tendencies. Looking back on the past decades experienced by the Eastern European countries, she states that they failed to reach their much-heralded goal: that is, to catch up with the industrialized world; instead they found themselves in a marginal position. The gap between them and the Western European countries kept on widening after the Second World War. She warns, based on a widely held view, that according to Jánossy's concept of stable development, economic growth accelerates in the "restoration" period "automatically" (following a set-back). However, in order to achieve this it is necessary to intensify investments.

Bekker has carried out a much deeper and thorough analysis of facts on the long-term development of Eastern European countries than anyone before her. She has focused her attention on economic policy and strategic decisions instead of the mechanisms of decision-making, guiding and implementation (as most of the other reform literature tends to do). Hers is a pioneering work, yet this is just why the reader has a certain feeling of want: examining macro-relations only one finds no answer to the question of why the efficiency of the economic activities was so low. What interests—not only that of economic policy but corporate and trade union interests as well—were in play when growth orientation regularly overruled efficiency orientation, and protectionism overruled openness. Also we get no explanation as to how, in spite of several defeats, reform conceptions calling for efficiency and openness could revive over and over again. This is because Bekker's research has intentionally excluded the mechanisms of economics and the enforcement of the interests of institutions. However, it involves the risk of the reader thinking that economic policy decisions were born of rationality/irrationality and not, as was the case, of conflicting interests.

Similarly disputable is Bekker's statement that the systemic change in the socialist countries resulted from their economic inability to adapt and operate; however, this could have happened earlier if the West had not had an interest in maintaining economic relationships and thus prevented a spectacular collapse taking place. There are several reasons behind the collapse, like the spreading of discontent, the weakening of suppression, and the fact that some groups recognized their interests in a switch-over to market economy.

A deficiency of the study, following partly from the method applied and partly perhaps from the author's attitude, is that her analysis of the economic strategy of socialist systems does not reveal that the socialist countries were in fact anti-democratic and totalitarian. They were built on political oppression where the needs of the military, the police and the secret service were always given priority. Speaking of consumption, the author does mention that the collective consumption included war costs, but she fails to point out that a sizeable part of accumulation also served the war industry, and the growth generated by it included war materials.

The four Eastern European countries selected by the author represent rather well the region's problems, the nature of socialist economic management and the differences between socialist countries and the developed industrialized countries. It is exactly these differences that would have deserved more attention. Czechoslovakia and Bulgaria did not run into debt and, although Romania had done so earlier, it recovered in the 1980s (albeit with a heavy price for it let its consumption slide). Yugoslavia's case, too, should have been presented: here, dependence on the Soviet Union had been much weaker and the market much stronger, respectively, and still they experienced similar difficulties as the others with adaptation.

Bekker should have been much more critical with the measurement and measurability of GDP and national income—that is, their importance—because most of her research has been based precisely on these factors. She does not mention, for instance, Bródy's well-founded doubts in this respect and makes no attempt to examine by estimate of error how far the distortion of measurement might affect her analytical results.

When looking into the problematics of adaptation, it is a serious mistake to deal with changes in price proportions and demand only and to disregard the shock caused by changes in interest rates to countries already in debt in the early 1980s. The author admits that she did not research the effect of changes in real interest rates, although her calculations could have been rounded off by these. The truth is that the sudden growth of indebtedness in the early 1980s was in a large measure due to the rise in international interest rates and this led to the withdrawal of a considerable volume of resources.

The author deals with the 1973 oil shock but hardly ever mentions that after 1985, oil prices measured at real values fell to pre-1973 levels; this was one of the main causes behind the set-back of the Soviet economy and most probably behind its collapse by the 1980s.

All in all, Bekker seeks an answer to the question: do Eastern European countries stand a chance of breaking out and speeding up development, and thus diminishing their time-lag *vis à vis* the developed countries? Her findings convincingly show that the past strongly limits the possibilities of progress. Her attitude, even if this is not evident from the study, has much in common with the widespread theory and analysis of "path dependency". She righteously warns that, by continuing on the path of past decades, we might easily get a quasi-market economy and this could conserve our marginal position. Yet it also follows from the study that the path was wrong and led to failure because leaders had for decades repeatedly chosen the worse solution: growth orientation instead of efficiency, closing-up and CMEA integration instead of openness, protectionism and conservation of a wrong and obsolete industry structure instead of export expansion and restructuring.

We may debate as to whether it would have been possible to opt for another, better way under Soviet dominance and Communist party rule. Now we do have that opportunity. Yet it is still not evident if the democratic governments can and want to take it. There are still many who argue for the priority of growth, who, instead of promoting exports, want to raise customs tariffs (and surcharges); powerful lobbies clamour for more subsidies for the military industry and secret services, and especially for the protection of obsolete industrial and agricultural structures. Everywhere there is a strong resistance to much-needed changes but no doubt there is also a potential for renewal. So, after reading Bekker's analysis we can certainly say there is hope. Let us not forsake that hope.

A. NAGY

BALCEROWICZ, L.: *Socialism, capitalism, transformation.* Budapest–London–New York: Eastern-European University. 1995. 377 p.

There are few who, before reaching the age of fifty, may say that they have reached the most that can be reached. For researchers having ventured into economic policy it is especially difficult to set the maximum. This is why this question has engaged the attention of one of the new schools of economics. The school named "political economics"—which sounds a bit perverted for Hungarian ears—attempts to describe with dynamic mathematical models how a situation can be achieved in which theoretically desirable economic policy trends continue to prevail after and in spite of changes of government. It is when this is fulfilled—under quite complex conditions—that the theory considers the economic policy successful.

In our region this theoretical requirement is an illusion for numerous reasons, including the gap between the political class and the profession of economic science. Still there is someone who, according to his own admission (p. 343), unexpectedly reached the axis of decision-making, built up a model concept in a few weeks under chaotic circumstances, and then saw his concept come true. Moreover, this not only happened during the two years when he himself could direct the processes which is not negligible in itself. In fact, the verification came when two governments who rejected this model sharply (first the national populist government of Olszewski and then the post-communist coalition) proceeded along the lines set out by Balcerowicz. Moreover, in his campaign, President Kwasniewski took good care to put non-economic issues and style to the fore, repeatedly taking an oath to continue with the reform trend. While in 1989, seven years ago, Poland was an insolvent, stagnating country with runaway hyper-inflation, today, for the fifth year running Poland is the fastest developing country in Europe, its currency is convertible, its balance of payments are in order and the possibility of joining the Euro-Atlantic structures exists. The price of this transition did certainly not exceed that of the 1929–33 world crisis—in respect of the recession—and it has been the lowest and shortest among all the countries in transition. The 8–9 percent of the GDP has remained below the 18 percent in Chile, 16 percent in Peru or 12 percent in Argentine from among the recessions experienced during the period of 1960–90 (p. 327); we may also add the 20 percent in Hungary or the 34 percent in Russia. In 1995 the inflation in Poland was at the same level as in Hungary. USD 1.3 billion working capital flew into Poland in 1994 and USD 1.6 billion in 1995 and the country could also return to the international bond markets. In short: the myth of "cack-handed Polish"—carefully built first by the Kádár government, then by the Antall government—has become ill-founded, and those who read through this volume (published at the end of last year) can obtain an insight into the thoughts of the spiritual father of this change, which is also unrivalled internationally.

The title of the book is an unmasked reference to the major work of Joseph Schumpeter, the theoretician of one of the greatest effects of democratic socialism, where he argued in favour of the compatibility of the market built on ventures and socialism. We may say that Balcerowicz—having the experiences of an intellectual brought up in the Soviet empire—has dedicated his book to formulating the contrary thesis.

This book is not a monograph, but a collection of lectures and articles written in different periods for different audiences. In spite of the implied overlaps this work has an internal logic. Part one—chapters 2 to 7—includes works produced in 1988–89. In addition to rejecting socialism it also explicitly formulates the necessity for an open break with the concept of the third way, i.e. democratic socialism. It is also from these works that the author's definite aversion to gradual changes can be deducted. On the basis of the Polish experiences, this is more than understandable (although theoretically this also leads to contradictions). The second part, that is chapters 9 to 13, contains writings produced between 1993–95. With the end of the recession implied by the results of the transformation, these elaborate on the general connections of the economic policy which has transformed the system and which can be enforced internationally. Finally, the third part, consisting of chapters 14 to 17, includes studies on Poland which have been prepared at various times, among them a closing chapter on a more personal note. The genre of the book is applied institutional economics. The latter tries to bridge the gap between the main stream of economics which is turning into mathematical abstraction, more traditional economic schools, and also the practice of economic policy.

From the first chapter, which outlines the framework of analysis, it is clear that Balcerowicz cannot be ranked among the ordinary authors of neo-classic orthodoxy. This is because his interest focuses mainly upon the institutions discarded by the mainstream of economic policy and considers it important to enforce the principles of traditional methodology, even within the frame of verbal argumentation. His approach is interdisciplinary for it is an economic analysis enriched with the inclusion of historical, social, cultural and psychological features. It is in order to avoid frequent abuses incurred due to this wider approach but which he considers necessary in order to empirically verify the prevalence of the said characteristics (p. 12) and include them in the general picture. His thesis on the maximum speed of institutional changes (p. 10) is a logical consequence of this approach, and it is deducted from the restricted learning capability of, and the limited possibility to motivate the players of the economy—especially the administration. With this the author differs pleasantly from the widespread vulgar economic trends which consider that the institutions can be selected, introduced or restructured at will. This also explains that, while he evaluates stabilisation as a routine step taking well-proved procedures, with regard to institutions he argues in favour of the variety of national ways and not only of the paces. Thus he avoids the frequent bureaucratic and intellectual sluggishness of the "economics of the transition".

The works in the first major part of this book may be looked upon with renewed interest given the atmosphere of the reverse change of regime. *Chapters 2* and *3* are a summary of the Polish and Hungarian economic approach of the eighties. According to this approach a capital market is needed for the effective allocation of capital, and this is in fact the trait of capitalism which socialism thought it could exceed by the central management of investments. Mixed systems, in which neither horizontal nor vertical coordination are in excess, cannot be maintained. This is what appears in the reversion of the reforms of the planned economy, and in the case of the liberalisation of foreign trade in the breakdown of vertical dependence, in the development of the reform into a change of regime. (pp. 32–33). The chapter comparing Western debates on socialism with reform economics is especially interesting from the aspect of history of theory. Here we can read interesting data on the first version dating back to 1922, written by Boris Broutskous, of the hybrid known in Hungary as the Liska model. The author shows that it is the naiveté of the socialist market models which appeared in the fact that they were subsequently neglected by practice, as their theoretical attraction came from the axiom-level elimination of practical problems. *Chapter 5* proves as a thesis, and *Chapter 6* on innovation proves in relation to a concrete area, that the economic system of the Soviet empire was a coherent whole. Problems were caused by the whole of the system, by a totality which could not be superseded by partial measures. It is hardly surprising that innovation research became the major field of dissatisfaction with the system as a whole: the relevant researches and criticisms were protected by the—naively utopian—declarations of the founding fathers against the thought and secret police. The question concerning insufficient innovation could not be eluded any more in the atmosphere of ideological excitement following the sputnik shock. The answer blamed the whole of the stability oriented system. The latter lacked the carrot and stick for encouraging basic innovation and overturning the ossification which was usual even before and irrespective of the extent of the stagnation of the Brezhnev years. The insufficiency of the reform socialist practice could be demonstrated here too.

It is an important point that in the long *Chapter 7* on ownership emphasis is placed on the significance of the private element not only on the side of supply but also on the demand side (p. 85). This represents a conclusion to the rejection of over-regulated mixed models and hybrid models which redistributed most of the profit "according to higher viewpoints". This recognition discusses the contradictions of institutional non-private ownership and—on the basis of examples taken from the OECD—the deteriorating effects of excessive regulation (pp. 98–99). Competition should be the mediator between ownership and performance (pp. 115–117), but this is what is usually eliminated by over-regulation. The author seems to have been carried away by the impetus of writing in this much debated topic as he describes the socialist system as being inferior in all dimensions, but fails to mention the issues of safety, equality and the possibility of calculating these factors.

Chapter 8 examines the possibility of achieving a "mix" and looks at the performance of political and economic systems dating back to 1994. The need for a comprehensive synthesis dominates here and perhaps this is the reason why Walter Eucken is missing from the list of references. It was Eucken who, forty years ago, arrived from German experiences to the same conclusions as Balcerowicz from the Polish ones—namely, that democracy cannot replace capitalism and capitalism cannot exist well—in a civilised way—with the absence of democratic institutions. Democratic socialism is therefore an attempt to square the circle, as if the freedom to choose means that the majority will opt for the more effective system (pp. 132–133). Opposed to this and contrary to the clichés of development theory, autocratic systems do not necessarily favour the aspects of capital accumulation and external growth. The performance of autocratic systems is more varied and the danger of the distortion of such systems into populist client system is also more likely than in a parliamentary shift system (pp. 138–140).

The second major part of this work covers the theory of change of regime. *Chapter 9* outlines the following: in Eastern and Central Europe a different quality of change is taking place compared to the reconstruction following the Second World War. During the war the institution of market was only suspended, while in the "Iron Curtain" countries it was eliminated. Similarly, in the developing countries in most cases it was only restricted or distorted. Consequently liberalisation will automatically solve most of the problems. In Hungary three types of reform—of different duration, depth and impact—became necessary: beside stabilisation and liberalisation the building of institution is fundamental. First on pages

161–162, then recurrently, the author underlines that there is a possibility for basic restructuring directly after the changes, in the period he refers to as the "era of extraordinary politics". This is when the most unpleasant, but necessary steps must be initiated, because later it is impossible. This is the recognition which was formulated in the recommendations of the Bridge [Híd] group which prepared proposals for the Antall government (*Külgazdaság*, 1990, No. 7), and also in the left centre coalition agreement (*Magyar Hírlap*, 22 June 1994). However, the Bridge Group met with little success.

Chapter 10 provides a comparative analysis of the Eastern and Central-European transformation. It points to the striking contradiction that, following the failure of the totalitarian state, policies for redistribution came to dominate public thinking and governmental practice in the region (sometimes with the proclamation of market principles). In this approach because state administration is seen as a profession and governance is a limited, even one of the most limited resources it falls into the background. The more it is pulled into the sphere which is referred to as "the state's natural incompetence" by Balcerowicz—restricted, for example, to issues of production, cash circulation or market protection—the more inattentive will be the issues requiring central coordination. Arguing in favour of quick privatisation on page 182 and elsewhere, the author emphasises that state-owned companies are always political in their nature and thus tend to invite intervention. At the same time, he does not discuss the issue of sustainability, although less effective or even scandalous privatisation may not only be a basis of reference, but also the direct cause of restoration—as seen in Russia.

Chapter 11 discusses the different ways of moving towards a private economy and contains most of the debatable statements. Although it was written in 1995, the treatment focuses almost exclusively on the issues of the change in ownership. Most of the issues concerning the second wave contain the most difficult part of the change of regime, including the reform of the large systems of redistribution and the state, the reform of the financial sector and the connections with international institutions. Unfortunately this is dealt with superficially at best. Obviously in favour of mass privatisation, Balcerowicz pursues a debate with the evolutionists (represented by János *Kornai*) who support the traditional way of propagating a private economy. In my view Balcerowicz's approach is exaggerated and unsuccessful. The domestic or even the Czech and Russian practices have not proved the theory that traditional privatisation is necessarily time-consuming and slow, or likely to involve restoration (as it is assumed on pp. 197–199), or that the secondary capital market can solve the issues of company management (unsolved in the coupon method). The institution-oriented, wide scope of interpretation of Balcerowicz is also evolutionist. Yet, Kornai was also criticised by several of his colleagues in 1989, and on the turn of 1995–96, because of his radical statements supporting equilibrium. Thus this debate seems artificial. The real battle-lines lie between those who play down the necessity of institutions and those who believe that institutions can be selected at discretion. On the other hand, the supporters of stabilisation and instinctive keynesians believe that the economy can still be stimulated by pumping in money and reducing interest rates. In the previous chapter (p. 180) Balcerowicz himself refers to the fact that in the Czech and Hungarian cases the extent of disequilibrium differed qualitatively from that in Poland and this is why they did not need the Polish-type stabilisation. This is, however, a theoretical difference.

Chapter 12 covers the presentation delivered (together with Alan *Gelb*) at the plenary meeting of the annual conference of the World Bank. In reviewing the country experiences it is the importance of the trio which stands out, comprises the starting speed, the harmonisation of the measures and their critical mass: without these the reform has no real substance and is inert. On the other hand, it is also evident (pp. 221–224) that the standard adjustment policy is viable in an unusual medium also, i.e. it is not necessary to wait until the building of institutions creates the "conditions of the model". This relationship—supported from two sides by both positive and negative experiences—has proved that one of the most recurrent commonplaces of post-socialist economic bluff is really a mistake. In the domestic context it is interesting to notice that part of the costs of restoring the banking system should certainly be borne by the state. Furthermore, the budget adjustment must focus on the expenditure side and the latter requires its curtailing. However, a successful adjustment does not replace, but rather lays the basis for the transformation of the system as a whole.

The theoretically most valuable and exciting part of the book is *Chapter 13*. This contains a catalogue of the misinterpretations of the change of regime. Everyone involved in studying Eastern and Central Europe using a theoretical approach or giving advice concerning economic policy should read this chapter. It is important in that it draws attention to obvious but often neglected rules. For example on pp. 234–238 it is stated that the appearance of a phenomenon in the OECD region, which perhaps in time will be closer to us, is not a clinching argument for implementing it domestically. It repeatedly reminds us of the fact that a complex system—for example, financial mediation—cannot be tailored to deadlines chosen at will. Moreover, it is described as a methodological gamble to mess up country specifics and therapeutic features (p. 247). It correctly reminds of the connection observed in our region—and thus not debatable in theory—that indulgence towards inflation and a reflationary policy leads to lower and not to higher growth, to slower and not to faster restructuring. Thus proposals built on contrary assumptions may, indeed must be rejected. It is instructive to read Balcerowicz's approach to the widespread thesis on the exaggerated social costs of the transformation. According to this approach it is methodologically incorrect to classify all negative traits under the term of "costs" because this suggests that none of these would exist—from crime through poverty to the increase of energy prices—if the old system had not been replaced. It is widely known that the latter took place due to the fact that even the beneficiaries of the *ancien régime* recognised the unavoidable failure of the situation. The actual losses must be compared not to the earlier or unchanged conditions, but to the costs under the alternative policy, the opportunity costs—that is, the Polish to the Ukrainian or the Czech to the Bulgarian. It is quite edifying that he repeatedly mentions on p. 267 and elsewhere what an advantage the stable political structure with elections every four years and a weak president means for Hungary. Many in domestic public life refer to this as politics by pacts and/or politics by a limited elite above the head of the people. The absence of this, constant elections and changes of government in Poland have seldom allowed comprehensive steps to have any impact. Continuity in economic policy—praised in the introduction—is seen as being even more remarkable. The part of the book which for me provided the least novelty and new experience was the third major part which includes a descriptive presentation and comment on Polish economic developments. The chapter reviewing the reforms of the eighties argues on an empirical basis in favour of the necessity of a radical market change. *Chapter 15* sums up the years 1989–92 and concentrates on the international experiences of adjustment programmes. This is especially interesting because it shows that in spite of the early dispersal of Solidarity in the summer of 1990, the teamwork realised in the technical management ensured the continuity of the economic policy. This policy was later supported against the lobbies by convertibility, an independent bank of issue and import competition. According to the Polish experience the IMF has played a negligible role in shaping the Polish therapy (p. 310), and the activity of Jeffrey Sachs is mentioned only in the context of presenting the international theory. Finally, a thorough examination of the return of the successful party coalition is surprisingly missing from the analysis of the Polish transformation between 1989 and 1993. This coalition partly overlapped with the previous one, as this material was completed at the beginning of 1994. In addition, I would also have enjoyed to have read something about the role of the banking system, local power and the agricultural lobby; the dilemma of restoration versus sustainability is an issue resulting from the author's own train of thoughts.

Chapter 17 includes personal reflections which are part of a series of interviews made with Central-European financial managers. In fact, any restricted summary with a theoretical approach would have been more successful. For me, among the various points of interest there is the statement (p. 341) that under general Jaruzelski a series of seminars of unhidden orientation had been going on in the offices of the Polish Economic Society on economic systems and models of radical market transitions. It was under these auspices that Balcerowicz (and his team) developed a strong anti-gradualism approach. It is clear from the preliminary studies that the Polish school of liberal market economy came to existence as a platform *based on the analysis* of international experiences *prior to* the appearance of any foreign consultants. If anything influenced the Polish approach it was Hungarian reform economics and the German ordoliberal school—the latter is known for its strong criticism of German social policy and agro-economic practice. The introduction of shock therapy was confirmed by necessity and not merit: Balcerowicz (pp. 343–344) states that the only other options were risky and obviously hopeless schemes. The risk is said to lay in the fact that the standard adjustment programme was applied in the context of companies which had not grown in a market environment. Consequently, their instincts, based upon their monopolistic positions, would lead them to expect the help of the state. The author refers several times to the Argentine president Alfonsin who started with radical reforms and then, scared by their impact, retreated—thus he forfeited both his popularity and the possibility of economic recovery at the same time. It was with this argument that he convinced a former trade union leader to support the market economy line in his role as president of the Polish Republic. Thinking of president Jelcin, this argument still sounds convincing.

Balcerowicz's book does not lead us into an unknown new world. However, it provides an insight into the theoretical background and practical trade secrets of the Polish change of regime. The argumentation of the author is balanced and good, although he will hardly convert readers of different approaches to his own belief. His own arguments are presented thoroughly, precisely and easy to follow; all presentations are well structured and have earlier been published or scattered in papers of restricted accessibility. This work also dissipates misconceptions inasmuch as it frees us from old theses which harps on about the political and ideological imperialism of the IMF or—referring to the fox of Aesop—from theses presenting shock therapy as the best of all worlds. Valuable theoretical realisations and practical knowledge can be found in this book. The often open, several times hidden comparisons with domestic circumstances are interesting. The volume can be read through and enjoyed without mathematical or technical economic qualifications. The reader gains a better knowledge of the issues and can avoid many usual traps and misunderstandings. A better understanding of our companions in distress may enrich our self-knowledge.

L. CSABA

JOHNSON, S.–LOVEMAN, G.: *Starting over in Eastern Europe.* Harvard University Press. 1995. 211 p.

In the wake of state socialism's downfall in 1989–90 there was a sudden growth in the number of institutions analyzing the Polish economy. Today there are many new or reorganized establishments investigating the behaviour of enterprises by using statistical data, questionnaire surveys and other methods of empirical analysis (*Belka, Krajowski and Pinto* 1993; *Dąbrowski, Federowicz and Levitas* 1993). This sort of research has substantially changed the presumptions and declarations of certain Polish economists and foreign consultants with regard to the supposedly "typical behaviour" of enterprises—including state-owned ones—in the post-socialist period.

In the first two years of the economic transition Polish state enterprises reacted to the radical reforms—i.e. the so-called "shock therapy"—spearheaded by Leszek *Balcerowicz* in a particular way. The behaviour of these enterprises was destructive and even irrational, especially with regard to changes in regulations and environment. They used their capital rashly and amassed huge debts with banks and with each other. In spite of falling revenues and market failures, powerful inter-company coalitions of workers' self-governments, trade unionists and managers failed to cut back on (or did not attempt to reduce) capacities and staff. This situation offered fuel for the arguments coming from advocates of radical reform and quick privatization. (*Sachs and Lipton* 1990, *Winiecki* 1991, *Frydman and Rapaczinsky* 1994).

However, empirical studies have revealed that many state enterprises singled out for privatization reacted in such a way for a short while only. The period of self-liquidation and a wait-and-see attitude had, in many cases, ended by 1992–93. In fact, most enterprises that mobilized their reserves, launched new or updated products, penetrated new markets and streamlined their organizations have contributed to the upswing of the Polish economy.

The debate on Polish enterprises has added new aspects to our view of post-socialist privatization, industrial policy and the role of the state, respectively. The book by *Johnson and Loveman* is an important contribution to this debate. It consists of two parts. The first part is a case study of three big enterprises and its aim is to look into the transformation of state industries. The second part is an analysis based on questionnare surveys and case studies and it gives an insight into the environment of a new and rapidly growing private sector and the behaviour of entrepreneurs and companies within it.

The stories of three big enterprises show many similarities. In the 1970s and 1980s both Prochnik (a men's clothing factory) and the shipyards of Gdansk and Szczecin were operating within the framework of a typical state-controlled economy. The shipyards worked mainly for the Soviet Union and less for Western markets. The clothing factory sold the largest part of its production in the West, and it also supplied the domestic market and the CMEA. The exports of all three enterprises were handled by specialized foreign trade companies, and the relevant financial transactions were dealt with by the state bank. Their production costs included the maintenance of social, cultural and sports establishments, as well as non-profit activities undertaken at the "request" of regional or central party leaders. The fulfilment of such "requests" was the price to be paid for exemptions and subsidies. The collapse of the state socialist system, along with the markets it offered, landed all three enterprises in an unexpected and highly difficult situation. The clothing factory could sell less and less of its products in the domestic and Eastern markets, and the shipyards faced a deep financial crisis since they had raised credits for the construction of ships that the Soviets could not pay for. Ministries, formerly willing partners in crisis management, were dissolved and contacts between party and management disintegrated as the party itself began to crumble.

The newly elected Mazowiecki administration opted for the privatization of the three enterprises. Moreover, Prochnik was part of the first privatization package of 20 enterprises. Another similarity, not unrelated to political changes, was that new directors were appointed to all three enterprises. In the two shipyards university-educated activists of the underground Solidarity movement became top leaders. The new director of the clothing factory was also a man with a university degree; he came from the inner circles of another company's management.

Yet here the string of similarities ends: the three men tried out different methods of crisis management. The director of Prochnik set up an export department and undertook job work. He also strengthened the network of domestic distribution. Targeting a well-to-do group of prospective customers, he added women's clothing to their existing range. Other crisis-smitten clothing factories were brought into the plan in order to work for Prochnik and these factories sold their products under the Prochnik brand domestically and abroad.

The Szczecin shipyard, after tough negotiations with banks, succeeded in avoiding financial collapse and set out to re-formulate their marketing policy. They narrowed their focus in order to concentrate on one market segment and tried to carve out a niche in that segment.

The new manager of the Gdansk shipyard took a quite different path. Placing his trust in the new Polish leadership, he set out to develop his close ties with the then-President Wałęsa, and thus built his strategy on the shipyard's political capital. (It should be noted that the shipyard was a buttress of Solidarity.) He held back from closing loss-making units and even increased the number of employees. Furthermore, he raised wages and let the shipyard's social and cultural establishment go on operating. He trusted in the time-honoured strategy of making a preemptive move, for he was sure that the government would be his guarantor and that the banks, too, would finance his ambitious plans for raising production.

No such thing happened. By the time the book here under review was written, the Gdansk shipyard was idly waiting for reflotation. At the same time, Prochnik was already making profits and for the Szczecin shipyard, too, the worst seemed to be over. In this part of their book, Johnson and Loveman rarely touch upon the subject of ownership. We learn that Prochnik was privatized, part of its shares went to a syndicate, and that not such thing happened to the two shipyards. The authors, however, do not tell us how the owner, be it the state or a private investor, has been able to control or influence the operation of Prochnik. It is clear that a key figure has been the manager-director who, according to the authors, has played a pivotal role in working out the enterprise's projects and decisions, irrespective of the form of ownership. Such interpretation fits comfortably into the familiar array of arguments centring upon the power of managers'. Interestingly (and in contradiction to the approach of case studies), the authors nevertheless arrive at the conclusion that their examples are not typical. As they say, Polish state industry has so far produced a negligible number of cases like that of Prochnik or the Szczecin shipyard. In fact, most state enterprises are still using the strategy of wait-and-see and running through their capital. It is generally accepted that the transformation of large enterprises cannot be achieved rapidly and therefore the authors think that the engine behind the desired growth of the Polish economy is more likely to be its newly established private sector.

The second part begins by analysing the criteria of entrepreneurship. Johnson and Loveman conclude from their (albeit, non-representative) database that the great majority of new Polish entrepreneurs have already worked (mainly in the 1980s) as employees in other private ventures and learned the "secrets of trade" there. They are typically 30 to 40 years old, well-educated, and versed in labour and business organization, market research and sales.

In Hungary, it was possible to acquire such skills not only in the private domain but also (and equally well) in the flexible sub-units of the reformed state sector, in traditional industrial and agricultural co-operatives, and in the various hybrids of state ownership plus private initiative. As Johnson and Loveman see it, the under-reformed Polish economy hardly provided any opportunities for learning such skills. Thus it is an open question as to how successful manager-directors, heroes of the first part of the book, acquired knowledge enabling them to implement modern forms of crisis management. Moreover, the authors have not mentioned anything about the knowledge that could or could not be acquired in private Polish farms; this sector seems to have been completely outside their scope of interest.

The best example of how involvement in an enterprise has helped to "make" entrepreneurs is a co-operative in Gdansk. We learn from the case study that this venture was formed in the early 1980s by persecuted and laid-off members of the illegal Solidarity trade union. Founders of the co-operative wanted to create financial security for those persecuted, and they also wanted to provide a framework for their political activities. At that time in Poland it was easy to find rapidly expanding and highly profitable market segments, in which even modest amounts of starting capital promised quick returns. This particular co-operative specialized on cleaning chimneys and smokestacks and the demand for its services increased rapidly. An important element of their success was decentralization and flexibility. The heads of 8 to 10-strong teams were free to gauge market demand and to make contracts with customers. The informality which was a feature of the solidarity movement itself, had the effect of further strengthening the horizontal democratic order of the co-operative.

However, the co-operative, although successful in the 1980s, began to encounter difficulties after the systemic change. One of the reasons for this was that a great number of its members and its leaders opted for a political career. Yet what was even more decisive in the downturn of the cooperative's fortunes was that the natural market of the co-operative—i.e. state industry—went into deep crisis and could no longer place as many orders as it had before. Another significant factor contributing to the decline of the cooperative was that several of its members left it to start their own ventures.

Beside ventures launched by ex-members of this Gdansk co-operative, Johnson and Loveman also present us with case studies of other new enterprises. Most of the latter achieved quick growth and a market presence by swiftly supplying the sudden demand created by shortages. There is the story of a venture that skilfully organized the import of bananas, the ultimate shortage fruit; another decided to import, translate and publish foreign books. Again others, seeing the poor performance and obsolete selection of goods offered by state industries, jumped at the opportunities for filling such market gaps.

An important conclusion drawn by the authors is that the surge in demand created by shortage entails quick, but only short-lived growth. Thanks to the new institutional environment, others, too, can easily enter a particular market and this market becomes saturated as competition becomes keener. In other words, in order to achieve long term growth it is not enough to drive out state industry or trade (especially when customers have less and less disposable income). Plans also have to be made in order to maintain competitiveness.

Despite the negative aspects, Johnson and Loveman are optimistic. The heroes of their case studies on private enterprise are (just like in the history of state enterprises) manager-entrepreneurs. Skills acquired in a shortage economy will, according to the authors, also be sufficient in a balanced market for keeping enterprises afloat, and even for helping the private sector to achieve rapid growth.

I know the situation in Poland only from reading newspapers, and thus I do not want to evaluate the above assumptions and estimates. Even so, I want to make two critical remarks.

In their case studies and surveys Johnson and Loveman focus their attention on enterprises of the Polish "seaside", and the latter region has always been more receptive to Western influences. Consequently, we do not know whether developments typical for Gdansk and Szczecin are the same for "sleepier" regions of Poland. This issue is all the more relevant since the authors—as references in their book reveal, intentionally or not—deal mostly with the new elite of Poland's political and economic scene. But what about small enterprises "down under" with little or no political capital? The methodological weaknesses of the book give rise to even more caution. The case studies presented use documentation or elucidation criteria which fall short of those used in Hungarian practice. They contain no systematic market description and lack a thorough picture of the internal organization. They use no source other then citations from interviews made with company directors, and these are not placed alongside documents which might support or weaken their arguments. Their concise stories will no doubt make good reading and one wonders whether it is necessary to adopt the usual scientific thoroughness and attention to detail or to copy (as is practised in Hungary) if the methods of these reputable MIT and Harvard-based authors seem to be effective and successful.

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ANNOUNCEMENTS

Conference 'Management at a Crossboards'

In September 1997 the Faculty of Management and Organization of Groningen University (Netherlands) will organize an international conference on new interdependencies between organization, labour and society. Themes are: *Economic and Technological Developments and Employment, New Production Concepts and Labour, Flexibilisation of Labour, Managerial Theory and the Management of Labour.*

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More detailed information can be found on Internet location:

http://www.bdk.rug.nl/oti/hrm/normal.htm.

1st International Conference on Technology Policy and Innovation

The conference, which is scheduled to take place in Macau, 2 to 4 July, 1997, is being organized very successfully. It will be aimed at providing a forum to discuss current trends on *management, assessment, commercialization, application and organization of science and technology.* Special emphasis will be given to knowledge integration over a range of traditional disciplines. In addition, visits to emerging economic zones in South Asia will be organized in order to promote cooperative ties between business, academia and government.

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