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1 Introduction

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1 The Hungarian success story

Hungary is now widely regarded as a 'success story'. The most visible evidence for this is the confidence demonstrated by the international business community, which is reflected in the increasing number of conference papers promoting this assessment. First of all, foreign direct investment (FDI) shows signs of a substantial acceleration. In 1991, FDI totalled US$1.25 bn, up from US$0.34 bn in the previous year. Hungary attracted almost half of total FDI into the region (not counting, of course, the former GDR) in 1991. This happened in spite of the fact that Hungarian labour costs are probably the highest in the region (again excluding the ex-GDR), and that the Hungarian forint (HUF) strongly appreciated in real terms (the real effective exchange rate appreciated by about 12–13 per cent in 1991). Although the HUF is officially still not convertible, and there are severe restrictions on exchange for non-business purposes, rates on parallel markets show a rapid strengthening of the HUF. The country has also regained secure access to international commercial capital markets, and this has happened despite the fact that Hungary, while achieving substantial improvements in many of the indicators of indebtedness, still belongs to the group of highly indebted countries.

The strong support on the part of international organisations, most notably the IMF, the World Bank and the EC, also demonstrates a favourable judgement on the country's performance so far. As a result, the share of non-commercial finance in total debt rose rapidly: the level of non-commercial debt rose from US$3.04 bn at the end of 1990 (out of a total debt of US$21.55 bn) to US$5 bn at the end of 1991 (out of a total of US$22.36 bn).

The signs of improved confidence in a successful transformation are visible not only abroad, but to an extent also inside the country. Private

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unrequited transfers, primarily representing the accumulation of hard currency-denominated deposits of households with domestic banks, remained high, and in fact slightly increased in 1991. Domestic private saving in financial assets increased substantially, although part of this, as just noted, is kept in hard currency-denominated balances. This can, however, be interpreted as portfolio diversification to reduce risk rather than as a distrust of the transformation process itself. Inflationary expectations seem to be gradually calming down, although very slowly.

2 The Hungarian transformation process: prospects and pitfalls

Is this favourable assessment justified by the results Hungary has achieved so far in its economic transformation? Or, put differently, is there any evidence to caution us against being too optimistic about the future prospects of the country? The reform process can best be judged at two levels: that of the macroeconomy, and the more detailed microeconomic structure. The macroeconomy is more visible in the published statistics, and maintaining or restoring macroeconomic stability is an essential step in the transformation process. If we concentrate on the macroeconomic aggregates, there is no doubt that 1991 was a year of major importance in the process of economic transformation in Eastern Europe. It was a painful year, and more so in the countries which started this process later. In the region as a whole (here and hereafter not counting the former GDR) real GDP declined by at least 15 per cent, and probably by even more than that: the figures for individual countries range from a decline of 22.9 per cent for Bulgaria to around 8 per cent for Poland; the latest official figure for Hungary shows a 10.2 per cent decline. It has to be emphasised that the statistical systems in these countries are increasingly unable to cover newly emerging small-scale private activity. However, if this is taken into account (by using business survey-type methods), then the relative position of Hungary further improves. As a consequence of the substantial decline of economic activity, unemployment started to increase rapidly, and this process will certainly accelerate in 1992. In Poland and Bulgaria, unemployment had already exceeded 10 per cent by the end of 1991. In Czecho-Slovakia (6.6 per cent) and Hungary (8.5 per cent) the values at the end of 1991 were lower, but they were also increasing rapidly. Although in Romania unemployment was around 4 per cent, this does not yet fully reflect the decline in economic activity, and there is little doubt that it will rapidly increase after the general elections in 1992. Similar trends can be expected in the republics of the Commonwealth of Independent States (CIS, i.e. the former USSR). One can thus expect a substantial increase in the number of registered unemployed

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people, amounting to at least 3 mn in the region as a whole at the end of 1991. This, taking account of the fact that unemployment is geographically strongly concentrated, will undoubtedly create enormous social tensions in each of the countries, and in fact has already done so in many regions.

The decline in economic activity in the region is even more pronounced in investment. For the region as a whole, real gross investment was estimated to have declined by 21 per cent in 1991, but this may well again turn out to be an underestimate. In Bulgaria, investment declined by more than 55 per cent, while the same figure for Hungary, most probably representing the other end of the range, was a decline of about 11 per cent. The estimated figures for Poland and Czecho-Slovakia were falls of 16.7 and 30.1 per cent respectively. Although the initial estimated decline for the CIS was about 7 per cent, the final figure will undoubtedly be substantially higher.

Inflation soared in the region during 1991. The expected figures for CPI inflation for 1991 ranged from 480 per cent for Bulgaria to 35 per cent for Hungary. Although Poland managed to bring down inflation substantially towards the end of the year, for the year as a whole it recorded a figure slightly above 70 per cent. Czecho-Slovakia had an initial large step-change in the price level, but this does not seem to have translated into persistent inflation, as the month-to-month inflation was down to 1.6 per cent by October, though for the year as a whole the change was 58 per cent. Although for 1991 as a whole the CPI inflation for the CIS was well below the figure for Bulgaria, the price liberalisation in January 1992 ignited an unprecedented inflation which – in the view of many analysts – could easily reach 700–1000 per cent for the year.

Real wages, incomes and consumption also declined, though to a somewhat smaller extent than the declines in GDP. Estimated figures for real private consumption range from a decline of 27.6 per cent for Czecho-Slovakia to an increase of 6.6 per cent for Poland. The figure for Hungary was a decline of about 6 per cent, again at the lower end of the range.[1]

As this brief overview indicates, the performance of Hungary in 1991 was relatively good compared to the other countries in the region, but the general tendency to a major decline in economic activity characterised Hungary as well. Indeed, there were other factors which were damaging for confidence. The budget deficit reached 4–6 per cent of GDP, depending on what sort of definition was used for the budget. This figure was considerably above the one agreed with the IMF for 1991, and the required reform of public expenditure was further delayed. How, then, given this fall in output, investment and consumption, and the worrying budgetary position, does one explain the markedly improved confidence

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in the ability of Hungary (or that of the Hungarian administration) to carry out a smooth and successful economic transformation?

First, one should point to some of the successes. Domestic demand management successfully curbed imports to a level that produced a positive current account of some US$0.3 bn. Riecke points out in Chapter 12 that as a result of increasing hard currency export revenues and a further improvement in the structure of foreign debt the debt-service ratio declined substantially, from around 54 per cent in 1990 to around 35 per cent in 1991 (these figures, taken from the somewhat different definitions used by the World Bank, are slightly different from Riecke's, but the trend is exactly the same). International (hard) currency reserves increased substantially from about US$1.02 bn in April 1990 to US$3.4 bn at the end of 1991, now covering more than three months of imports. The increased level of international currency reserves will enable the National Bank to continue the real appreciation of the HUF which, if not excessive and thus sustainable, will undoubtedly further ease inflationary pressure. The prospect of continuing real appreciation should also encourage foreign investors to move in, as investment will be cheaper now than later, and the dollar value of future profits will be higher. However, the policy of real appreciation of the domestic currency is not without risk, as we shall argue below. Although gross foreign debt expressed in US$ increased, totalling US$22.4 bn by the end of 1991, net debt somewhat decreased.

Another, perhaps even more promising result, pointed out in Csaba's Chapter 2, is the substantial increase in the exports to OECD countries, and a remarkable success in weathering the collapse of CMEA trade. Hungarian firms, even the state-owned ones, proved to be fairly successful in finding new markets for their products, and/or changing their production lines to meet demand in foreign markets. This remarkable result was achieved despite a strongly appreciating domestic currency, and with very high domestic interest rates: that is, firms were able to improve their cost efficiency substantially. Some of the reasons for the apparently surprising flexibility and responsiveness are to be found in Chapter 4 by Halpern and Székely, in which they find that enterprises after the reforms of 1968 were quite responsive to market signals (exchange rates, taxes, subsidies), but that this responsiveness was obscured by the opacity of the regulatory and tax system. As exchange rates are unified and adjusted in response to trade deficits, and taxes made more uniform, so these market responses show up at the aggregate level.

At the macroeconomic level, then, Hungary's performance appears creditable when compared with her neighbours, and appears to have satisfied the critical test of international acceptance. We shall return to the credi-

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bility of the reform, essential for international confidence, below. Macroeconomic stability is a necessary but not sufficient condition for transforming a Soviet-type economy into a market economy. For that, institutions, laws, and behaviour have to be transformed in profound ways. The next section asks how far these structural reforms have proceeded.

3 Enterprise reform

The objective, shared by all the formerly socialist economies of Eastern Europe, is to transform a Soviet-type economy into a market economy. The distinguishing features of the Soviet-type economy are now fairly familiar. There was little or no private ownership outside small-scale agriculture and services. Enterprises were confined to certain defined lines of production, and the production units were large, creating monopolies either by product or by region or both, under a system of tutelage from the responsible ministry. The guiding ministries had reasonably well-defined targets for the outputs of different sectors, and the negotiated pattern of CMEA trade had first priority as it enjoyed the status of a treaty obligation. In the more decentralised system of planning introduced in Hungary in 1968 the enterprises were under indirect but nevertheless tight central control implemented through a complex system of taxes and subsidies as well as investment allocations. After-tax wages were determined by political criteria which reflected the objectives for the economy. Wage differentials were relatively narrow, and the degree of after-tax and transfer income inequality was much lower than in market economies. Much of the system of social security was devolved to the large enterprises. Many systemic features of the economy follow from these characteristics.

The highly concentrated structure of industry reduces or eliminates the ability of enterprises to find competing sources of supply, and leads to bargaining rather than market-mediated transactions, as well as to excessive vertical integration. The same concentration reduces the quality of information flowing to the centre, and forces the pattern of relationships between the centre and enterprise into one of bilateral bargaining under asymmetric information, likely to lead to inefficient outcomes. Worse, the government finds it hard credibly to commit itself to any agreement reached today, as all future transactions are subject to renegotiation. This in turn undermines incentives for efficient investment, management, and innovation, and creates the whole syndrome of the 'soft budget constraint'.

If we ask what characterises market economies it is harder to find uniformities, especially in the system of ownership and control over large

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corporations. Stock exchanges and dispersed equity ownership are characteristic of the USA and UK, while bank finance and more concentrated control are characteristic of Germany and Japan. The extent of state ownership in the productive sector varies widely, as does the choice between regulation and public ownership for natural monopolies. Some countries have very liberal trade regimes and no restrictions on capital mobility, others are at almost the other extreme. Nevertheless, one can make some broad generalisations. The most striking difference between the formerly socialist and market economies of Europe lies not so much in the industrial structure, but in the size of firms and the degree of industrial concentration within each industry. Market economies have many small and medium-sized firms, and few large firms, while the formerly socialist economies have very few small and medium-sized firms, and a predominance of large enterprises. The striking similarity in the size distribution of firms in market economies suggests that there are powerful market forces at work to generate and reproduce this pattern. Where not actively prevented by the state, firms everywhere will seek to establish cartels or monopolies to secure profits. In a market economy the resulting profits will attract entry, and the observed size distribution is the outcome of the more successful firms growing faster and increasing concentration, while new firms enter at smaller scales. In Soviet-type economies, producer interests have captured the state and prevented the competitive erosion of their market power. Entry is impossible if there are no independent sources of finance, such as commercial banks, and if it is illegal to employ wage labour. Firms are prevented from entering different lines of business in competition with incumbents. Unsuccessful firms are subsidised, rather than going bankrupt and being restructured. Stassis rather than success is rewarded, dulling incentives and removing the spur to efficiency.

The economic advantages of the market economy are its flexibility, adaptability to change, ability to innovate, and its efficiency in resource use, both static and dynamic. These result from the coincidence of private gain and public good under competitive conditions, but this coincidence appears to require strong competitive pressure, which rewards success, penalises failure, and reallocates resources from the unsuccessful to the successful. Private property is a key element in providing the incentive for efficiency, but for other than small-scale enterprise there is normally a separation of ownership and control which creates principal–agent problems.

If the state enterprise is profitable, has little debt, and is sold to achieve dispersed equity ownership, as was typically the case for British privatisations (and would be for the various mass privatisations proposed for

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Eastern Europe), then the problem of corporate governance is acute, and a change of ownership from the state to private individuals may have little effect on efficiency if the enterprise remains a monopoly protected from serious competition. Evidence from market economies suggests that liberalisation which increases competitive pressure is more effective than a change of ownership. If the firm is encumbered with debt, and not very profitable, then equity owners are likely to be less important than the debt holders who, by refusing to roll over debt (or defer interest repayments) are well placed to insist on restructuring to improve efficiency. In such cases the product market does not play such a central role in enforcing efficiency, and privatisation, even of monopolies, may have a dramatic efficiency effect. It may be that the situation in Soviet-type economies is closer to the second case than to the first, which somewhat reduces the urgency of demonopolising the product market compared to privatisation. However, for this to work, debt holders (banks) need the competence and motivation to play this role, and this may require that they be privatised and subject to competition from foreign banks. It also remains true that privatising monopolies forecloses the option of reducing market concentration, so the impact on efficiency may be ephemeral even if the banks were able to play this role.

One of the main questions under debate in Eastern Europe is the urgency of privatisation, and the method to be adopted. The closely related questions of competition policy, trade liberalisation, industrial policy and reform of the financial sector, all of which affect the environment for privatised firms, are perhaps less salient in the popular debate, but no less important. Three authors in this volume address the key questions of privatisation and competition policy. Járai and Mihályi (Chapters 5 and 6) both examine the progress of Hungarian privatisation, while Stadler (Chapter 7) looks at competition policy. Already one can point to differences in the approach of Hungary and her neighbours. Hungary has a tradition of gradual evolutionary reform, starting with the New Economic Mechanism (NEM) of 1968. Similar reforms in Czecho-Slovakia (the 'Prague Spring') were suppressed and the system remained ossified until the Velvet Revolution.

Hungary's sequence of reforms aimed to reform the management of enterprises, to raise their efficiency and accelerate their productivity growth. On the one hand the government attempted to decentralise decision-making, and use price-guided signals (taxes and subsidies rather than directives and quantity requirements), while on the other hand it attempted to redress the extra market power given to the enterprises by maintaining tight control over the use of profits and the allocation of investment resources. As firms acquired more control over decision-

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making, the temptation was to raise wages rather than lower prices, and to counter this the government imposed steeply progressive excess wage taxes. This system of individually adjusted taxes and subsidies at penal rates effectively eliminated the incentives provided by the move to more decentralisation, and lead to widespread disillusion with the reforms.

The tax reforms of 1988, described in Koltay's Chapter 14, were an attempt to escape from the bilateral bargaining relationship which so reduced the efficiency of decentralised incentives. As Koltay points out, it is not enough to introduce a tax system modelled on that of a market economy when the underlying industrial structure still resembles that of a Soviet-type economy. Lowering the marginal tax rates on enterprises improves incentives, but the incentive may be to increase profit without efficiency, and to reduce state revenue while increasing consumption. We return to the essential reform – that of imposing competitive pressures on enterprises. Here the Hungarian approach has been one of cautiously increasing competitive pressures by liberalising international trade, while attempting to maintain price control through the Price Office. This institution has now been replaced by a Competition Office, as explained in Chapter 7, and a large fraction of imports are now allowed in without restriction. Restrictions on setting up private firms have been removed, and the necessary legal framework of commercial law and contracts is gradually being put into place, as set out in Sárközy's Chapter 13. Hungary's approach and sequencing differs quite markedly from those of Poland and Czecho-Slovakia, who have deferred tax reform but have moved to rapid liberalisation of foreign trade, partly to stabilise prices, but mainly to increase competitive pressure on enterprises.

Just as Hungary has adopted a gradual approach to reforming institutions, the tax system, and the foreign trade regime, in contrast to the more abrupt liberalisations in Poland and Czecho-Slovakia, so her privatisation programme has been state-guided and gradual, aimed at selling enterprises rather than giving them away to the populace, again in contrast to the aspirations of Poland and Czecho-Slovakia. How well has this gradual approach worked, and how far is it addressing the major sources of inefficiency?

The first point to make about enterprise reform is that it has both macro and micro consequences. As already noted, there is a tension between decentralising decision-making and improving incentives, and losing control over the macroeconomy. Improving incentives means lowering taxes and hence state revenue, and requires corresponding cuts in expenditure if a budget balance is to be maintained. The evidence in Eastern Europe, China, and the heavily indebted developing countries is that cutting public expenditure is difficult and typically slow, while revenue

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can fall quite fast unless supplemented by transitional taxes (or increased seigniorage from the inflation tax). Worse, where the enterprises have market power and are profitable, they are free to raise prices, and with the extra revenue to increase investment, and/or to raise wages and hence consumption, rather than hold down consumption and increase savings. If enterprises are unprofitable (perhaps because they cannot raise prices in foreign markets, or because they have lost their market), then the state typically has to subsidise the losses (either directly, or through the banking system). Profits are no longer fully returned to the state, but are either consumed or invested, while losses that formerly were counterbalanced by profits are fully transferred to the state, unbalancing the budget. If the budget does not explicitly subsidise loss-making enterprises, but allows state-owned banks to roll over debts and advance additional finance, the capital base of the banking system will be eroded and financial stability threatened. Indeed, one of the problems facing the authorities, international agencies, and foreign investors is that the whole national accounting system becomes less informative as the old system of central accounting is replaced by a variety of often unrecorded transactions, through banks, special funds, and local government accounts.

These macroeconomic consequences of enterprise and tax reform are visible to a greater or less extent in all the reforming countries, and Hungary, like other countries, is finding it difficult to reduce public expenditures in a systematic way. In her Chapter 16 on social security, Augusztinovics draws attention to the lack of any systematic plan to reform and secure the financing of pensions, whose finance at the moment is being used to subsidise other parts of the budget. The conference did not address the important question of local government finance, but Bird and Wallich (1992) give a clear account of the potential problems arising from the devolution of responsibility for important and expensive items, such as education (38 per cent of 1990 local government expenditures), health (21 per cent), and local transport (10 per cent). Local authorities are heavily dependent on the central government for income, and have a limited local tax base, which they are in any case reluctant to use. Property taxes are potentially important and attractive revenue sources, but exemptions and local political resistance make this an unlikely source of revenue in the near future. Local governments own extensive property and housing, but charge so far below commercial rents that they are failing to cover maintenance expenses out of current rents, which are in any case fixed by the central government (and not indexed). While these rent controls may have the desirable effect of encouraging sales to occupants, this will not solve the revenue problem. Faced with heavy expenditure claims and limited revenues, local governments may be

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tempted to borrow (they have unlimited borrowing authority under the 1990 Local Self-Government Act, para. 88) and are certainly undertaking commercial activities with property transferred to them by the central government. As they have little business skill, and as they will be tempted to subsidise loss-making enterprises, this transfer of state property to local authorities achieves the exact opposite of privatisation: it retains all the undesirable features of state ownership, but with reduced accountability (because of dispersed responsibility), while unfairly competing with the private sector through these subsidies.

In the short to medium run, the most likely outcome is that many services will be underfunded or will disappear, partly because the revenue allocated to finance them will not be fully adjusted for inflation, and partly because in transferring responsibility for supply either from the central government to local government, or from state enterprises to local government, the necessary infrastructure and expertise to administer the programmes will be lacking. Expenditures may therefore be cut by default, but the pressures to reinstate them will be strong, and will eventually have to be addressed. It is hard to judge whether Hungary has the process more or less under control than her neighbours, though there are certainly worrying political tensions between the central and local government levels.

There is one important sense in which Hungary has taken the fiscal implications of enterprise reform more seriously than her neighbours, and that is in insisting on selling, rather than giving away, state-owned enterprises. Augusztinovics puts one aspect of this case in Chapter 16, by pointing out that previously pensions in Hungary were financed by a *funded* pay-as-you go system, in which contributions were used to finance investment in enterprises, whose returns would pay for future pensions. If these assets are given away, the state loses the income stream that finances those pensions. If it sells them, it can then reduce its public debt (as in the UK), and the interest that would otherwise have gone to the debt holders will be released to finance these pension liabilities. The problem with this solution is that it is slower than mass privatisation or redistributing shares in the enterprises, that it may be prone to manipulation and capture, and that it may fail to raise much revenue. It may also tempt the authorities to preserve monopolies in order to raise their market price, though rapid privatisation also means that too little time (or attention) is being devoted to restructuring and demonopolising before sale.[2]

Centralised sales of larger state enterprises have not been a success, and the 'First Privatisation Programme' which was launched in 1990 to sell 20 of the most attractive enterprises completed only two major transactions.

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