HUNGARY'S EXPERIENCE: TRANSITION TO THE MARKET

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I Marketization: the hidden shock therapy

I. 1 Performance

The transition to market in Hungary resulted in a deep crisis between 1990 and 1994. Table 1 reveals that GDP, real incomes are still creeping in the negative range, industrial output was 40 percent less in 1993 than in 1988, agricultural output dropped to less than the half of its earlier level. Temporary positive developments, like the positive balance of payments are now turning into negative, and seem to follow the downward spiral. Unemployment is still high (13%) with similar trend in crime-rates.

Looking at the indicators, the question arises: what are that reasons for such a crisis? The question is the more interesting, since Hungary after a long period of step-by-step reform preparation peacefully transformed in 1990.

The fact of a severe crisis cannot be denied. It is no exaggeration to say that the present crisis is greater than the great depression was (1929–1933). At that time national product dropped by 7 percent, but now by 19 percent, industrial output decreased by 12 percent, while now by 36 percent. Also, there is a general understanding that the newly liberalized market and the monetary mechanism do not work [6].

Expectations before the systemic change were not optimistic either but real developments with their graveness and prolongation surpassed even those who tried to assess the effects of the transformation. Western economists did not foresee such a crisis. They only advised in a simple way that the predominance of private ownership and a restriction of the redistributory role of the state budget are necessary conditions for a market economy, but did not provide answers as to what to do in a not-underdeveloped postcommunist society where private ownership is rather limited and all public services are financed by the state budget. Also politicians were not aware of such a danger and a look at the new parties' programs for the 1990 elections will suffice to conclude that conceptions on the practical transition were drafted rather roughly and did not sense an aggravating crisis [2]. There were several economists who warned of the disastrous consequences of suddenly opening up the

Table 1 Main indicators

	1990	1991	1992	1993	1994
GDP (%)	−3.3	−11.9	−4.3	−2.3	2.0
Consumer prices (%)	28.9	35.0	23.0	23.0	18.0
Real income per capita (%)	−1.6	−11.6	−2.8	−5.0	2.1
Unemployment (thousand)	79	406	663	632	520
Exports ($million)	6,346	9,258	10,028	8,094	10,701
Imports ($million)	5,998	9,069	10,076	11,340	14,554
Trade balance ($bn)	0.348	0.189	−0.048	−3.3	−3.8
Current account balance	0.127	0.267	0.324	−3.5	−3.9
Gross foreign debt, in convertible curr. ($bn)	21.3	22.7	21.4	−24.6	28.5

Source: Statistical Yearbook

economy and connecting it with massive privatization. True enough, these opinions could not be published at that time, which again is quite understandable remembering the unidirectional "away from socialism and state" revolutionary swing.

The prevailing conception of the transition maintained, basically, that the state, as it is, together with its bureaucratic institutions and its initiative-killing ownership must be liquidated, and domestic market must be opened for foreign competition. Private ownership and live competition will then press companies to restructure and catch up with advanced western nations. Even the somewhat sober monetary approach did not foresee that marketization could go so much wrong. All it was concerned about was the problem of hidden inflation and the monetary overhang, namely, that as prices were freed high inflation would develop. Inflation was to be left until it hits the limit of demand. Then, at that point inflation would stop, the monetary overhang disappear, price ratios stabilize and an expansive monetary policy could begin to boost growth[1]. All in all, the leading opinions maintained that through abolishing the remnants of the state, a free market would automatically result in 2–3 years in tangible growth and rising living standards[2]. Transitional hardships of unemployment and dwindling real incomes were deemed to be compensated through maintaining a social network.

1 It is in this line, for example, that the heavy corporate income tax in 1990 was promised to be eased after 2 years. Yet, in 1992 the opposite happened: taxes were increased.

2 (This approach) "extremely strongly believes in the power of the market and private ownership. Accordingly, it is only a question of time, and the immanent forces of the economy by themselves will lead to an upswing from the bottom ... I must confess that for a long time I myself too, was inclined to accept this stance." – Kornai admits in retrospect [11] p. 597.

I. 2 The main lesson: hidden shock therapy

For gradual transition usually the Hungarian practice is referred, where elements of the market were gradually created beginning from 1968 so that when in 1990 the moment for systemic change arrived, the soil for the transition has already been prepared and transition progressed smoothly. In fact, however, transition proved to be not smooth. How can then the Hungarian case be assessed? Is it a case for gradual transition or not?

It is quite true that several elements of the market were created before the systemic change. Thus, for instance the central planning with its mandatory directives was abolished, prices were to a great part freed, the exchange rate was introduced helping to harmonize domestic prices with world market ones, and especially from the early 1980s the overcentralized industrial organization structure was split off into smaller units, the embryonic forms of private enterpreneurship like private taxis, restaurants, small industry (first up to 20, then to 40 employees) were lincensed. The reform of 1968 was even coined at that time as "radical type" because from the beginning several fields of the management system were simultaneously reformed and because one of the key elements of the old system, the central planning indicators were abolished. In contrast, other Eastern European countries reformed a selected part of their economic mechanisms and modified only the central planning.

However, the year of 1968 is also known for suppressing the Prague Spring. This circumstance had a serious effect on how to carry out the reform in Hungary. The effect was that the reform became rather pragmatic avoiding basic issues of which two were especially decisive: the state ownership and the close relation with the Soviet economy (and politics). As a result of the pragmatic compromise, the reform was tolerated by the Soviet Union and, on the other hand, remained controversial.

Probably one of the most striking examples of this controversion is how the ownership issue was circumvented by tricky reforms. After the mammoth industrial organizations were split into smaller units, around the mid 1980s the problem of their running arose. Since their state ownership was a taboo, the main approach argued that, following the example of developed western economies, ownership and management should be separated, leaving the ownership issue aside, and focussing on more effective forms of how to manage state assets. One new form was the enterprise self-management, that is, directors instead of being nominated by ministries, were elected by workers. Workers also elected an enterprise council. The result was that due to the lack of a real owner and the ensuing lack of capital efficiency, companies sold their assets, using the incomes for wage-pays. Also at the same time, workers were allowed after normal working hours to form associations in order to undertake work from their own or mainly from other companies, whereby they could freely use the assets of their own company. As the income from association work was exempt from the strict wage regulation binding enterprises, the overwork efficiency increased but the official work's deteriorated and the wage outflow gave a push to inflation.

In a reappraisal then, it can be concluded, even the Hungarian reform was not "radical" because it left the basic issues of state ownership and Soviet relations unresolved (priority of the linkage to the Soviet economy). Therefore, the capital efficiency, the deterioration of which together with the exhaustion of the resources (free labor and cheap industrial resources) of the former extensive growth type were the causes leading to the 1968 reform, did not undergo any substantial changes. This is apparent in the GDP development curve. The growth rate after 1968 only temporarily improved in the early 1970s giving way to a continuous downward trend which in 1988 and 1989 entered already the negative range.

Under such conditions, in 1990 the systemic change started. The changes were dramatic:

- *Privatization* began, resulting in massive unemployment. In a single year, during 1991, the number of unemployed jumped from 80 thousand to 406 thousand, from a 1.9 percent rate to 7.5 percent. Such an explosion in unemployment could have been prevented by simply asking companies to distribute cuts for a few years, as it is practiced for example in Japan[3] or other western countries which consider also social effects of restructuring.

Other companies being not involved in the first packages of privatization, were also discouraged because of unclear expectations causing further decline in performance.

- *Import was dramatically liberalized*: in 2 years 90% of imports were freed. This exposed domestic producers to hard foreign competition and, since it was impossible for them to restructure in such a short period, they inevitably lost markets. What is important, however, is that loss of market outlets and idleness of capacities was in many causes not an inevitable crisis-phenomenon necessarily accompanying the transition, but the result of an uncoordinated import liberalization, and it was the more so because a restructuring-oriented industrial policy was lacking[4]. When domestic made toothpaste and garden-tools suddenly disappear, squeezed out by foreign made ones, the relevance of ill-considered liberalization is hardly deniable.

- *Prices were freed*, budgetary subsidies were drastically slashed. Companies tried

3 As a result of the strong yen, affected companies decided 15–30 percent cuts in 1993, however it will be realized evenly distributed within 3 years.

4 "This crisis is an ensuing phenomenon of the transition from planned economy to market economy, which includes a considerable loss of markets and in which, just because of losing markets, the great part of production capacities proves to be of no use" – Erdös writes [4] p. 730, and feels it satisfactory to stop at such a general explanation.

to make up for the outfall in their revenues by raising their prices, which fuelled inflation.

- *COMECON collapsed*, and due to problems resulting from the new dollar-payment system, the market of the former Soviet Union closed. Hungary's export to COMECON markets diminished by 55% between 1989 and 1993. Surprisingly, companies could during the one year switch to OECD, especially EC markets, pushing out their stocks and thereby refuting the generally accepted belief that eastern market oriented capacities cannot be converted to western exports. The actual shock appeared 2 years later, when it became clear that companies cannot adjust to new changes on western markets, and so from 1993 western exports began to shrink considerably. This can also be ascribed to the lacking industrial policy. In addition, from 1992 to September 1993 a severe bankruptcy law was applied, liquidating companies which had been responsible for 31% of total exports.
- From 1992–1993 *a new shock-element was added, the privatization of the land*, which caused the collapse of the relatively successful agriculture production system relying on the cooperation between large state-cooperative farms and smaller household plots. Agriculture, which through the past 30 years was a successful pillar of the economy and contributing an important share to western exports, suddenly collapsed, production and living stock dangerously decreased, import of basic food items became necessary. Although sober economists warned of such an outcome, the privatization of land was given a political priority[5]. But, even so, a well prepared agricultural policy combining financial help and promoting the access to necessary machinery for new farmers could have considerably smoothed the transition. It is not appropriate to argue in this case with the standard statement that such deficiencies are due to deficiences in the coordination mechanism of the market[6], but it seems quite evident that the transition itself was not "coordinated", that is, it was unduly prepared.

From the points mentioned above, the conclusion emerges, that

- contrary to common belief, the transition in Hungary was not gradual because earlier reforms failed to resolve the basic problems. Therefore *it was in fact a hidden shock therapy*. Leading economists not only took a liberal market approach and urged the government to follow their advice but the government also deviated from its original, more balanced transition concept.

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5 The Smallholders Party when consenting to participate in the coalition government, stipulated as a precondition the reprivatization of the land, that is to return the land to its original owners according to the status of 1947, or to their descendants.

6 Kornai in his analysis simply registers that the new, market coordination is not working in some fields like agriculture and construction industry, and that economic actors in the new market-system can hardly see an orientation. [8] p. 581.

– the *systemic changes are not a mysterious task* but can be deciphered in concrete terms like opening the domestic market, importing foreign capital, handling of inflation and unemployment. To master these tasks, however, a concerted transition scenario would have been necessary, including an established industrial-foreign trade-agricultural policy. Since such a policy-making implicitly means a governmental guidance, which was falsely identified with the former detailed state regulation (central planning), it was generally rejected in the wave of "liberalization".

– from the above it also follows, that what we have to do with, is not a "transformational crisis", a crisis necessarily appearing with the transition from socialism to capitalism, but it is *the disastrous consequences of a one-sided, naively liberal marketization approach*[7].

I. 3 Reasons

a) The real economy

The market is already in existence, yet it is not working. The shortage economy ceased to exist, because companies do not complain any more of difficulties in obtaining resources for their production. Thus, the earlier sellers' market transformed into a buyers' market. Import was liberalized and a real competition began.

However, the market is not working positively. Companies face now a low demand. The pattern of real economy is not improving because supply adjustment is slow. The former coordination mechanism was abolished, but the new, market-type one is just emerging, therefore companies have no orientation. Here privatization is not helpful for the short run either, it can result in higher efficiency only in the long run. Banking is underdeveloped, the relatively high liquidity is pinned down and not flowing to companies. Companies are not confident about future, investments dramatically fell (-29% over 3 years).

b) The monetary mechanism

The Hungarian crisis is unique and incomparable with western ones because its main elements like balance of payments, real rate of interest on loans and budgetary deficit exhibit a different development.

Throughout 1990–1994 the monetary policy was restrictive. this has its origin in the deepening deficit of the state budget. The budgetary deficit through the crowding out effect causes only a diminished part of saving to be used for investments, the other part being sucked up by deficit-covering bonds. To cover the

7 Tardos maintains that the crisis is in a 3/4 part due to the problems inherited from the previous regime and in 1/4 part to the failures of the government [15]. Such an approach is at least as much apologetic as argumenting with the omnipotence of free market and to ascribe the crisis to the rigidity of the real economy in complying with new market conditions.

deficit, the government through its central bank draws in money from commercial banks (by increasing their reserve ratio) and pays them only a low interest. Commercial banks, however, in an effort to make up for this low interest rate, charge their client companies a high interest rate. Therefore, interest on loans will be high, which deters companies from investment[8]. In the present crisis situation, when companies lost their markets and are burdened by heavy taxes which in turn are triggered by the needs of budgetary deficit-covering, the rate of profit of companies is understandably low. The depression in which the economy is trapped is then basically due to the extreme discrepancy between the low rate of profits and the high interest on loans.

In the following we will take up two basic issues of the transition, the privatization and the reform of the state budget.

II Privatization

II. 1 Main characteristics

Similarly to the 1968 economic reform, the Hungarian way of privatization was conceived rather pragmatically, which is again a distinctive feature from the privatization methods adopted in neighboring countries.

The choice of the pragmatic approach was rooted mainly in the shortage of potential domestic capital to buy up state firms on the one hand, and in the budgetary deficit, on the other; or rather the budgetary deficit-cutting pressure from the IMF. The relationship between the budgetary deficit and privatization may at first seem not self-evident. In concrete terms is meant the intention to use the earnings from selling state companies in a fifty-fifty proportion for covering budgetary deficit and upgrading loss-making state companies for later selling, respectively. Also, privatization policy makers were aware of the necessity of upgrading state companies before putting them for sale. Therefore, the *capital-raising aim became the most important* point in the privatization conception. As a result, ideas about the voucher-type or cross-ownership[9] type privatization were discarded, since there

8 This is a crucial difference with Kornai, who contends that in Hungary real interest rate on loans is at present not high for companies, but it is the uncertain expectations which retain companies from investing ([8] p. 584).

9 Cross ownership means that companies mutually own the decisive stake among themselves. This form is especially developed in Japan where banks, trading houses and insurance companies are also participants. A Japanese professor, M. Iwata suggested for postsocialist countries to carry out privatization through cross ownership. His main concern was the capital shortage and the aim to prevent inflationary money emission. Therefore, according to him, the bank would give a targeted money in form of credit to enterprises which could use this money only for buying shares from each other. Enterprises when selling their shares could use their earning also for buying the shares of other enterprises. Finally, at the end of the process the

would no new capital be raised, moreover there would no new influential owners be created, the ownership would remain shared by many hands, hence no change in the management could be expected. In Czechoslovakia or Russia where the voucher type of privatization was accepted, the lengthy process of exchanging vouchers for shares and, in turn, selling the shares to real owners, or the concentration of shares in the hands of a few owners only retards the privatization without resulting in any new capital.

The pragmatic approach in Hungary also *solved the dilemma of privatization versus reprivatization*. Namely, it was decided not to give back state firms to their earlier owners, but to new ones. The only exception was land where former owners or their descendants according to the ownership status of the year 1947 could get back their property. Due to the way of realization[10], however, not the original size of land was returned to them.

The task of privatization was immense. Altogether 2,200 state enterprizes were to be privatized, of which 350 were employing between 5 and 10 thousand people. All fields of the economy were open for privatization except for energy, medical care and partly the transportation and telecommunication. The new government's program envisaged a 3 years period for giving the above mentioned 2,200 companies into private hands which would mean the privatization of 30–35 percent of total state assets [21]. Actually, this 30–35 percent of assets to be privatized means, that it was not the aim to privatize a dominant part of the economy, though the companies targeted for privatization were the key ones, but rather to introduce a new, mixed ownership system in which, together with private companies, also companies owned by public sector, local governments, pension funds etc. would exist.

The 2,200 state enterprizes had assets at a nominal book value of HUF 2,000 billion. The potential stock of private savings was estimated at the same time only at one-tenth of the assets value, so it was apparent that privatization should be based on inviting foreign investors.

In order to provide a certain supervision and to operatively handle privatization, the State Property Agency was set up in 1990, which together with well-known western auditing companies like Price Waterhouse, Barclays de Zoete Wedd Ltd and Baker and Mc Kenzie selected companies for sale and prepared valuations of the companies to be sold.

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money will be withdrawn (Business Review, Hitotsubashi University, Vol. 30 No 1, Aug. 1990; in Japanese)

10 Land was not returned in its natural size but through a value adjustment. First, original owners received a so-called compensation certificate with a face value which could be exchanged for land. This exchange was organized in the form of a licit procedure during which the land's price increased. Consequently, the certificate's unchanged face value could buy up a land smaller in size than the original one. Thus, proprietors could recover in terms of size only about 1/10–1/15 of their original land.

II. 2 Results

The results after 3 years are shown in Table 2. Of the 2,200 companies intended for privatization about one-third in number as well as in book value have in fact been transformed. Although the figures may vary according to sources[11], it can be concluded that the target could not be fulfilled, the pace was too slow. What is in accordance with the expectations, is the dominant role of foreign capital, which accounted for 60–80% of the proceeds in the years 1990–1993.

Thanks to the free atmosphere of enterpreneurship, many new companies opened (Table 5). Almost 80 percent of them, however, were employing less than 20 people (Table 6). The private sector contributed already 39 percent to the GDP, with cooperatives it comes to 45 percent (Table 7). Small private organizations are rather active in exports, alone in 1992 their deliveries rose by 126 percent.

The large number of new establishments is, however, fallacious. Many small companies are hibernating because due to initial market failures they are waiting for a new opportunity, or are existing only on paper. This is supported by the evidence, that their registered capital remained at HUF 1 million or so which is just the minimum limit required for setting up a shareholding company. In practice, the number of companies being active on the market is estimated at 2000–2500 which is almost identical with that before privatization. In this sense, privatization did not (or not yet) contribute to creating a competitive market.

II. 3 Privatization methods

The law on transformation was enacted in 1989 allowing state enterprizes to transform themselves into shareholding and limited companies. Transformation

Table 2 Transformation of state owned companies*

	Dec. 31 1990	Dec. 31 1991	Dec. 31 1992	Apr. 30 1993
Number of companies	27	218	602	760
Book value (bn Forint)	26.19	345.07	645	650.85
Value acknowledged for transformation (bn Forint)	42	465	1,364	1,439

*Companies belonging to the State Property Agency (SPA)
Source: [8], for 1993: [15] Vol. I. p. 100

11 According to another source (Népszabadság 20 May 1993) only 18.69 percent of the Ft 2000 billion state assets could be privatized. It must be admitted that data in different sources vary, e.g. the National Bank estimates the total revenues from privatization for 1992 at HUF 67.6 billion (table 5) while the report of the SPA puts it at HUF 72 billion ([5] p. 23).

Table 3 Privatization revenues of the SPA* (HUF billion)

	1990 HUF	%	1991 HUF	%	1992 HUF	%	1993 HUF	%
Property yield	—	—	0.9		4.7		2.4	
Sale for foreign exchange	0.53	79	24.6	81	41.0	65	25.5	59
Sale for forints	0.14	21	4.8	16	17.5	28	15.3	35
Cash revenues, total	0.67		30.3		63.2		43.2	
Sale for loans	—		1.0		9.1		21.7	
Sale for compensation vouchers	—		—		2.3		13.0	
Privatization revenues, total	0.67		31.4		74.4		77.9	

*State Property Agency, a governmental organization carrying out privatization
Source: Privinfo 1995

Table 4 Results of privatization

	Planned (A)	Actual, 1993 (B)	Performance (%) (B/A)
Number of companies	2200	760*	34
Book value (bill. Forint)	2000	650.85	32

*30 April 1993
Source: compiled from table 2 and 3

Table 5 Number of economic entitites

	1988	1989	1990	1991	1992	1993, 31 July
Incorporated economic associations	919	5,191	19,401	42,697	59,363	69,104

Source: [15] Vol. I. p. 89

was stimulated by tax allowances. As a result, many enterprizes transformed into smaller units taking with themselves the assets and leaving behind a merely formal company office. This period of "hollowing out" continued until March 1990, and is called a "spontaneous privatization" because no state authority controlled the real value of assets and the process itself. Using this opportunity many state enterprise managers, the "nomenklatura" personalized state assets under often formal shareholding company establishment deals with foreigners, thus securing for themselves a new footing in the market economy. To provide a controlled flow of privatization, the State Property Agency (SPA) was set up in March 1990.

The SPA then, launched *centrally initiated programs*: the first privatization program involved 20 companies with a total assets value of HUF 70 billion in 1990, followed by the second privatization program including 22 companies. In addition, there was a pre-privatization program aiming at retail outlets (domestic trade, restaurants, services, gasoline stations). In this latter case accumulation of citizens helped by credits bought up the assets.

The *enterprise-initiated self-privatization* targeted medium size enterprises which could find new owners through privatization consulting firms (not the SPA). In two steps 420+210 enterprizes were involved. The decisive majority of investors were Hungarian citizens, many of them using the opportunity of employee buy-outs.

Employee partial ownership program enabled employees to acquire the shares of their enterprise. They were helped by preferential loan, instalment payments and profit tax allowance. By July 1993 24 sales were realized.

Privatization by leasing aimed at bridging the problem of capital shortage. Here also, tax preferences were granted.

Compensation vouchers acquired by citizens as a compensation for their nationalized property or land, can be exchanged for shares in state companies. The market value of compensation vouchers is only 50–60% of their face value, because the supply of state assets offered for exchange is limited by the SPA[12].

The small investor shareholder program aims at involving masses of citizens. According to the program, shares may be purchased by individual citizens up to

Table 6 Concentration of labor force

No of employees	Share of companies in total (%)
300–	2.9
51–300	8.5
21–50	10.5
–20	78.3

Source: Central Statistical Office, 1993

Table 7 Composition of GDP by sectors (percent)

	1991	1992
Economic associations in private ownership	15	18
Small entrepreneurs	18	21
Private sector (without cooperatives)	33	39
Cooperatives	8	6
Total private sector	41	45
Economic entities of central and local governments	59	55
GDP total	100	100

Source: [15] Vol. I. p. 92

12 A. Kurcz: Készpénz helyett (Instead of cash) Figyelö 30 Sept. 1993

a maximum of HUF 100,000 to be repaid within 5 years without interest. This program started in early 1994.

Privatization is being helped by special *credit facilities* to back domestic investors. One is the credit line of the National Bank of Hungary, the second is the so-called existence loan (E-loan) channelled towards small investors through the commercial banks (and refinanced by the National Bank of Hungary). To help borrowing for small investors through extending guarantees the Small Enterpreneurs' Guarantee Fund and the Credit Guarantee Corporation were set up.

In 1992, as a new institution, the Hungarian State Holding Company was established. Its role is to manage the state assets to be retained in state ownership for a longer run.

A special field is *agriculture* where the reprivatization was allowed. Cooperative members or non-member owners could get back their land. As for the members, the majority of them (80–85%) opted for a new cooperative form. However, the transformation, including re-forming cooperatives and privatization of land tore up effective cooperation between the large scale production of cooperatives and private farms. This resulted in an abrupt decline of agricultural output throughout in 1991 and 1992.

II. 4 Evaluation of results

The main advantage is probably, that the pragmatic line has been followed throughout 1990–1994. First it means, that state property was sold against effective money and created new owners. Second, it was good that compensation claims to be satisfied by distributing state property, were restricted[13]. In this context even the manipulations of exchanging compensation vouchers for land or shares leading to considerable loss in original property for the former owners, could be assessed positively.

In the final result, however, the meaning of new capital becomes dubious, since revenues from selling the state assets were sucked up by the increasing deficit of state budget. Originally, half of the revenues was supposed to be reinvested in loss making companies to upgrade and to restructure them. There is, however, no evidence, that such a recycling of revenues took place[14].

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13 The suggestion to grant compensation for political damages was for example declined.

14 As Mr. Imre V. Csuhaj, cabinet chief of the privatization minister explained in an interview, the SPA from the revenues must transfer a considerable part to the state budget for deficit covering, further it must pay dividends after the enterprizes under the SPA (payable to the state budget), contributions to central funds like employment fund, regional development fund, agricultural fund, helping small banks and insurance companies, and contributions to write off debts of enterprizes to be privatized. In the final balance, expenditures exceed revenues for 1993. (Több a kinadás, mint a bevétel; Expenditures exceed revenues, Népszabadság 28 Jan. 1993)

The main deficiency of the privatization was its slowness, according to widespread criticism. The general explanation for it argues, that the 3 years privatization plan was too ambitious and that in fact a longer period is necessary when an emerging new wealthy class will be able to buy up state assets. More concrete reasonings blame the SPA for the slowness (for example [14]), saying that its small staff was unable to handle the process, or, that the SPA consciously delayed it. In addition, however, it must be mentioned, that negotiations about a given enterprize usually stumbled on two difficult problems. First, the real value of the assets: foreign investors were in a stronger position because of the oversupply of assets, thus the idea to invite them for an open tender, proved unworkable, while on the other hand the SPA did not want to agree on a bargain sale. Second, in several cases negotiations were delayed on the side of the enterprize, where employees were privatization-averse fearing a severe restructuring and dismissal. Considering the ensuing massive unemployment, however, the slowness is hardly to be blamed, otherwise it would have caused more severe problems.

During the early 1990s the world economy entered a depression together with a contracting capital supply. Western Germany, one of the most powerful potential investors, became involved in the reconstruction of Eastern Germany as a result of unification, while starting privatizations in Czechoslovakia, Poland, Russia distracted capital flows from Hungary.

Remarkable is also, that foreign capital entering Hungary, in competitive industries preferred establishing new facilities to buying up existing assets, which is a further factor in the slow privatization [8]. A striking example is the Magyar Suzuki which trained unskilled labor and erected a new plant instead of using existing capacities in the automobile industry [3]. These facilities mean a real market restructuring and help creating a competitive market. Those foreign investors who bought up existing assets, usually conserved the market structure. They were mostly content with buying a company and acquiring its market share in the Hungarian economy, so they just kept running production or instead, sold their own products through the sales network of the purchased company. Since the Hungarian market is shared by usually 2–5 companies, the foreign investor at once acquired 20–30 percent of the market, securing for himself an oligopolistic position whereby the need to modernize equipments or increase the market share was not compelling. Due to this circumstance, the participation of foreign capital was not always promoting a competitive market.

An interesting phenomenon is the considerable growth of private savings since the systemic change (1990). There are various reasons for this like an increased saving propensity due to the emergence of a new wealthy class or to higher risk of everyday living for lower income masses. Concerning the real increase in savings, there are several estimations, one even denying any increase but attributing it to the ballooning effect of inflation[15]. For our purpose, sure is, however, that citizens were not willing to spend their savings for buying up shares. And if buying securities, they bought rather state bonds, guaranteeing a safe interest. But, due to the fact that these bonds were covering the deficit of the government's budget, these private spendings are just a part of the crowding-out effect, that is, they do not become investments to boost restructuring or production. Nor have they any connection with helping privatization.

In 1995 privatization entered a new phase, the energy sector. For the state it is convenient to modernize through privatization, but since energy is a monopolistic sector, the ensuing unemployment will be left to the state, whereas profits will flow out from the country and higher monopolistic prices will give a push to inflation. Therefore, according to some opinions, only 25% of the sector should be privatized [13].

Was it, at all, necessary to sell the well-functioning successful companies? In developed western economies privatization is usually preferred if the performance of a company is deteriorating and through privatization an upgrading is expected from private initiative. Actually, the conception on privatization visioned a pluralistic system with different forms of ownership allowing for state ownership, too. Probably, it could have been a better solution to put on sale at the beginning just a few good companies to attract interest and to retain other successful ones. Because, even in the case of selling successful companies, the new (foreign) owner laid off employees increasing thereby unemployment. Concerning the privatization of loss-making enterprizes with surplus labor, the cuts of labor force could have been distributed for a period of a few years.

It was hoped that market liberalization and privatization would automatically produce an effective management and lead to restructuring. It was also a serious failure of the privatization that, contrary to initial principles, the revenue from selling state assets, was not recycled in order to upgrade bad enterprizes. It happened so, however, not by accident. Namely, to upgrade bad companies some strategic vision is necessary, be it called industrial policy[16]. But, from the 1990 systemic change industrial policy was considered as a foe to marketization resembling the perpetuation of earlier governmental intervention therefore it was impossible to work out least to apply any industrial policy. Hence, at the present stage investments must be con-

15 A. Simon calculates that in 1992 savings in real terms were on the same level as in 1989 [12].

16 The usual argumentation runs that it was the increasing budgetary deficit which swallowed revenues from privatization. However, would have been there a development strategy, it would have had a priority in spendings.

nected with a development strategy including industrial policy[17].

III State budget: double-hard constraint

Several tasks were set at reforming the state budget:
- since the overwhelming part of revenue was redistributed through the budget, this redistributory role was to be greatly curtailed
- tax revenue was to be increased, and budgetary subsidies for consumer prices and companies making losses were to be restricted
- items of social welfare (health, pensions, education) were to be separated and

Table 8 Pattern of budget revenue and expenditure 1990–1995 (%)

	1990	1993	1995*
Revenue			
Payments by economic organizations	39.1	19.5	15.5
Taxes on consumption	40.4	47.0	43.5
Payments by citizens	10.7	21.7	21.8
Payments from budgetary organizations	—	0.2	0.4
Revenue from international transactions	0.7	2.3	3.0
Tax from financial institutions	7.6	2.6	2.0
Revenue from debt servicing	—	6.3	13.5
Revenue from privatization	—	..	..
Expenditure			
Subsidies to economic organizations	13.4	4.8	4.8
Consumer price subsidies	6.5	1.9	1.9
Investment expenditure	7.9	5.6	5.3
Transfers for social security	—	0.8	0.6
Social security services	—	10.3	11.4
Transfers to central budgetary institutions	30.0	23.6	22.6
Transfers to local governments	17.9	23.0	18.0
Transfers to extra-budgetary funds	9.9	6.7	2.1
International expenditure	3.1	2.7	2.7
Debt service	10.7	17.7	27.0

*Preliminary
Source: Ministry of Finance

17 M. Tardos in his lecture on Hungarian transition [15] went one step further than in his article ([14], here writing only about holdings and other new forms of privatization) by mentioning explicitly the necessity of "industrial policy", leaving its content however unspecified.

Table 9 Payments by economic organizations (billion Forint)

1990		1991		1992	
plan	actual	plan	actual	plan	actual
273.7	257.753	231.6	200.4	215.8	193.85

Source: [9] p. 603

Table 10 Expenditures of the budget in percent of GDP

1990	1991	1992	1993
62.5	69.9	74.9	73.6

Source: [9] p. 608

run as distinct funds with market footing
- expenditure on government administration was to be cut

Between 1990–1995 the pattern of both revenue and expenditure has undergone several changes (table 8). In accordance with intentions, tax revenue increased. This increase, however, is true only for taxes paid by citizens and consumers, but not for companies. Revenue from companies drastically fell not only in their share within total revenues, but which is worse, in absolute volume (table 11). Revenue from companies in 1992 was only 47% of what it was in 1990. This is a signal that companies are in severe transformation difficulties. It must be added, that the efficiency indicators in privatized companies are 25 percent higher than in state companies [8], but private companies are paying only 65–70% of what is paid by state ones ([6] p. 731). This contradiction is due to increased tax evasion, low tax-paying morals and lacking effective methods of corporate income control[18].

On the expenditure side, subsidies to companies and consumer prices radically decreased as also did centrally financed investments. These developments are in accordance with the intentions because they repressed the redistributory function of the budget. However, social expenditures remained with the same share and newly established governmental institutions were also added. Thus, in the final result the ratio of budget expenditure to GDP not only did not decrease but actually increased from 62.5 percent in 1990 to over 70 percent in 1993 (table 4). Even if some distortions due to cumulative account are eliminated, the redistribution for 1993 remains at 64.5 percent which is ahead of the Scandinavian welfare countries (50–60%), not to mention the United States (36–38%).

By now a new contradiction emerged: the budget became hard for companies, the earlier "soft budget constraint" disappeared, but neither changed its redistributive character, nor is it possible to eliminate the large social items like health care, education and pensions. To separate the latter items, they should be put on new market footing inevitably connected with restructuring personal incomes and accompanied by temporary evils of the transition for large masses of citizens.

18 Not to the badly constructed tax system, as Kornai and Mihályi assume ([9]).

This would be politically too risky until real incomes do not recover. Thus, for a while these items will remain stiff. Therefore the present state of the budget can be called as *double-hard* budget, meaning that to outside the budget constraint became hard but its inside pattern is also hard.

Table 11 Deficit of the budget

	Billion of Forint	In percent of GDP
1990	1.9	0.0
1991	144.2	4.9
1992	197.1	7.4
1993	250.0	7.1
1994*	350	10

*Prognosis
Source: [9] p. 608 and Figyelö 21 Oct. 1993

A further problem is with the increasing budget dificit (Table 11). The deficit is financed by treasury bonds issued by the government and bought up by commercial banks. Therefore the deposits of companies are not recycled as loans for investments but are used for budget deficit financing. This is the deficit's crowding out effect which directly restricts investment. In addition it has an indirect effect causing interest rate on loans to companies to rise, because banks prefer lending to the government.

Earlier, since the deficit was actually financed by money obtained from the National Bank of Hungary, also a governmental institution, the debt problem could, in fact, have been solved by simply annulling it. Today, however, this way is not feasible:

1. Before 1990 the total governmental debt was due to the National Bank, but as a result of market-type financing (issuing bonds), the government now owes debts to companies and citizens.
2. Concerning the government's debt towards the National Bank, this money was lent by the National Bank mostly on the basis of credits taken from foreign sources, so this part is also repayable.

How to reduce the budget deficit?

The requirement to reduce budget deficit is strongly pressed by the IMF and the Hungarian government is obeying the IMF, because the opinion of this prestigeous organization is important for obtaining foreign credits. The ministers of finance, especially in 1994 and 1995 devised a plan (mainly the Bokros-program [5]) for a drastical cut in spendings for social security services (family allowance) and budgetary institutions like state administration and education. These items have a high 11% and 23% share in the 1995 budget (Table 8). Still, the highest item is that of the debt service, which increased from a 10% share in 1990 to 27% in 1995. The increasing debt service is due to the two digit inflation, which is a phenomenon being only recently proven in detail by economic theory[19]. Therefore, no cut in spendings can be a real solution unless inflation is not supressed. Also, a sound compromise with the IMF would be necessary. In 1995 the Hungarian prime minister, Mr. Horn already criticized the IMF, saying that the requirement to halve the deficit by 1996 is a too hard condition leading to social and political tensions [Magyar Hirlap, 7 July 1995].

IV Outlook for the future (summing up)

For the future two main steps are considered necessary: (1) to start growth, and (2) to give a new role to the state.

IV. 1 Again growth

The desire for growth is fueled by the fall of real incomes, the high rate of unemployment (13–15%), its demoralizing effects and the deteriorating social services. The real danger is a political one, the "weimarization" as Kornai puts it ([11] p. 596), meaning a socialistic turn again and a halt to marketization. The economic danger is the "low-level equilibrium trap" when unemployment remains high, private sector will not grow further, budgetary crisis and inflation perpetuate. The downward trend may perhaps stop, but economy will remain unable to begin growing.

The transition period faces the hard dilemma: what to prefer, stabilization or growth? Between 1990–1995 economic policy considered stabilization to be the priority task, by 1995 it became clear, that growth is not an automatic result of marketization, therefore growth and stabilization must be treated simultaneously. Only if the economy begins to grow, can problems of restructuring, budget reform and living standards be resolved.

IV. 2 The new role of state

At present three main lines of action seem to be necessary: the continuation of key elements of transformation (privatization and budget reform), the elaboration of a development strategy and an organisational infrastructure.

Development strategy. It is important to work out an economic development strategy with a supportive monetary policy. The development strategy should focus on starting growth and boosting exports. The strategy should select some fields for

19 See for reference: M. I. Blejer – N. Cheasty: The Measurement of Fiscal Deficit, Journal of Economic Literature 1991, pp. 1644–1678; G. V. Jump: Interest Rates and Inflation, American Economic Review 1980, pp. 991–1004; R. Eisner: A new View of the Federal Debt and Budget Deficit, American Economic Review, March 1984; C. T. Taylor: Inflation Adjusted Saving the Sectoral Balances, Bank of England Quarterly Bulletin, 1982.

priority development while leaving other fields in the framework of general monetary policy. Such priority fields could be:
- infrastructure, which is relatively less import-intensive but helps business connections among companies and helps to reduce unemployment;
- agriculture, which could soon again become a substantial contributor to exports. For this, not only recovery of the production base but also the modernisation of food processing will be necessary;
- in manufacturing, industries with market prospects should be selected for development. Subcontracting and assembly opportunities from Western countries should be temporarily promoted; this would reduce unemployment and help to upgrade working and technical skills.

The general approach in development strategy should focus on:
- *import and diffusion of new technologies* At present there is no targeted monetary policy to help improve technologies. During the transition technical development was conceived as a result emanating automatically from market liberalisation and privatisation. However, in developed market economies basic R&D especially is not usually left to the market because of its high risk. Therefore, the government should share this risk with companies. A clear system of monetary tools should be devised with tax-free technology imports, considerable corporate tax breaks for R&D projects and for applied research.
- *employment policy* Present employment policy distinguishes only labour in the two extreme situations, the employed and the unemployed. A more flexible approach is necessary, including in-between stages, and a focus on companies' responsibility. New forms like temporary layoffs, part-time jobs and in-company retraining should be encouraged. Today dismissed masses on the labour market are left alone to find a new job and consume an increasing portion of the government budget in unemployment allowances, while companies are subject to a special tax to contribute to the unemployment allowance fund (in the state budget). Probably this money could be used more effectively if spent as a temporary subsidy to wages because companies could keep or retrain their labour force until restructuring is carried out and not then need to recruit and train completely new labour.
- *investment and savings* The central dilemma for monetary policy at present is how to harmonise the real interest rate for credits to companies with that for private savings. In any case, interest rate should be pressed down, so that cheap money could promote investments.
- *external economic relations* The main line will be the integration with EU. At the same time, however, trade with neighboring countries should be also developed. Since there is an increasing competition on Eastern markets, these markets will not

conserve production pattern and will provide an outlet for capacities, which at present are not able to face western competition. A payments union for Central European countries would help their cooperation [3a]. Recently a similar idea was proposed by the U.S., to set up a joint fund with the US Eximbank, the EBRD and Western European governments for providing export-guarantees to Eastern European countries[20].

- *organisational infrastructure* To devise a development strategy and provide guidance for its implementation, a ministry is necessary in which three fundamental fields, industry, international trade and technology, are integrated. The importance of MITI in Japan's postwar development is well known, as is that of similar organisations in South Korea or recently in China. In Hungary a similar ministry was set up in 1994, by merging the ministries of industry and international economic relations and the national technology agency. This strategic ministry could select the new and promising activities to be promoted and help the decline of shrinking branches. It could reasonably combine trade policy for new industries with helping the inflow and application of new technologies.

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