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Author's Guide

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EEPS
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2. Eric J. Hobsbawm, "The Crisis of the Seventeenth Century," in Trevor Aston, ed., *Crisis in Europe, 1560–1660* (Garden City, 1969), p. 6.

For articles:

3. Simon Kuznets, "Economic Growth and Income Inequality," *American Economic Review* 49 (March, 1955), pp. 22–24. OR, if there is only a volume and number for the issue:

4 Simon Kuznets, "Economic Growth and Income Inequality," *American Economic Review* 49:1(1955), pp. 22–24.

For newspaper articles:

5. "Head of Soviet Atom Power Plants and Five Others Penalized by Party," *New York Times,* August 15, 1986, p. 4. OR, if there is a specific author, begin with the name.

Socialist Transformation and Privatization: Shifting from a Socialist System*

János Kornai

Introduction

What follows was originally written for a Hungarian readership. I was invited to talk about my proposals for an economic policy for the next few years to be considered by the new parliament and government to be formed after the first free elections in the spring of 1990. My lecture, presented on August 25, 1989, was attended by economic experts of several opposition parties and also by a few officials and managers of state-owned firms working with the present government. Out of the notes for that talk grew the present article.

I am confident that the core of the ideas presented here applies not only to Hungary, but to all the other countries in transition from a socialist regime to a free economy. But before pointing out what is *common* to them all, a few words are in order about the *unique* features of the Hungarian situation.

The dramatic changes of 1988–1989 were preceded by a long sequence of important events. One has to start with 1956, the days of the revolution which established, if only for a few days, a multiparty political system and expressed the political will of the people to turn toward genuine democracy. This revolution was defeated by Soviet tanks and followed by years of cruel repression. When the backbone of resistance was broken, totalitarian control gradually relaxed. Hungary became a peculiar blend of more consumer-oriented economic policies (called "Goulash-communism" in the West) and belt-tightening, of more autonomy for the state-owned firms (in the spirit of "market

* This paper is a revised version of the first chapter of the author's book *The Road to a Free Economy. Shifting from a Socialist System: The Case of Hungary*, W.W. Norton and Company, New York, 1990 which presents comprehensive policy proposals for the development of the private sector (Chapter 1), a surgery for macroeconomic stabilization (Chapter 2) and some reflections on the creation of political support for these changes (Chapter 3). Thanks are due to the publisher for permission to draw on the book. The author gratefully acknowledges the help of Ms. Florence Stankiewicz in edition of the present text.

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socialism") and thousands of interventions in their affairs, of rigid central controls and free markets, and also of more permissive attitudes toward, and bureaucratic restrictions on, private property and private activities. The same ambiguity existed in the political sphere: while the political monopoly of the Communist party was officially maintained, the situation was characterized by an unpredictable mixture of tolerance and intolerance vis-à-vis opponents of the prevailing political structure and the dominant Marxist-Leninist doctrine.

This long prehistory, beginning in 1956, explains the pioneering role of Hungary in experiments first to *reform* the existing socialist system and then, after 1988–1989, to step over the limits of reform and start a non-violent revolutionary transformation of the whole political and economic system. As my subtitle points out, this is a transition *shifting* these countries *away* from the socialist system. When the time was ripe for these changes, Hungary was in a sense better prepared than the rest of Eastern Europe. It had an influential faction within the ruling Communist party committed to the shift toward democracy and a market economy. There were certain organized political groups that could draw on the moral authority and the experience gained from their past dissident struggles; intellectuals who had proven their autonomy of thought; and also political parties with a long history going back to pre-Stalinist times. In the economy, entrepreneurship and private property existed already, even if they were confined to a relatively narrow field. The transformation of Hungarian society did not have to start from scratch.

While the distinctive characteristics of Hungary must be spelled out, there are many fundamental attributes of the situation that it shares with the rest of Eastern Europe. When the first draft of this paper was written in Hungarian (in September 1989), Poland and Hungary were the only two countries where the political monopoly of the Communist party had been officially dismantled. Today, as I write this, East Germany, Czechoslovakia, Bulgaria and Romania have joined the same ranks, and a similar development can be witnessed in Yugoslavia. In spite of all the important differences in history, culture, and present political and economic conditions, all these countries have important common properties, and they will face similar difficulties in the forthcoming years.

In all of them the public sector plays an overwhelming role, so they must overcome similar obstacles if they want to proceed with the privatization of the economy. Although there are sporadic elements of a genuine market mechanism, the institutions, the legal support and (no less significant) the culture and the ethics of a well-functioning free market are not yet developed. Prices, interest rates, and exchange rates are distorted. These countries have small open economies in dire need of becoming an organic part of the world economy, and yet the composition and quality-standards of production are not at all adapted to the demands of the world market. A huge bureaucracy penetrates every cell of the economy's organism. Albeit in different proportions in the various East European countries, similar malaises weaken the economy: stagnation or recession of real output and consumption, open or repressed inflation, chronic shortages and, in most cases, a huge burden of external debt service. Social tensions threaten the balance of society. In most instances, workers are unhappy with the protracted sacrifices asked for by the sake of stabilization, large strata of the population sink deeper into poverty, and at the same time technocrats, bureaucrats, and managers selected by the former regime are afraid of a "change of the guard."

This paper responds to the following question: what is the economic policy to be pursued in the coming two or three years, given these circumstances? These answers are, of course, calibrated to the Hungarian conditions. But many essential parts of these answers, if they can be applied to Hungary at all, should be applicable to the other former East Bloc countries as well.

At the time of this writing, the Soviet Union and China, the two largest socialist empires, are still at stages very different from present-day Eastern Europe, but in many respects similar to the Yugoslav, Hungarian, and Polish situations before the drama of 1989. I think it may be instructive to readers in these two giant countries to consider their own situation in the light of the set of issues discussed in Eastern Europe these days. It may happen that our present tells something about their future. The study of contemporary Eastern Europe may help in understanding the difference between *reforming* socialism and *shifting away* from socialism; between experiments in simulating a market with "market socialism" and the introduction of a genuine free market. More than four decades ago Friedrich A. Hayek wrote his classic book *The Road to Serfdom,* pointing out that the way toward tight central planning, toward the overwhelming power of the state and the abolition of private property endangers political freedom as well. My title echoes Hayek's, considering the first section of the road in the reverse direction. We in Eastern Europe are on the road to a free society and a free economy, and we have to learn how to overcome all the roadblocks in our way. This is a learning process to be mastered by all of us who live in the vast area between the Elbe and the Yellow Sea.

I am aware that my *proposals* are controversial and may meet vehement opposition and criticism. Yet I am convinced that at least the *issues* discussed here are among the key problems to be addressed in each of these countries. The list of issues is not complete, but none of its topics can be dismissed as being irrelevant. Like it or not, these are among the problems that *must* be solved in the coming years. I do not offer a miraculous, universally applicable cure for all our troubles, but my *approach* can be used, I believe, in all the countries engaged in the transformation process. It is my conviction that the shift in property relations toward privatization, the package of measures needed for stabilization, liberalization and macroadjustment, and the strengthening of political support for these changes are inseparably intertwined. None of these tasks can be successfully accomplished without completing the others. Arbitrary selection of some targets while ignoring others can backfire and lead to the failure and the discredit of the process of democratization and economic transformation. In that sense the various parts of the program make an organic whole and offer a *comprehensive* plan for transformation. I am sure that this set of proposals has many weaknesses. Nevertheless, it might contribute to the debate over these exciting issues just because it advocates the search for comprehensive solutions instead of arbitrary, ad hoc, partial measures.

Having clarified how this study might be of use to readers in Eastern Europe, we must ask why should an American or any other Western reader be interested in the subject? The term "historic" is used in quite a lighthearted manner these days, often applied to a court decision or even a baseball game. But if there is one event that really deserves this name, it is the transformation of socialist systems into democratic societies and market economies. Everybody's life will be affected in some way. There will be more grounds for hope for global peace. Although perhaps not in the near future, but certainly at a later stage there will be less need to spend vast resources on defense, leaving more for other ends: economic growth, welfare, science and culture, aid to the poor at home and abroad.

Apart from *general* interest in the subject, various groups might have a *special* interest. First of all, in the world of learning and research, a class of experts focuses on the study of Communist systems and on comparing them with other social formations. It will certainly become their top priority to follow the changes occurring where heretofore socialist regimes shift to another system. All courses dealing with socialism, central planning, and comparative economic systems must include in their curriculum the study of transformation processes. But of course the set of people with a special interest in the subject is not just academic experts. It includes politicians, government officials, members of parliaments and congresses, diplomats, officers of international organizations, and economic advisers, who are engaged in the formulation of international politics. It also includes journalists and others working in the mass media who report on affairs in this part of the world and influence public opinion. And last but not least it extends to bankers, businessmen, and exporters/importers who want to enter these new markets. All these groups need to understand the new situation in Eastern Europe. Many of their individual members have already made quite a few trips to this area and returned with certain impressions, some of them based on correct understanding, others much better, much worse, or simply different from the typical. The deeper and more balanced their knowledge, the more efficient will be the impact of these various groups on East European affairs.

A rather common fallacy combines oversimplification with suggestions to merely imitate. Visitors arrive in Eastern Europe, many of them bringing home-remedies with promises of instant success. "Just do what we do at home and everything will be all right." Maybe so—but maybe not. In this paper the Hungarian reader, and indirectly all foreign readers, are repeatedly reminded that we have to keep in mind the peculiar *initial conditions* of the transformation process. The point of departure is the dominance of public ownership and an almighty bureaucracy with millions of hands reaching each business unit, each family, and each individual. These are countries where such desiderata as the sovereignty of the individual, autonomy, private property and private business, political and intellectual freedom, the institutions of democracy, and the rule of law were suppressed for decades. The fulfillment of these desiderata does not jump out of a box: they can be re-established and generated only by a historical process. It is a process which could and should be speeded up; nevertheless it will not be finished in a few weeks. We have to learn from Western experience, but selectively, carefully distinguishing examples that can be followed tomorrow from those that must await conditions that require a long evolution and, finally, rejecting certain patterns, institutions, and habits that are not applicable (or not worthy of application) at all. Artificial transplants, hastily forced upon these societies, will be rejected by their living organism.

Not only a revolutionary change in institutions is needed, but also one in *thinking*. New sets of values will replace the old ones which the old regime has imprinted on generations of people. Let us consider just one example: the feeling of a Western reader that we are talking about trivial ideas, such as that people have the right to earn more than others if they are more successful in business. If this is a self-evident truth to an American or a Swiss reader, it is not at all so to a Polish or East German one. At each stage of his life, from the child entering kindergarten to the old retiring to a home for the aged, the individual has been told that not business, but only work (and more specifically, work done in the framework of an enterprise or organization in the public sector) was the single legitimate source of income. He was taught furthermore that some inequality was tolerable or perhaps even useful as a material incentive, but not "too much" inequality. He was never told about the most glaring violation of this principle, as the privileges of the elite were carefully hidden from the public. Right now, in the beginning of a new era, many people in various political groups, even within strongly anti-Communist movements, are still under the spell of their former indoctrination in extreme egalitarian values. They suppose profit or high income to be the result of unethical practices, and speculation and profiteering as sure signs of unacceptable greed. My goal here is not only to make pragmatic proposals concerning the elimination of inflation and shortages or the easing of the foreign debt burden, but also to show the relationship between practical policy proposals and underlying values and philosophy.

Needless to say, I am not representing a philosophy and ethical outlook shared by everyone in Eastern Europe, but a particular one, accepted by certain groups and rejected by others. As the title of this piece hints, the central idea is *freedom.* It is the approach of *liberal* thought (using the term "liberal" in its traditional European sense). Its focus is respect for autonomy and self-determination, for the rights of the individual. By contrast it advocates a narrowed scope for state activities. It speaks against the paternalistic role of the state, against treating the citizen as a helpless child to be guarded by a wise (or stupid and cruel) government. It proposes a citizen who stands on his own feet and relies on his own power and initiative. Perhaps at a later stage, the role of government will be reconsidered. But right now, in the beginning of the transformation process, people are really fed up with the excesses of state intervention, with the totalitarian power of the bureaucracy. It is probably inevitable that history move not in a straight line, but with oscillation. Following a number of decades when a maximal state prevailed, it is now time to take great steps in the direction of a minimal state. Perhaps later generations will be able to envisage a more moderate middle way.

At this point it is appropriate to interpret the "free economy" of my title. A free economy is of course a *market* economy, but the concept is richer and does not just refer to the fact that the main coordinator of economic activities is a specific mechanism, namely the market. A free economy is one that allows unhampered entry, exit, and fair competition in the market. It also implies a certain configuration of property rights and a certain institutional and political structure. The system promotes the free establishment and preservation of private property and encourages a situation in which the private sector produces the great bulk of the output. It is a system that encourages individual initiative and entrepreneurship, liberates it from excessive state intervention, and protects it with the rule of law. A free economy is embedded in a democratic political order, characterized by the free competition of political forces and ideas. In the value system of this author, the guarantee of these liberties has a high intrinsic value and should therefore enjoy top priority in economic policy-making.

I do not aim here at offering *predictions* concerning future developments in Eastern Europe. In most of my writings until now I have concentrated on exploring the properties of the existing socialist systems and on elaborating explanatory theories. A positive explanatory theory is expected to have predictive power. The purpose here is different—not to answer the question of what *will be* the future role of parliament in Eastern Europe, but what it *should be.* It may turn out that some deputies act as advocates of local or sectoral interests, that some corruption occurs, that a lack of expertise hinders the efficacy of parliamentary supervision and so on. Nevertheless, I advocate an increased role for a freely elected parliament in monitoring the activity of the administration and in supervising the huge state-owned sector. My aim is, if I may say so, at least in part *educational.* I would like to suggest to future deputies that they be aware of their national responsibilities, raise their considerations above narrow local interests, and not bow to pressures and threats. Take another example: the problem of wage discipline and the role of trade unions. If I were asked to make a prognosis, I would admit that there is a good chance of strong wage drift, of lax wage discipline, of populism and demagoguery in the trade union movement in the near future. But I here urge: do not go that road! You are hurting the long-term interest of labor, which requires strict wage discipline for the sake of stabilization, fast adjustment to the demands of foreign trade, and ultimately, the acceleration of growth. This is the only safe way to start the steady increase of real consumption for all strata of society, including blue-collar workers. I do not need to give other examples, just to advise the reader that the original Hungarian version of this paper was entitled "A Passionate Pamphlet . . ." I do not pretend to offer a calm booklet of instruction in the manner of "How-to . . ." manuals. It is a plea to reason, but also to the emotions of the reader, describing what kind of changes are needed in actions, in institutions, and in values. I am convinced that my suggestions are not unrealistic; they are *feasible* given present political, economic and social conditions. But whether they go through depends on the will of all people involved, inside and outside Eastern Europe, and on their persistence in overcoming the many obstacles blocking the way to a free economy.

The Private Sector

For the sake of clarity, it is expedient to begin by making explicit the components of the private sector,[1] which are:

1. In writing this section I was greatly inspired by the literature on the theory of property rights in general. See, for instance, Armen A. Alchian and Harold Demsetz, "The Property Rights Paradigm," *Journal of Economic History* 33:17 (March, 1973); Harold Demsetz, "Towards a

a) the household as an economic unit; production and services are carried out within the household to cover its own needs;

b) formal private enterprises, operating legally in conformity with the legal statutes, and whose size varies from one-man enterprises to large-scale firms;

c) informal private enterprises, i.e., productive or service activities and all exchanges between private individuals that take place without special license from the authorities, or that are performed informally by private individuals for formal private or state-owned enterprises;

d) any utilization of private wealth or private savings, ranging from the renting of privately owned flats to money-lending between individuals.

These categories overlap to some extent.

Although it is often said that Hungary as a whole is in the grip of an economic crisis, I cannot fully subscribe to this view. To be sure, grave tensions and disequilibria are manifest on the macroeconomic level. They affect all economic processes and the lives of all Hungarian citizens. The largest sector—the state-owned firms—operates inefficiently. There is, however, a healthy part of the economy—the private sector. Although it too is grappling with great difficulties (to be discussed below), it remains the one sector which has *not* fallen into crisis. In point of fact, the economic situation of the country is better than the official statistics suggest, precisely because private production and private property have developed considerably during the past one or two decades. Indeed, the private sector is the most important "built-in stabilizer" of the economy. In my view the development of the private sector is the most important achievement of the economic reform process so far.

The vitality of the private sector is proven by its ability to develop at all amid alien and unfriendly circumstances. In one of his oft-quoted

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Theory of Property Rights," *American Economic Review* 57:2 (May, 1967), pp. 347–359; Erik G. Furubotn and Svetozar Pejovich, eds., *The Economics of Property Rights* (Cambridge, MA: Ballinger Publishing Co., 1974). I was especially inspired by those writings that discuss the question of property rights in the socialist system. Among these I should like to single out the classic work by Ludwig von Mises, "Economic Calculation in the Socialist Commonwealth" (1920), in Friedrich A. Hayek, ed., *Collectivist Economic Planning* (London: Routledge and Kegan Paul, 1935), pp. 87–130; the book by Don Lavoie, *Rivalry and Central Planning: The Socialist Calculation Debate Reconsidered* (Cambridge: Cambridge University Press, 1985), as well as the article by Gertrude E. Schroeder, "Property Rights Issues in Economic Reforms in Socialist Countries," *Studies in Comparative Communism* 21:2 (Summer, 1988), pp. 175–188.

"One Minute Stories"—"Budapest"—the famous Hungarian writer István Örkény describes the Hungarian capital the day after an A-bomb blast. The city is invaded by mice. Suddenly one can see "a piece of paper posted on the ruins of a house. It reads: 'Mrs. Varsányi undertakes the killing of mice with clients' own bacon'." We have been witnessing something similar during the past two decades here. The private sector, private initiative, and private property had almost fallen victim to a series of nationalization, collectivization, and confiscation campaigns. But they mushroomed as soon as some restrictions were relaxed and supervision was more casual.

The strongest evidence of the vitality of the private sector is the *spontaneity* of its spread. The organizational framework, management, and coordination of the state sector had to be devised artificially through central measures originating at the top. But the private sector continues to develop *by itself,* on a grassroots basis and without instructions from above. The units of the private sector require no stimulation, agitation, or directives to act *along the lines of the market,* as this is their natural mode of existence, whereas the state-owned firms need perpetual encouragement and even orders to follow the market, but still cannot do so.

In fact, no one knows exactly the actual size of the private sector in today's Hungary. Statistics abound, but an accurate survey has yet to be made. A couple of years ago there were estimates using various approximations. According to one of these calculations, the Hungarian population spends one third of its total worktime in activities classified as part of the private sector (by the above definition).[2] This sector has probably increased since then. In any case, we have every reason to suppose that it is by now a strong segment of the economy, and one of the key issues of this country's economic development is whether or not its further growth will be successfully promoted.

In Hungary now, proponents of various economic theories and political currents recognize the need for the development of the private sector, although many of the statements to this effect are fairly general

2. Cf. the studies of János Tímár, "A társadalmi újratermelés időalapja" (The Total of Man-hours Available for Social Reproduction), manuscript, (Budapest: Marx Károly Közgazdaságtudományi Egyetem, 1985); and Pál Belyó and Béla Dexler, "Nem szervezett (elsősorban illegális) keretek között végzett szolgáltatások" (Services Supplied Within Non-organized, Mainly Illegal Framework), manuscript, (Budapest: Szolgáltatáskutatási Intézet, KSH, 1985).

or even vague (which enables the economist, politician, or party making them to remain non-committal). In the following I lay down six concrete requirements which I consider to be vital to the development of the private sector. I deliberately polarize my formulations so that the problems will be highlighted rather than blurred and the points of agreement and disagreement by the proponents of various positions will be revealed.

One cautionary remark—there would have to be some carefully considered exceptions and temporary compromises to these requirements in practice. The details of such exceptions and compromises fall beyond the scope of this paper, but rather than blunt the edge of the requirements with many reservations, I prefer to risk simplified formulations.

1. *The private sector must be wholly and truly liberalized.* There is no need for hundreds of new regulations fussily softening bureaucratic restrictions on the private sector, and vacillating over which points to include. It would be more expedient to approach the issue from the opposite direction, by giving unambiguous and emphatic statutory force to the principle that the private sector's scope of activity is unrestricted, except for such extra-economic acts like fraud or violence.[3] Of course, some legal restrictions based on economic considerations are necessary, like taxes and environmental regulations, which are well known and need no elaboration here. The emphasis is on the basic principle: as a rule, the private sector should face no prohibitive measures at all.[4]

The substantive content of the liberalization requirement is far from self-evident. In fact, it has quite a number of components. Therefore, I will only list its most important elements here:

3. I make no distinction here between regulations to be put into the Constitution and laws passed by Parliament. Suffice it to stress now that the basic principle should be incorporated into law.
4. This would mean an end to the distinction between categories b) and c) of the private sector. All kinds of private firms become legitimate and require no special license, except for those legally banned cases that are usually based on extra-economic considerations (e.g., the trafficking in drugs or children). Certain private activities could be subject to registration or official licensing when justified by considerations of defense, public security, or other external effects.

The law must specify those exceptions where the activity is subject to license. It should also adduce weighty reasons. Consequently, all the other activities become legally practicable without special license. This would mean a radical break away from the current practice, in which the starting point is just the opposite—no activity is legal without registration or license. At the very best, we can expect the authorities to ignore these cases and tolerate the unlicensed activities.

— freedom to establish a firm; free entry into the production sphere;
— free prices, based on a free contract between the buyer and the seller;
— unrestricted right to rent out privately owned assets, again on the basis of a free contract between the lessor and the lessee, (including freedom to rent out privately owned flats or real estate, with the rental freely agreed upon between the lessor and the lessee);
— unrestricted right to employ people in all cases when the employer belongs to the private sector (household or privately owned firm); the employer and the employee must be free to agree on wages;
— unrestricted right to accumulate, sell, or buy any article of value (e.g., rare metal);
— unrestricted right to accumulate, sell, and buy foreign currency through transactions within the private sector and between Hungarian and foreign citizens;
— unrestricted right to take out and bring in domestic and foreign currencies;
— free foreign trade activity, in which the members of the private sector have unrestricted right to engage in both export and import;[5]
— unrestricted right to lend money, with credit terms freely agreed upon between the creditor and the debtor;
— freedom of financial investment in the private ventures of other individuals;
— freedom to sell and buy, at free prices, any privately owned flat, real estate, or other asset.

It is worth comparing these concrete "freedom requirements" with the present situation. It is beyond the scope of this article to give a point-by-point comparison, but even a random test is sufficient to show the hundreds of legal obstacles blocking the genuine liberalization of the private sector. The existence of an informal second economy, the "shadow economy," the grey and black markets, the invisible incomes, etc.—is rooted in the hundreds of constraints that hamper private activity and the utilization of private property. The

5. The state, of course, is entitled to levy customs duties. This does not run counter to the above requirements.

phenomenon of a second economy may well be seen as a special kind of "civil disobedience movement," raising its voice against senseless legal regulations and administrative restrictions. It has been the lesser evil so far that the state has failed to enforce some of its bureaucratic restrictions on the private sector. In other words, the state seems to have resigned itself to letting these activities be grey rather than black. Now it is high time the whole thing was painted an unambiguous, glaring white.

To avoid possible misunderstanding it ought to be made clear that all of the above-named freedoms apply exclusively to transactions between members of the private sector—between buyer and seller, lessor and lessee, creditor and debtor, etc. They are not meant to apply to connections between the state or some of its institutions and the private sector.

By way of example, let us look at *foreign exchange transactions,* which I choose as a clear example, not as the number one priority among the requirements. I would also like to make it plain that I do not wish to propose the immediate introduction of the following measures without taking into consideration which other measures are taken. The liberalization of the foreign exchange transactions of the private sector can be successful only if it is an organic part of that sector's general liberalization, which in turn assumes implementation of a stabilization program.

Requirement 1 does not oblige the state bank to offer me, a Hungarian citizen, the sale of an unlimited amount of foreign currency for Hungarian forints. The question of the conditions and amounts of such an exchange should in fact be settled separately from the requirements. The "freedom requirement" referred to above means that I should be free to sell my dollars on the street, under the nose of the police, and to buy them as freely. I should also be free, in good conscience, to keep as much foreign currency at home as I wish. I should like to fear only burglars, not the police or the foreign exchange authority. I should have the right to offer my dollars for purchase to the state bank without any obligation to give an account of where I got them. If I do not like the exchange rate offered by the state bank I should have the right to sell my dollars to anyone who offers a better rate or to sell my forints to a private bank in Vienna, or to any private individual there for Austrian schillings. I should also have the right to take my Hungarian forints with me to Vienna or to anywhere else, and to buy as large an amount of convertible currency as I can.[6]

Transactions such as those are common even today, despite the fact that they are banned by law. The police are avoided whenever possible, but a policeman witnessing the trading usually ignores it. This ambiguous situation opens up two choices: to take the word of the law seriously and enforce it, or to lift the restrictions. I propose the latter.

But let us dwell a bit longer on our example, foreign exchange transactions. How does it affect the convertibility of the forint? It promises the evolution of a genuine market exchange rate between the forint and convertible currencies, and all this on private markets, where each client pays out of his own pocket. The requirement here boils down to the need to clear the way for a *private exchange rate* which is neither black nor grey but *bright white.*[7] In other words, the forint should be made convertible on the *private market.* This rate should not be determined by bureaucrats, but instead should be based on the real market forint price of the convertible currencies. Here the rate should

6. The demand to liberalize foreign exchange transactions usually raises the counter-argument that there is a danger people will seek to keep their money in hard currency rather than in forints, and even try to deposit it abroad. I see this as a faulty argument, a topsy-turvy treatment of the real relationships. People would dispose of their forint only if its purchasing power falters. Then they would strive to maintain their wealth in a way that preserves its value, i.e., by investing in real estate, art, precious metals, and, of course, hard currency. No administrative regulation can eliminate this drive. The only solution here lies in the stabilization of the domestic currency's purchasing power.

   As for the escape of hard currency to foreign countries, it can well be likened to emigration: it is worth the trouble only if it is banned. If the border is wide open and people are free to cross it to and fro, the majority would surely opt to stay. Consequently, if each and every Hungarian citizen is granted the right to freely take out or bring in hard currency, and to exchange money on the private market, then there will be no special incentive to keep the money abroad.

7. Under the proposed system, for as long as the state banking system fails to introduce the convertibility of the forint, the parallel existence of two different legal exchange rates is bound to emerge. One of these rates is the private exchange rate. It represents the real *market* rate, which is based on a voluntary agreement between the seller and buyer of the hard currency. The other rate is the official one, quoted by the state bank system. It has no market character, as the rate is dictated by one of the parties (the seller when the hard currency is sold and the buyer when it is bought) by right of its *administrative power.*

   There is nothing unusual in the existence of a dual rate. After all, we already have a private rate as a result of the large scale grey and black currency dealings. It would be ostrichlike to ignore this fact. Moreover, we can add here that the dual price system is also rather widespread in today's Hungarian economy: besides the official price charged by the state sector, there is also a private price used in the formal and informal private economy. My proposal is rooted in the mere cognizance of this fact, and it supports the legalization of private prices. This would promote the reduction of private prices, among them the private hard currency exchange rate, because this system would no longer involve the risk premium due to illegality.

express the value of the schilling or the dollar for the Hungarian citizen who pays from his *own pocket.* In this situation the value of the forint against the schilling would be roughly the same in Budapest and in Vienna, apart from the usual transaction costs.

Naturally, the legalization of private foreign exchange circulation does not solve the basic problems associated with the rate of exchange. A comprehensive and truly reassuring solution can only come as the result of universal convertibility guaranteed by the state banking system, together with a uniform exchange rate. I do not deal with this subject here, where my remarks are coming from a single viewpoint: the liberalization of foreign exchange operations is an essential part of the private sector's fundamental economic rights.

These freedom requirements should not be seen as grandiose favors granted by the state, but as basic civic rights, which have been almost completely denied to Hungarian citizen for a long time. Although the economic freedom of the Hungarian citizen has increased during the reform process, the permitted scope of activity is still rather tight. Instead of these limited liberties a genuine liberalization is needed.[8]

2. *The enforcement of private contracts must be guaranteed by law.* Any violation of a private contract should entitle the injured citizen to a court hearing, and the fulfillment of the contract should be truly enforceable. This would require a judicial apparatus of appropriate size, a sufficient number of lawyers, a modern and suitably detailed body of

8. I am well aware that requirement 1 is not fully or consistently satisfied in a number of capitalist countries. Quite often those who have curtailed liberties in Eastern Europe refer to Western or Far Eastern deficiencies. In my opinion, this argumentation is mistaken in two respects. The first is historical: the capitalist countries at issue reached their present stage after a long historical development. By contrast, Hungary has hardly begun with the embourgeoisement process following the almost complete elimination of private enterprise. The role of the state is different at the early stage of this development from that at a much later stage.

The other consideration has to do with the evaluation of contemporary capitalism. Why should we consider the current practice of any of the developed capitalist countries an example to be followed? The practice of these countries is criticized from several sides. I myself go along with those critics who find fault, among other things, with the fact that in some of the developed capitalist countries, intervention in the life of the individual and in the economic activity of private property is unnecessarily frequent. In some of the contemporary capitalist countries, conditions of free foreign exchange transactions are granted, while elsewhere there are fewer or greater restrictions.

Those who wish to cite foreign experiences should decide first on the country whose example they want to follow. Whoever declares himself an advocate of capitalism in Hungary should bear in mind that it is impossible to refer to "capitalism" in general. Instead, he should put more precisely which combination of liberalization and bureaucratic restriction he has in mind.

civil law, etc. The operational expenses of this "legal infrastructure" should be covered by the private sector, i.e., it should pay the necessary fees to meet the costs of civil courts, with the retainer freely agreed upon between lawyer and client. On the other hand, a private action should not be so protracted as to make a party to a private contract feel from the outset that there is no use taking the contract seriously since there is no chance of enforcing his rights.

To the oft-repeated question of what role the state is supposed to play, one possible answer is: it should administer justice in case of conflict between contracting parties, but it should not interfere in the dealings of citizens.

The provision of incentives for private savings and investment constitutes the guiding principle of the next four requirements. However, the method to be applied here is not persuasion but instead the creation of circumstances that would prompt private entrepreneurs to save and invest voluntarily.

3. *The absolute security of private property should be emphatically declared.* It is not my task here to clarify how this might be achieved. Certainly, guarantees should be included in laws, party programs, and statements by leading statesmen. In this respect, it is not a number one priority to retroactively cancel the confiscation of private property, which usually cannot be done but for a few specific and in fact fairly important exceptions (e.g., the lands of the peasantry). As far as future willingness to invest is concerned, the most important thing is to build sure confidence that there will never again be another confiscation.

4. *The tax system should not restrain private investment.* I can touch here on only a few points vis-à-vis the tax system. Those who are committed to the idea that the private share of total investment should increase would have to agree with the proposition that private savings should also represent an ever larger part of total savings. But private savings can increase only as personal incomes do. This in turn means that people should be allowed to earn as much as they can. Private production can be increased, modernized, and raised to the level of successful, large modern firms only following a considerable accumulation of private wealth.

Many politicians and economists show a peculiar ambivalence, on the one hand protesting the excessive power of the state and the high ratio of its budget to the GDP, while on the other hand speaking against the excessively high incomes of the private sector. But one cannot have it both ways; one must choose which one to complain about.

5. *Private investment as well as the formation and growth of private capital must be promoted through credit.* In my opinion the slogan of "equal opportunity" for the two sectors is false. In fact, opportunities have not been equal since the nationalization of 1949, and today the various sectors are positioned on uneven launching pads. To begin with, a huge amount of capital has been accumulated in the state sector, and the bureaucratic apparatus, state-owned banking, and state firms have become intertwined. Also, it is primarily the state sector that knows which strings to pull. How can we expect equality of opportunity between the private sector and this vast political, social, and economic power?

The legislature should also determine, within the framework of the annual government program, how large a slice of the economy's total credit supply will be reserved for the private sector, including a couple of basic quotas in each type of credit. For example, the decision should make explicit the percentage of the private sector's share of the total investment credits granted by the state bank sector for the next fiscal year. Guarantees are essential to protect the private sector's quotas from being siphoned off by the considerably stronger state sector.[9] If this governmental motion goes before Parliament, then the emphasis will definitely be shifted from grand rhetoric to tangible figures. Proceeding with the earlier example, the concrete issue will be whether 5, 25, 50 or some other percent of the investment credits is to go to the private sector.

While requirement 5 is meant to defend the private sector's right to credit from being siphoned off, it is not meant to suggest that credits should be distributed improvidently. Let us remember that one of the credit sources has its roots in requirement 1, i.e., credit is granted by one member of the private sector to another, on terms that would be fairly tough. No one in his right mind would reach deep into his pocket and lend money to another without assurances that he will be able to recover the loan. But state banks should also set rigorous terms. The classical tools of a credit system, i.e., the various forms of securities,

9. This is similar to the phenomenon known in the Western literature as "crowding out".

collaterals, and mortgages must be applied. Requirement 4 was that members of the private sector be free to make as much money as they can. Let me add here that they should also risk losing their investment if they fail to repay their debt. The credit markets have various patterns of terms. The financier of a deal might grant more credit relative to the amount the investor puts in, provided that the debtor guarantees repayment of the credit to the extent of his total private wealth (unlimited liability). Limited liability, where guarantees do not exceed the amount of the private investment, would attract a lower credit share. But regardless of specific credit terms, the private entrepreneur must risk collapse in case of financial difficulties. In other words, the private sector should face genuinely hard budget constraints. Overprotection, or attempts to "grow" it as a pure specimen under a glass jar, will simply make the private sector as weak and feeble as the featherbedded state firms.

In my opinion the use of the term "entrepreneur" should be strictly limited. It is not appropriate for one who uses the state's money and makes the state pay dearly for his losses. "Entrepreneurs" are those and only those who are willing to risk personal financial loss.

6. *Society must learn to respect the private sector.* This requirement means explicitly that castigations against the private sector, be they restrained or harsh, must cease. People in general today have great regard for peasants working on household plots or artisans laboring in their workshops. No hostility is directed against them, but it is against the likes of "boutique" owners or private greengrocers. It is high time to stop branding prosperous entrepreneurs as "sharks," "self-seekers," or "shrewds" out of sheer envy or populist demagoguery. This kind of primitive anticapitalist attitude goes against the grain of the market, where it is good to buy cheap and sell as high as possible. If the buyer needs a product and is willing to pay the asking price, then the dealer's activity can be considered useful to society.[10] Those who buy dear and sell cheap make bad bargains—which is all too familiar and has already cost the whole nation a hefty price. Clever businessmen deserve respect rather than reprobation.

Now that we have surveyed the six requirements for the develop-

10. There are certain cases, not considered here, that might be exceptions, e.g., during war or famine, rationing might be necessary.

ment of the private sector, I think it would be appropriate to add a few comments.

There is a debate going on these days about whether we need identifiable, "flesh and blood" entrepreneurs, or impersonal joint stock companies instead. Let me comment here only on the problems of the fully private joint stock companies (the issue of stocks owned by the government or non-profit institutions are another matter). To answer the question, I would emphasize socio-economic aspects rather than legal ones. One of the most important elements of the social transformation we seek is the development of a *new middle class,* whose core would be composed of industrious, thrifty entrepreneurs who want to move upwards in society. From among the proprietors of such small and medium-sized units the pioneers of economic progress and founders of large enterprises will eventually emerge as the result of the market's natural selection process.[11] Later, these entrepreneurs can be surrounded by a mass of people who do not themselves take part in the creation of new organizations, who do not found new firms, but willingly invest in the economy through the purchase of shares or in other ways.

The critical deficiency of socialist state property is the impersonalization of ownership: state property belongs to everyone, and to no one. In the midst of the ongoing transformation in Hungary it is high time that this contradiction be spotlighted. I would like to see individuals taking long chances with their own wealth, with the certainty that their failures mean real losses. Let the entrepreneur persuade others to entrust their money to him if he can. He should be free to involve silent partners as well; if they are judicious, they will first study him closely. Within a short period a few private bureaus or intermediary institutions will emerge that will enable silent partners to trade their shares. We have every ground to expect that sooner or later these developments

11. It is worth noting that even in the most developed capitalist countries, where industries are the most concentrated, small and medium-sized firms do not die out, but continuously reproduce themselves and even today contribute a significant portion of the GDP, confirming that their existence is essential to the market. See on this David J. Storey, ed., *The Small Firm: An International Survey* (London and Canberra: Croom Helm, 1983). It reviews the proportion of small and medium-sized enterprises in a number of developed and developing capitalist countries. Over the last decades in Hungary, it was precisely the small and medium-sized firms that were liquidated in the process of nationalization and artificial concentration.

will lead to genuine private stocks, authentic private joint stock companies, and a real private stock exchange.

All these changes will take place in the course of the organic historical development of private property. It is not advisable, and perhaps not even possible to skip this stage of historical development, although it can be shortened by appropriate measures. The course of events is not symmetrical here: while it is possible to liquidate the private sector by state fiat, it is impossible to develop it that way. Here we have to reckon with a decades-long hiatus which cannot be ignored. Entire generations were made to forget the civic principles and values so closely associated with secure private ownership, private property, and markets. Mere imitation of the most refined legal and business methods of the leading capitalist countries is not sufficient to ensure their general application.[12] A comparable attempt has already been made by those who wanted to lead African tribes, or backward village communities in Asia, straight into communism. There is no need to give the "great leap forward" yet another try.

In current political debates, the question is raised whether Hungary should adopt the market economy of the nineteenth or of the twentieth century. Of course it goes without saying that we desire the latter. But there is a considerable gap between our wishes and the pace of change we can realistically expect given our current stage of development. Let us look at the actual status of the private sector in today's Hungary! But for a few exceptions its standard resembles that of the Balkans at the turn of the century, or of today's developing countries. The difference between the equipment and buildings used by private farmers in Hungary and in Denmark or the United States is tremendous. The private farmer in Hungary does not own trucks, tractors, or silos, and it is beyond his wildest dreams to have his own telephone. Let us look in at the crammed workships of the artisans! Let us look at how the private sector works in services or trade! What we find are the ramshackle kiosks of street vendors, and stores which are cramped and shabby. A considerable portion of the private activity is still semilegal, with incomplete equipment or with gear borrowed or usurped from the state

12. I by no means suggest that we should ignore the experience of the most developed countries. It is well worth our while to take from modern capitalism anything that might also be applicable to our own circumstances, and avoid the sheer stupidity of "reinventing the wheel."

sector. In many respects present standards fall far behind those of Hungary's private sector in the late 19th century. It is not now simply a matter of having the government fix a date for abandoning its miserable, balkanized, underdeveloped standards, and catching up with the Western private sector of the late 20th century. True enough, we must speed up this development, primarily through meeting the requirements described above. (We must also turn a portion of state property over to the private sector—a point yet to be discussed.) But the fact remains that an impatient "leap" would be irrational. We must expect that for a long time to come we shall find side by side different generations of units in the private sector varying considerably in the modernity of their legal structure, business methods, and technical endowment, some belonging to the past century and others perfectly up-to-date.

This point leads to a second comment: the private sector develops step-by-step. It is impossible to institute private property by cavalry attack. Embourgeoisement is a lengthy historical process[13], which in Hungary suffered a dramatic break in 1949, to be retarded for decades. In the 1960s, the process revived in certain fields, i.e., the greater role of household plots, the widening of the scope for legal private activity, and the growth of the second economy.[14] Today, odds are that the process of embourgeoisement will gather momentum. The more consistently our six requirements are satisfied, the faster this process will be. It is conceivable that this process will not work itself out uniformly in the various branches. It will be particularly rapid in less capital-intensive undertakings in the service sector, and in domestic and foreign trade. But even if it accelerates, it may take many years before the private sector is able to provide the larger portion of production; possi-

13. On this subject, remarkable ideas and empirical references were published by Iván Szelényi, "Szocialista polgárosodás" (Socialist Embourgeoisement), (manuscript, October, 1986), and Szelényi, *Socialist Entrepreneurs: Embourgeoisement in Rural Hungary,* (Madison: University of Wisconsin Press, 1988). See also Pál Juhász, "Társadalmi csoportok együttműködése az első, második és harmadik ökonomiában" (Cooperation of Social Groups in the First, Second and Third Economies), *Fogyasztói Szolgáltatások* 4 (1981); and Iván Pető, "Polgárosodás, restauráció nélkül" (Embourgeoisement without Restoration), *2000* (August, 1989), pp. 5–8. I would highlight the pioneering activity of Ferenc Erdei and István Bibó.

14. See the work of István R. Gábor, "The Second (Secondary) Economy. Earning Activity and Regrouping of Income Outside the Socially Organized Production and Distribution," *Acta Oeconomica* 22:3–4 (1979), pp. 291–311; and István R. Gábor and Péter Galasi, *A "második" gazdaság. Tények és hipotézisek* (The "second" economy. Facts and hypotheses) (Budapest: Közgazdasági és Jogi Könyvkiadó, 1981).

bly a longer period must pass before a truly developed, up-to-date, and *mature* private sector takes shape.[15]

I do not at all want to create the impression that I idealize the role of the private sector in general or specifically in today's Hungary. As for Hungary, I am fully aware of how common it is to find private entrepreneurs who greedily want to make money hand over fist, even by cheating their customers or defrauding the state. Instead of striving firmly and soberly to establish their businesses for the years or decades to come, their priority is to make the largest possible profit in the shortest possible time. This kind of entrepreneur forgoes productive investment and settles instead for conspicuous, prodigal consumerism. They also tend to be impolite towards their customers, with the "take it or leave it" attitude akin to the high-hat behavior of the state sector in a shortage economy. Together, these abuses turn public opinion against the private sector, and then public sentiment makes no distinctions and is unjustly hard on the honorable, industrious, and thrifty private entrepreneurs who expand their businesses only by fair means.

Of course, we could do with further education and with the propagation of the principles of plain-dealing, thrift, and farsighted business behavior. The organizations and syndicates of the private sector should take a strong stand against ethical offences. Legal regulation is also needed, e.g., to prevent cartel arrangements aimed at the elimination of rivalry, to ban collusion, monopoly, and unfair competition. However, I am of the opinion that all these can play but a secondary role. Crucial change can take place only with the fulfillment of the above-named six requirements. Long-term considerations and investments by the private sector depend on a sense of security about private property. The ending of the shortage economy, the emergence of competition and rivals, and the fear of business failure—these are the very incentives that can make the private entrepreneur attentive to the customer.

My last comment here concerns the introduction of foreign capital. In my view, the key to foreign investment should be sought in the development of Hungary's own private sector. I for one would not

15. The tempo of the Hungarian private sector's modernization and ripening will depend to a considerable degree on how tightly the country plugs itself into the European and world capitalist blood circulation. The economic culture streaming towards us from the West, Western consumers' higher quality requirements, and the organization and discipline of business and production undertaken jointly with Western partners can all exert a stimulating effect.

count on foreigners making a considerable investment in the Hungarian economy solely on the basis of the *exceptional conditions* offered them by a number of state decrees favoring them over Hungarian private firms. Any foreign investor in his right mind would know that these preferences are very easy to revoke. At best he would venture an investment whose security is guaranteed by his own government. Consequently, foreign investment is bound to become a function of the home country's governmental policies. This might well take us somewhere, but definitely not far, as is already obvious. Moreover, this situation might also attract sharks in search of a quick large return, who are ready to clear out at a moment's notice. By contrast, the serious-minded, sober foreign investor will want to find out about the status of private enterprise in Hungary, and if he sees that each and every Hungarian citizen is free to do whatever he wants with his labor, money, and wealth and is allowed to engage in unrestricted foreign trading, then the foreign investor will have no reason to be seriously concerned. I consider it rather childish of Hungarian statesmen abroad to use persuasive words in order to attract foreign capital to Hungary. It will surely come of its own accord once it feels secure in this country and no longer has to fear a myriad of bureaucratic restrictions.[16]

The State Sector

Provisionally, I include here all the different forms of public ownership. Finer distinctions will be made later. The salient distinctive criterion is negative: entities belonging to the state sector are not in private ownership. Or, as the economic theory of property rights would put it: the residual income which emerges as the difference between expenses and receipts does not pass into the pockets of natural persons, and losses are not covered by them.

In Hungary, and also in a number of the other socialist countries, the principle of "market socialism" has become a guiding idea of the reform process. This is a rather complex docrine[17], so I concentrate here

16. It is another question whether it is worthwhile to promote interest in foreign investment by providing correct information and by demonstrating the advantages of investment in Hungary.
17. The literature on the debate over "market socialism" would fill a library. I mention here only the most important works: Enrico Barone, "The Ministry of Production in the Collectivist State," in Friedrich A. Hayek, ed., *Collectivist Economic Planning* (London: Routledge and Kegan Paul, 1935), pp. 245–290; Ludwig von Mises, "Economic Calculation in the Socialist

only on the heart of the issue. Under this principle, state firms should remain in state ownership, but by creating appropriate conditions these firms should be made to act *as if* they were part of a market. Further on I shall use—and challenge—the term "market socialism" only in this limited sense: "*market socialism*" = *state property* + *market coordination.*

I wish to use strong words here, without any adornment: the basic idea of market socialism has simply fizzled out. Yugoslavia, Hungary, China, the Soviet Union, and Poland bear witness to its fiasco. The time has come to look this fact in the face and abandon the principle of market socialism, even though a number of people still want to continue rear guard actions for it. I for one cannot go along with them. Indeed, there is need to note the following facts:

The market mechanism is the natural coordinator of private sector activities. This is linked to the autonomy of the decision maker under the market mechanism and to the centrality of the notion of free contract to both the operation of the market mechanism and to the safeguarding of private property. In this light, it is futile to expect that the state unit will behave as if it were privately owned and will spontaneously act as if it were a market-oriented agent. It is time to let go of this vain hope once and for all. Never, no more. It is simply useless to dwell on the fact that state ownership permanently re-creates bureau-

Commonwealth," in Hayek, *Collectivist*, pp. 87–130; Fred M. Taylor, "The Guidance of Production in a Socialist State," *American Economic Review* 19:1 (1929), pp. 1–80; Hayek, *Collectivist;* and Oscar Lange, "On the Economic Theory of Socialism," *Review of Economic Studies*, 4:1 and 2 (October, 1936 and February, 1937), pp. 53–71 and 123–142. A classic summary of the debate is found in Abram Bergson, "Market Socialism Revisited," *Journal of Political Economy* 75:5 (1967), pp. 655–673. Lavoie's *Rivalry* has an outstanding survey. The pioneers of the reform ideas based on decentralization were Boris Kidrič, *Sabrana dela* (Beograd: Izdavački Centar Komunist, 1985) in Yugoslavia; György Péter, "A gazdaságosság jelentőségéről és szerepéről a népgazdaság tervszerű irányításában" (On the Importance and Role of Economic Efficiency in the Planned Control of National Economy), *Közgazdasági Szemle*, 1:3 (1954a), pp. 300–324; Péter, "Az egyszemélyi felelős vezetésről" (On Management Based on One-Man Responsibility), *Társadalmi Szemle* 9:8–9 (1954b), pp. 109–24; Péter, "A gazdaságosság és jövedelmezőség szerepe a tervgazdaságban I–II" (The Role of Economic Efficiency and Profitability in the Planned Economy I–II), *Közgazdasági Szemle* 3:6 (1956), pp. 695–711, and 3:7–8 (1956), pp. 851–869; and János Kornai, *Overcentralization in Economic Administration* (London: Oxford University Press, 1959) in Hungary; Wlodzimierz Brus, *The Market in the Socialist Economy* (London: Routledge and Kegan Paul, 1972) in Poland; Evsey G. Liberman, "The Plan, Profit and Bonuses," in A. Nove and D.M. Nuti, eds., *Socialist Economics: Selected Readings* (Middlesex: Penguin Books, 1972), pp. 309–318 in the Soviet Union; and Yefang Sun, "Some Theoretical Issues in Theoretical Issues," in K.K. Fung, ed., *Social Needs Versus Economic Efficiency in China* (Armonk: M.E. Sharpe, 1982) (works originally published between 1958 and 1961).

cracy, since the state-owned firm is but an organic part of the bureaucratic hierarchy. During the initial, "naive" phase of the reform process we all cherished the hope that the mere discontinuation of plan commands would be enough to create the market coordination of state-owned firms. However, this hope was not fulfilled. Instead, as several post-1968 analyses have revealed, *direct* bureaucratic regulation of the state sector was replaced by *indirect* bureaucratic regulation. The various state authorities found a hundred means to meddle in the life of the firms.[18] If a campaign managed to do away with one form of interference, another cropped up immediately. This kind of bureaucratic coordination is as much the *spontaneous* effect and natural mode of state property as market coordination is of private property. Suffice it to cite here twenty years of Hungarian experience together the experience of all other reform-minded socialist states in support of the conclusion that this is no longer a debating point, but simply a fact which must be accepted.

The matter of reducing the state's share of the market is a separate point. The desirable outcome of this process is for the firms in the state sector to provide only the lesser part of total production. It is also conceivable that once the state-owned firms become small islands in the sea of the private economy, they too will be compelled to behave almost as if they were privately owned. However, this one problem we can safely leave open now, since for the time being it is very far from reality. Today, and for a long while to come, we shall have to cope with the reverse situation: the tiny islands of the private sector surrounded by an ocean of state-owned firms. This is the nub of the following exposition. My line of thinking is of course contestable, but there is no contradicting it with arguments such as: "Renault of France is also a state-owned firm, and yet it is profit- and market-oriented."

Under existing conditions in Hungary and taken in a sociological sense, I consider state-owned firms part of the state bureaucracy, be-

18. For analyses of the relationships between indirect economic control, economic management, and the firms, see, e.g., László Antal, "Development—with Some Digression. The Hungarian Economic Mechanism in the Seventies," *Acta Oeconomica*, 23:3–4 (1979), pp. 257–73; Antal, *Gazdaságirányítási és pénzügyi rendszerünk a reform útján* (The Hungarian system of economic control and finance on the way of reform) (Budapest: Közgazdasági és Jogi Könyvkiadó, 1985); Tamás Bauer, "The Contradictory Position of the Enterprise under the New Hungarian Economic Mechanism," *Eastern European Economics* 15:1 (Fall, 1976), pp. 3–23; and Márton Tardos, "The Role of Money: Economic Relations Between the State and the Enterprises in Hungary," *Acta Oeconomica*, 25:1–2(1980), pp. 19–35.

longing to the sphere of "government" rather than "business". They should be treated accordingly. The state sector must not be "liberalized" unconditionally, but we should rather keep a watchful eye on it! In fact, each organization of the governmental sphere tends to spend the citizens' money in an unbridled manner. Therefore these strong tendencies must be blocked.

The problem has already been treated in many theoretical and empirical studies.[19] By way of example, a leadership that places high value on the bureau's performance of its duties would be determined to maximize its own budget. Conversely, the legislative body supervising this bureau is required to resist this when it comes to setting its budget.

Let us look at the relationship between the government and its branches, e.g. the army, in a parliamentary democracy, e.g., the United States. The Congress must sensibly reckon with the Pentagon's ever-growing propensity to spend. The national budget was created to set limits on these demands, and it is the role of budgetary discipline to enforce these limits. True enough, the Congress is subject to political pressure, and the military also brings pressure to increase its budget. The usual practice then is all too familiar from the way state investments are treated in a socialist economy: preliminary estimates give the expected cost of a new project, but once production is under way, it turns out that the actual expenses will be double or triple that. By then, however, it is too late to scrap the whole thing, and here is another argument for maintaining congressional control, with special committees to supervise military spending. The opposition also keeps an eye on expenditures. If abuses occur, there is a good chance they will be discovered.

The relation between the armed forces and the Parliament is only one example of the more general relationship between the executive (i.e. the bureaucracy) and the freely elected Parliament. The former is perforce expansive, and thus it is the number one obligation of the latter to check this expansion. The money spent by the bureaucracy comes from the citizens and not from its own purse. It is the task of Parliament to oversee the spending of the citizens' money.

Only a year ago, it would have been illusory to raise this point.

19. A pioneering work on the subject is William A. Niskanen's *Bureaucracy and Representative Government* (Chicago: Maldine, 1971).

Today, even as I write, the political and organizational conditions for legislative supervision of the state sector have yet to be realized. Such a change requires among other things a freely elected Parliament, deputies who devote their energies exclusively to their tasks there, and resources available to each of them. But there is today a *chance* that these conditions will be met. Therefore the time has come to make the following proposal in all seriousness: Let us *not* give unrestricted power to the manager of the state-owned firm!

Precisely because I am a proponent of liberalizing the economy, I would like to be liberal with the citizen and the private-firm owner who risks his own money. Conversely, I would like to see tight control over the ways in which the taxpayers' money is spent. In this respect I classify the manager of a state-owned firm as a state officer. If he does good work, I do not really begrudge him his large salary. If he is a flop, he must be given the sack. But let us not harbor illusions: the manager of a state-owned firm is not an entrepreneur. There is no getting away from the fact that he, like the heads of other state institutions, is out to expand his spending limits as far as possible. The manager of a state-owned firm also wants to invest more, obtain an ever greater amount of hard currency, import more machinery and equipment from hard currency markets, travel more and let his colleagues do the same; and of course he wants to pay higher wages since this will boost his popularity among the employees and thereby ease the tensions around him. Hitherto he could behave in this way, because he did not have to contend with a private owner who protected his own money from overspending. If this manager overspent, he had a realistic chance to obtain relief: the state budget or the banking system were sure to help him out. As long as the state sector remains the dominant sector in the national economy, the firms, due to their spontaneous and internal concerns, do not have and never will have hard budget constraints, and it is time to abandon the hope that they will.

I do not wish to present my views in an oversimplified or extreme form. I do not maintain that the state firm is simply one among many kinds of public offices, and differs in no way from, for example, those that provide services (like the police). Nor would I say that the state firm manager's attitude resembles in all respects that of a mayor or a metropolitan police chief. The state firm sells its products for money, operates on the basis of revenue and cost calculations, and maintains a relationship with sellers and buyers. Therefore, state firm directors show some of the characteristics of businessmen, and in the two decades since the 1968 reform they have surely been more marked. It would be a great shame to weaken these attributes. But at the same time, all responsible directors, from the highest to the lowliest manager, must be made aware of the fact that each and every one of them is a state officer entrusted with the disposal of state funds. They must be held fully accountable, and it is entirely justified that the citizens' representatives oversee their work.

Several practical suggestions follow from the foregoing, but I shall here outline only their basic principles.

1. The director of a state firm should have complete independence in deciding: the composition and quantity of production, the combination of inputs and choice of technology, agreements with suppliers and purchasers, and hiring and firing of labor.

Nominally these decisions belong to the firm, but in practice higher organs interfere in a hundred different ways. For my part, I favor a more complete, consistent realization of independence. As a matter of fact, I would call for the kind of independence for the state firm like that enjoyed by individual plants *within* very large private firms in developed capitalist systems. There the the manager of the subunit is usually free to make numerous decisions independently, while the large firms' headquarters decide on basic financial targets.[20]

2. On the whole, the state firm directors should set prices independently, as the producers generally do in the market economy, and be free, as seller, to agree with the buyer (state firm or private buyer) on those prices that under normal market relations would be voluntarily agreed upon by sellers and buyers. In certain cases the authorities may justifiably prescribe prices, but only as exceptions to the general rule of free price determination.

Now we come to those spheres of authority in which, from my point of view, it is necessary to *restrict* the independence of the state firm.

3. Most important: the state banking system must strictly control

20. Many studies have been published on the way the various subordinate units receive partial autonomy within the huge capitalist firms. This partial autonomy implies that the subordinate unit is treated as if it were self-accounting and producing for its own profit. However, this is not the case, since the real owner, the huge capitalist firm, stands in the background.

credit to the state sector, enforcing tight monetary control with no yielding to any type of pressure.

4. We must require similar strictness of fiscal discipline in relations between the state treasury and state-owned firms. I do not discuss here the subject of ultimately ending subsidization of money-losing state firms, but I only wish to say that until then we must set strict limits on it. Taxes must be collected, and in general we must put an end to bargaining between the treasury and state-owned firms.

5. The wage policies of state firms must not be liberalized. This point of view runs directly counter to the widespread opinion that the state firm should have total independence in this area as well.

6. The danger remains that the unbridled state firm will spend hard currency on imports, in the hope that it will somehow be able to cover the rise of the forint that results. I see two possibilities:

a) If a stabilization operation is completed, and if then we manage to implement with iron consistency a policy of strong restriction on the supply of credit to state-owned firms, and if in addition we attain the convertibility of the forint at a realistic rate of exchange, then (and only then) we can lift the special restrictions on state firms' purchases of hard currency. Then forints will be available to the firm on a limited basis, and thus the demand for hard currency will be held in check.

b) If the conditions summarized in point a) are not met, then the state-owned firms' purchases of foreign currency must be restricted by direct administrative means.

7. The state-owned firm should be independent in making investments it can finance from its own savings, bank credits, or with funds obtained on the capital market. But if the central or local state budget contributes or guarantees credit, then it must also be approved by the legislative body (Parliament, local council) that oversees the state organization. Parliamentary approval is also required when the implementation of investments is tied to intergovernmental contracts. We must not present current and future generations with a fait accompli, as happened in the past with such already notorious investment projects as the Bős-Nagymaros Danube Power-Station, or Hungarian participation in the construction of the Siberian gas pipeline in the Soviet Union. If an investment turns out to be a losing proposition or is dangerous in any other respect, it can be called off. Naturally, since such decisions

usually involve considerable losses, it is far better to give them due consideration in advance. The elected representatives of the people must be granted the right to reach a responsible decision *prior* to the opening of the huge state purse or the signing of the related international contracts.

8. I mention the following point here only for the sake of completeness, though it will not be addressed in detail now: the managers of the state-owned firm do not have the right to sell the enterprise. This is the right of the *owner,* whereas the manager is only a paid employee.

I do not believe that, taken together, the autonomy described in Points 1 and 2, or the limits to autonomy discussed in Points 3 through 8, would ensure the highly efficient operation of state firms. Let us be clear: this is a *vain hope.* The state firm carries its fate within itself, especially as long as it is the predominant form of ownership, and there is no wonder drug to make it operate at a high level of efficiency. It is true that the degree of inefficiency in the state sector cannot be a matter of indifference to anyone, and the above suggestions might help reduce it, but they are primarily justified by other goals, of which I emphasize two.

The most important is the *protection of the private sector.* The country's resources are limited: both the state and private sectors want to utilize them, but they are not equal competitors. The state firms' appetite for resources is virtually insatiable, because it is accustomed to a soft budget constraint, while the private sector is limited by a hard budget constraint. The state firm has well-developed connections with the banks and the authorities, not to mention that their large size in itself ensures many advantages for them in the procurement of resources. The tight restriction on credit extended to state enterprises, the regulation of the wages it pays, the supervision of state investments, and other restrictions are necessary to protect the private sector from being crowded out by the state's tendency to siphon off resources. Those who take seriously the task of developing the private sector cannot allow the free play of political and economic forces to determine the shares of the two sectors in the distribution of resources.

I am not one of the many who call for equal terms of competition for the two sectors. With head erect, I argue instead that all sectors of the national economy need not be treated uniformly. Those who spend state funds cannot claim the same rights as those who have to rely on their own resources. The citizen who spends his own money exercises a basic human right. But when the money comes from the state's purse, society should exercise tight control. Just as the exhortation "Hands off the private sector!" is fully justified, one must demand that a strong hand be applied to the state sector!

Let me call attention to the fact that this standpoint is quite counter to current practice, i.e., to the bureaucratic restriction of the private and the liberalization of the state sector. My viewpoint also runs counter to that of several economists and politicians, who in their proposals and platforms repeatedly argue for the continuation, and even expansion of present-day policies: they want to ensure unlimited liberalization for state-owned firms while maintaining hundreds of constraints on the private sector.

The second goal, equally important, that justifies restriction in the state sector is *macroeconomic stabilization.* Firm enforcement of fiscal, monetary, and wage discipline is indispensable, as is careful deliberation prior to any decision on investments when state resources are involved. In the above analysis the role of the Parliament has been referred to repeatedly. I do not want to dwell here on what the working relationship should be between the future Hungarian Parliament and the bureaucracy elaborating the economic plans for the state sector. We shall have to consider the earlier relationships between the leading political bodies and the lower-level economic institutions under the monolithic structure of the planned economy (e.g., bargaining processes, distortion of information). We shall also have to weigh the pros and cons of the relationships between Parliament and state bureaucracy in the developed democracies. At the same time, we must realistically recognize that no parliamentary democracy has ever faced such a vast state sector as will confront the future Parliament of Hungary. If we do not want our future Parliament to remain a rubber stamp for the bureaucracy, and if we want to avoid crippling the state sector by endless parliamentary debates, then we have no other choice but to try and steer cooperation between them toward a negotiable middle course, avoiding both excessive intervention and unlimited liberalism. It is vital for all political forces to have their own small expert bodies, which then enable them to exercise genuine control over the state sector without ever having to needlessly interfere in its everyday activity.

In addition we need to develop a range of institutions which come under the supervision of Parliament, not the government, to provide an effective counterweight to the state administration. A start has been made. A State Audit Office patterned after those found in many parliamentary democracies is being set up to oversee spending by the state apparatus. The new institution designed to manage the privatization of state property is likely to be supervised by Parliament, and it would be practical for the central bank, the National Bank of Hungary, to be under parliamentary control as well. No doubt a good many other organizations independent of the government machine will be required.

I do not want us to expect too much of the future Hungarian Parliament. Again, a process of organic development and a long period of learning will be required before the members of Parliament and the institutions answerable to it are proficient in their tasks. That implies a very important role for the press and public opinion as a whole in continuously monitoring the state sector, particularly during the learning period. The business results (profits or losses) of state-owned firms must not be kept secret; those who ultimately foot the bill—the citizens—must be kept informed.

It is apparent from the foregoing remarks about the inevitable bureaucratic traits of state ownership that I myself am deeply suspicious of that brand of so-called "property reform" which assigns state property to another state-owned institution or firm in various legal forms (for instance by transferring shares) instead of placing it in truly private hands. Similarly, I am quite suspicious of the "state capital market," which I consider to be one of the most grotesque absurdities of the whole Hungarian reform process. The past decades were replete with pseudo-reforms; what we are experiencing today is the latest wave of these fake, illusory changes. We have seen that there is an organization out there with the authority to spend the money of the state, and which does so irresponsibly. The so-called solution is that we hand over the ownership rights held by this state organization to another state organization, which in turn spends the state's money irresponsibly.

The changes I am wary of are manifold. One of them is what in Hungarian economic lingo is "cross-ownership." In this scheme, one or more state-owned firms become joint owners of yet another state-owned firm. A further change is the intertwining of the state-owned commercial banks and certain other state-owned firms. The bank acquires part of the shares of the state-owned firm, or conversely the state-owned firm becomes a shareholder of the state-owned bank. Yet another form of this is something called "institutional ownership," a scheme in which a state-owned insurance company or a city council buys into the shares of a state-owned firm.

These forms have been introduced at least partially, and these changes in general are rapidly gaining ground. Some studies in Hungarian reform literature have been pushing them for years, and others still urge their further spread.[21] However strong this current may be, both on the level of ideas, intellectual debate, and in actual practice, I myself am determined to speak out against it. I daresay that I am not the only one around who is fed up with this practice of stimulation. We have already tried our hand at simulating quite a number of things: the state-owned firm simulates the behavior of the profit-maximizing firm; bureaucratic industrial policy, regulating expansion or contraction of various branches of production, simulates the role of competition; the Price Control Office simulates the market in price setting. The most recent additions to this list are the simulated joint stock companies, the simulated capital market, and the simulated stock exchange. Together, these developments add up to Hungary's Wall Street—all made of plastic! The Westerner who hops over here for a couple of weeks coming from, say, the World Bank or the International Monetary Fund, may fall under the spell of these simulations; visitors from abroad tend to like experiences they find familiar. The Westerner strolling around Budapest will be pleased at the sight of a McDonald's, simply because it reminds him of home. Similarly, it is a pleasure for him to see here the familiar banks, joint stock companies, or the stock exchange. Odds

21. I cannot offer a survey here of the entire literature on this idea, and it does not fall within the present paper's province to assign priorities among them. My impression is that the influence of Tardos's activity was the greatest (among his most recent works, see Márton Tardos, "A gazdasági szervezetek és a tulajdon" (The Economic Organizations and the Question of Ownership), *Gazdaság* 22:3 (1988a), pp. 7–21, and "A tulajdon" (The Question of Ownership), *Közgazdasági Szemle* 35:12 (1988b), pp. 1405–23. I also wish to mention the work of Tamás Sárközy, "Egy törvény védelmében I–II" (In Defense of a Law I–II), *Figyelő*, August 24 and 31, 1989, p.3. Similar ideas were published by the Consultative Committee for Economic Management in "A szocialista piacgazdaság megteremtése: Tézisek a gazdasági reformkoncepciót kidolgozó munkabizottságok számára" (Creation of the Socialist Market Economy: Theses for the Committees Working Out the Concept of Economic Reform), *Figyelő*, Dec. 8, 1988, pp. 1, 17–20. A thorough survey of the debates in Hungary on the ownership reform in the state sector is to be found in Jenő Barsony, "Hol tart a tulajdonreform ügye?," (Whither Ownership Reform?),*Közgazdasági Szemle* 36:5 (1989), pp. 585–596, and in Lengyel, *Végkifejlet*, pp. 153–85.

are that he will not notice that these banks, joint stock companies, and the stock exchange are fakes. What is going on here is a kind of peculiar "Monopoly" game in which the gamblers are not kids but adult officials, and they do not play with paper money but with real state funds.

Whenever I get to this point during a conversation, someone will argue "Why don't you just take a look around today's capitalist world? There too one can find plenty of joint stock companies, the majority of whose shares are also held by other firms—insurance companies, nonprofit institutions (e.g., pension funds or universities), or local governments." Now why indeed do I expect the degree of this non-private form of ownership to be any smaller in Hungary than in the contemporary capitalist countries?

It is my firm conviction that history is not like a film reel that can be stopped at any moment, or run on fast forward or backward at will. Socialist state ownership means the complete, 100 percent impersonalization of property. We cannot simply reverse this process in an attempt to reduce this percentage gradually to 95, 90, 85 percent and so on. The reel must be fully rewound and played from the beginning. Let us look more closely at the past and current developments in the capitalist world. We have already touched upon this issue in the analysis of the private sector in today's Hungary. Let us pick up the thread again with a brief outline of the dynamics of the centuries-long capitalist development.

The first engines of capitalist development in all countries are individual entrepreneurs: they are the smartest or luckiest smalltimers who either quickly or through successive generations accumulate capital. Entrepreneurs enter and exit; some survive while others go under. There are those who get stuck at the level of shabby shops or modest medium-sized factories, and also those whose ventures grow into mammoth companies. In the meantime, more impersonal capital is continuously being acquired, coming from people who place their savings in bank deposits or shares. As ownership grows more secure, as a related legal infrastructure is developed, and with the ethical norms of fair business management gaining ground, we can expect the parallel spread of various forms of non-private investments. Of course, this process also implies that the state acts as the guarantor of sound business dealings.

All things considered, many of these institutional investment forms are in the last analysis backed up by the interest of the ultimate private owners who have funds in the institutions. This interest exercises pressure on the investment behavior of a non-profit institution. Or there is a fairly powerful institution—for example a university or a foundation—in the background, which has its own traditions and its own organ of genuine self-government, and it will surely apply a firm hand to ensure that its investments are good, all the more because it is also financially autonomous and cannot count on the paternalistic patronage of the state. The ratio of such non-private investments will grow as a result of this process.

But two qualifying comments should be added here. First, brand new undertakings rarely get non-private investments. Most of the important new products of the past fifty years were backed by identifiable enterprising individuals or groups who financed the whole thing from their own pockets. The only major exceptions were innovations closely connected to military development, and large infrastructural projects. It seems natural to expect that the central government should raise the necessary capital for the construction of a new airfield, and in the process cooperate with the local authorities. But let me reiterate: this form is but an exception when something genuinely new is being introduced. In the normal course of events the pioneers may make a sizable profit on a new product in a new industrial branch or new market, but they are also the ones to take the loss if the venture hits the rocks. The innovator's capital is often supplemented by outside private investors, primarily those who are ready to take a long shot in hopes of an exceptionally high profit.[22]

The second qualifying comment is in fact a question: why should Hungary imitate capitalist countries in the impersonal, or institutional ownership of property? I am fully aware that joint stock companies play a large role in highly developed contemporary capitalist countries, and that there is at most an indirect linkage between the millions of shareholders in corporate business and the control of the corporations. Using Albert Hirschman's well-known dichotomy, the small shareholder expresses his disappointment rather by "exit," i.e., getting rid of shares that do not appeal to him anymore, than by "voice," i.e., directly

22. In the United States and in other developed industrial countries specific financial institutions are formed to finance such "venture capital."

influencing the management of the firm. Many private owners do not decide on their investment portfolio directly but use the services of intermediary agencies. In a modern capitalist economy, thousands or tens of thousands of insurance companies and pension funds have sizeable shareholdings in big corporations. The "little" private owner is far away from the dealing on Wall Street. His money is at stake; the profitability of corporations will ultimately affect his personal wealth and well-being, but this connection is established through long and indirect linkages, and has become impersonalized to a certain degree. Yet in spite of these well-known facts, Hungary today does not have to imitate the United States or Japan. If, for example, the proportion of institutional ownership stands at 42 percent in Japan and 37 percent in the United States (of course, these are fictitious numbers), then do we really have to follow this 37 to 42 percent pattern?

The impersonalization of property is criticized in the West too, and in my view these criticisms are often accurate. Ironically, the germs of socialism are already present in today's capitalism. There are many who believe that ownership has become inordinately impersonal in the insurance industry, health services, and banking. In the United States, we can witness today a classic example for the softening of the budget constraint, namely in the sphere of savings-and-loan associations that specialized in financing housing projects. Several of these associations have already reached the verge of bankruptcy, in many cases because they abused the confidence of the depositors and gave vast credits to contractors who proved to be unreliable debtors. The pattern is all too familiar to a Hungarian economist. Now the state must reach deep into its pocket to rescue these associations or trigger a run on them, and this in turn might result in a grave financial crisis similar to the depression of 1929. But is this really an example for us to follow? Certainly not! Many American economists believe that considerably tougher constraints should have been applied on these associations right from the outset, and the conditions of state guarantees should have been more clear-cut. A country like Hungary must take special care not to follow such a pattern, since an unswerving confidence in the paternalistic role of the state has put down deep roots there over the past few decades.

Now let us come back briefly to the salary of the managers of state-owned firms. I for one would like to look upon the successful manager of a state-owned firm as a highly-esteemed official, whose prestige is no less than that of an ambassador, a mayor, or a general. But make no mistake: he is not a businessman! If he does his job well, he should earn good money, though his wages should not be allowed to reach astronomical figures. I disapprove of that not only because the country is now facing great difficulties. If the country were well off, a manager in the state sector would still remain an official paid out of the state budget, and not a person licensed to manage the money of private individuals. It is the task of the deputies in Parliament to fix the salaries of the prime minister and the generals; the same body should set the wage ceiling for the state-owned firms' managers.

As mentioned before, the partial decentralization accomplished by Hungary as part of the reform process has made managers of the state-owned firms develop a few qualities approximating those of genuine businessmen, and it is reasonable to expect that these will show in their financial and moral incentives as well. While no one would reasonably propose that attorneys get bonuses depending on the total number of years their clients spend in jail, it might well be justified to give managers in state firms the prospect of bonuses on top of their salaries, but in moderate amounts. It is economically unjustified to link such bonuses to the firm's so-called profit, the definition of which is in dispute in the mostly arbitrary and distorted price and tax systems in Hungary today.

While I propose that Hungary's future Parliament put a ceiling on wages of managers in state firms, I do not consider this necessary for managers contracted by private firms. If the private owner wants to pay one million forints for a year from his own pocket to any of his employees, he must be free to do so; he knows whether it is worth it or not. But no one has the right to draw an arbitrary amount for wages from the company payroll, or for it to be approved by any administrative authority when the money comes from the state's budget.

Shift in the Proportion of the Two Sectors: The Process of Privatization

I consider it desirable to increase the proportion of the private sector as fast as possible to a point where this sector accounts for the larger part of the country's GDP. This, however, can be achieved only through an organic process of development and social change. This process, as already pointed out, is not a recent development but has been dragging on for one or two decades already. The task is now to accelerate it by implementing a number of practical measures.

I myself am not fond of the slogan "reprivatization." Margaret Thatcher was able to implement the policy behind that slogan in Britain, where the private sector had survived the period of nationalization, and where there was enough domestic capital to buy up the state sector, and at fair market prices (although I have to add that reprivatization is also facing difficulties there).

Now what are the aims that can reasonably be achieved in Hungary, and which are the points I consider prejudicial? Let us examine the latter first. State property must not be squandered by distributing it to one and all just out of kindness. This occurs in countless forms at every turn. For example, it is absolutely unjustified to sell state-owned flats to the tenants at a price that is but a fragment of the real market price, and to make it worse, requiring a cash deposit that is only a trifling portion of the purchase price. A former tenant can thus obtain a hundred-square-metre flat in Buda, in the most expensive quarter of the Hungarian capital, by paying in cash the equivalent of the real market price for one square metre of the flat. This is sheer nonsense, especially in view of the fact that the same tenant had for years or decades been subsidized by the state through low rents.

I actually do not know just how many shares are available to private individuals in the current drive to transform state-owned firms into joint stock companies, and I am also unacquainted with the current prices offered to the managers and other employees of the firm. A limited right of preemption and some discount seem justified to a certain extent. But it would be completely wrongheaded to let anyone become a stockholder for a song, be he a manager or just a staff member of a firm.

The proposal has been made that state wealth should be distributed among the people as a matter of civil right. This scheme would entitle each citizen to receive a bit of capital which he or she would be free to invest or sell. This proposal is mistaken. It leaves me with the impression that daddy-state has unexpectedly passed away and left us, his orphaned children, to distribute the patrimony equitably. But the state is alive and well, and its apparatus is obliged to handle carefully the wealth it was entrusted with, until a new owner appears who can guarantee a safer and more efficient guardianship. The point now is not to hand out the property, but rather to place it in the hands of a really better owner. A precondition to this is that genuine private entrepreneurial motivation should be established and take hold.

Let us now turn our attention to my positive proposals.

1. The members of the private sector should be given the chance to buy the wealth of the state sector in suitably divided parts. The household should be free to purchase state-owned realties (flats or even an apartment house, lots, stores, etc.). Private entrepreneurs should have the right to acquire state-owned enterprises. It would obviously be unrealistic in today's Hungary to count on private entrepreneurs to purchase huge state-owned firms. But they should have the opportunity to buy smaller enterprises, which would be made available by breaking up the enormous Hungarian enterprises that artificially unite a number of smaller units. The principle of all or nothing must never be applied here. It is feasible to split an artificially inflated mammoth into smaller and healthier units, sell some, and keep the rest under state management.

This process of passing state property into private hands should in no way lead to the brutal dismantling of huge indivisible units. The Hungarian economy today is inordinately concentrated, even compared with the developed industrial countries. There are plenty of possibilities to create smaller units, but there is no need to act overhastily either. In this context it is indispensable to thoroughly analyze the pattern of concentration in genuine market economies, where competition has resulted in a kind of natural selection. In those economies the large, medium, and small enterprises, and even the people engaged in home industry coexist and cooperate. Hungary needs the whole range of plant sizes.

It would be unwise to employ uniform methods, irrespective of the branch of the economy or the size of firm concerned. A giant firm needs a different procedure from a state-owned greengrocery or a small automobile repair shop. The same applies in choosing among all the forms of privatization considered under Points 2–8 below. It is comparatively simple to transfer smaller units from the state into the hands of an individual or group. The larger the unit, the more necessary other legal forms become. (See the comments on the joint stock company under Point 9.)

2. Regardless of its size, state property should be sold at a real market price. It should generally be auctioned, and potential buyers should always be notified of the public sale. Since there is often no guarantee that the state institution, which acts as the nominal seller, is really interested in fixing a realistic (suitably high) selling price, it might be useful to give independent bodies a say. In certain kinds of sales the asking price is easy to fix: in the housing market, for example, the price on the private market offers an appropriate starting point. Of course when it comes to the sale of manufacturing firms, the task is more difficult, but one might start with the question of how much of his own money the private entrepreneur would have to invest to establish new, similar business.

3. In the sale of state property to private owners, a credit plan must be established. The example below of a feasible credit arrangement is only illustrative, and not at all a real proposal.

Let us say that a private individual or group wants to acquire state property valued at Ft. 20 million (in accordance with what has been said under Point 2 we suppose that this is a real price with no discount). The potential buyer is obliged to make a down payment of Ft. 5 million and pay the remaining Ft. 15 million plus interest in equal installments over no more than five years. The Ft. 20 million state property becomes private property at the very start of this transaction, but it remains charged with a mortgage.

The mortgage conditions must be tough. If the new private owner fails to make his installment payment when due, he should lose a proportionate part of his original investment (following the necessary legal proceedings), and the property should revert to the state body that transacted the credit.

The point of this example is to illustrate two important economic policy requirements. First, that sales to private parties are not limited to the current total of private wealth, since if cost exceeds resources, credit can make up the difference. It is thus possible to accelerate markedly the process of transferring state property to private hands. Second, this credit should be granted to real flesh-and-blood persons instead of distributing it through an intangible stock market. This flesh-and-blood person should be entitled to a sizable credit, but once he fails in his payment, he should face the complete loss of even his initial capital.

4. The practice of leasing state assets to private individuals is already widespread in Hungary and is definitely needed. However, two kinds of mistakes must be avoided. One is when the state-owned firm, acting as the lessor, is greedy and demands an unreasonably high rental. This can only incite the lessee to ruthlessly exploit the property of the state: he will squeeze out everything he can from it, then move on. The other mistake is when the lessor squanders state property by setting a gratuitously low rental. In short, rentals must be rational and realistic.

The rental system can also serve as a transition to sales. On the one hand, the lessee can gain experience before he decides whether the asset is worth buying. On the other hand, the state-owner can discover a realistic asking price. There are well-known formulas for converting rents into non-recurrent capital value.

5. Part of Hungary's state wealth can be sold to foreign owners, but only to the extent compatible with the nation's interest. No economic hardship can justify the bargain-basement sale of national wealth.

Let us consider the interests of foreign capital: it comes to Hungary not just out of kindness but, first of all, to make a profit. Other motivations also play a role: for example, it might regard Hungary as a beachhead and training-ground in capturing the East European market. In any event it is understandable that it is guided by its own interests, and it would be pointless to paralyze this process on account of ideological or moral prejudice.

Now the question is the following: does Hungary benefit in any way after foreign capital has earned its profit? There is no universally valid positive or negative answer, since it always depends on the concrete conditions of the deal. It would be nonsense to try to attract foreign capital without setting any conditions: "Please be good enough to come and buy up Hungary's state wealth." First of all, Hungary could benefit if the purchase price is reasonable.[23] Furthermore, Hungary could gain if foreign capital brings along up-to-date equipment and managerial,

23. The daily papers reported that a British firm bought the controlling stock of Hungary's Ganz Vehicle Factory with two million pounds in cash, the remaining (fivefold) amount of the price to be paid in installments. This two million pounds is a shocking sum. I am familiar with the current apartment prices around Boston in the U.S. If we take the price for a modest 70-square-meter apartment, we find that the sum of the British down-payment would not buy more than twelve of them! Even if the physical assets of the factory were absolutely worthless, the trade name Ganz is still worth several times the purchase price. Such squandering of Hungary's state wealth is simply unacceptable.

business, and technical expertise. When the firm is managed by foreign owners, it is often possible to introduce a high degree of organization and discipline. When these happen, Hungary does gain.

Of course, we must also consider the possible effects of foreign capital on employment, which might well be beneficial. But here again we cannot justify the transaction solely on this basis. We must not sell Hungarian state-owned property to foreign owners at just any price merely to preserve the Hungarian jobs at stake. All in all, it may be worth placing an upper limit on the proportion of Hungarian state-owned property that foreigners may buy.[24] But no case can be made for any such restriction on direct foreign investment, i.e., on using largely foreign capital to set up a new installation.

6. One often hears the modest argument that the sale of state assets is not meant to produce extra income for the budget. In fact, some have managed to discredit the idea of a balanced budget to such a degree over the past couple of years that an eagerness to collect revenues has become something shameful. The budget needs further discussion, but suffice it to state here that we should accept the fact that the sale of state assets is bound to become a major source of income for the state budget. It logically follows that one cannot be indifferent to the selling price. There are many who just cannot stress enough the need to impose heavy taxes on high incomes. But they fail to talk about the price to tenants when buying state-owned flats, and they keep skipping the issue of who is entitled, and at what price, to own private stocks under the so-called transformation scheme.

Each sale of state assets at a good price (to domestic or foreign buyers) reduces by the same amount the citizens' contribution to the treasury via taxation or inflation. This state revenue, to be sure, is non-recurrent and not permanent, but it occurs at the best moment, when the country is preparing to overcome the greatest difficulties of stabilization.

7. While Point 6 gave a brief outline of the fiscal consequences of state property, let us now turn to the monetary consequences. A considerable amount of money has been accumulated by the population, and by the private sector in general. There is no way of telling how much of that is forced savings, i.e., so-called "monetary overhang". In any case

24. The South Korean government created an institutional and legal framework for regulating a similar process by setting up a so-called Korea Fund as the only channel through which foreigners could buy Korean property. That example certainly merits careful study.

this amount of unspent money exerts an inflationary pressure on the market. There are various ways to pump it out, and one is the sale of state property.

The actual cash-credit ratio in sales transactions is important, both from the fiscal and monetary angles. To come back to our Ft. 20 million example: it is not inconsequential whether the down-payment is 2, 5, or 8 million. Macroeconomic considerations argue for the biggest possible share of cash in the deal. However, an excessively rigid adherence to an exorbitant down payment could well throw serious obstacles in the way of the sales process. Thus some experimentation on the market will be inevitable.

8. In Hungary the so-called Corporation Law enables a state-owned firm to convert itself into a joint stock company and its shares to pass into the hands of various owners. To my mind the form itself is flexible enough to permit a favorable result, but misleading and even quite adverse changes might also occur. There is widespread public debate on this issue, with strong criticisms from interested parties and outside observers. I would like at this point to make my own position clear: conversion into a joint-stock company ultimately achieves its purpose as long as it leads to a *real* privatization of the firm. Though it may do no harm for shares to pass from one hand of the state into another, I would expect no improvement from that; I expressed my doubts about this in the previous section.

As for the passing of shares into private hands, let me state first of all what I would consider *incorrect:* One cannot simply allow the current managers to appropriate the firm, converting themselves from state employees into owners, or more precisely into owner-managers, combining both roles. The new owners should have a free hand in appointing the management, keeping the old or appointing new executives, as they prefer. It should also be up to the new owners to set executive salaries and financial incentives; that should include the right to offer managers a proportion of the equity at a discounted price. But it is inadmissible for the previous managers themselves to choose the new owners or to promote themselves to the top of the list of new owners.

As I have mentioned, the employees of the firm may be offered the opportunity to buy shares at a discount, but only a small proportion of the shares, I think. It would not be desirable for the firm's workforce as a whole to receive the entire equity (let alone *free,* as the advocates of this solution suggest) so that state property becomes the collective property of the firm's employees. That would amount to *de facto* introduction of the self-management property format, which I oppose. Here I would like to refer first to the ethical side of the problem. The wealth of the firm at the moment ownership is transferred was not created exclusively by that firm's workers; every citizen has contributed through the state investments and subsidies the firm has received. There is nothing to justify a smaller group of citizens acquiring that wealth as a gift. Moreover, some labor collectives would do very well as they receive a thriving firm as a gift, while others would become owners of heavily indebted, loss-producing "negative wealth." Most importantly, the prime consideration is not legal entitlement to acquire the property but the ability to run it well. In my view the only format capable of supplying permanently the incentives to guarantee that more effective use is made of the resources is private property.

One cannot calibrate in advance, by laws or other regulations, how the ownership of the shares is to be distributed. All I can point to is what the desirable trend would be. Let us say the capital of a formerly state-owned firm consists of 10,000 shares. Under the present conditions in Hungary, it would not be advantageous for that capital to be dispersed among 10,000 different shareholders. In that case the previous, quite impersonal state ownership would be replaced by an equally impersonal private ownership. The desirable thing would be a dominant individual shareholder or small group of shareholders capable of acquiring an appreciable stake in the firm (at least 20 or 30 percent of the shares) and thus a decisive say in the appointment and supervision of the firm's executives. This aspiration is consistent with the argument already put forward in favor of the need for visible, "tangible" owners whose private investments (in this case *sizable* shareholdings) give them a strong interest in the firm's success. This dominant group of shareholders could be Hungarian or foreign; the essential requirement is for an effective, direct ownership interest to form. My belief is that in general, conversion into a joint stock company or into some other legal form of private property should be embarked upon only when and where such an individual or group of shareholders has appeared. Once "tangible" owners have appeared and proved, by buying a large number of shares, their willingness to take an appreciable risk, the remaining shares can be sold to other, interchangeable buyers. For my part I would have no faith in the success of reversing this, i.e., of first selling shares to all and sundry, fragmenting the equity, and then hoping that someone will appear who can make his voice heard in the management of the firm.

9. The marketing of state wealth should be a fully public process, in a framework laid down by law. The law must be circumspect in regulating and limiting the rights and duties of the previous managers. At the time of writing, the legal and organizational framework for the state institutions' handling of privatization is emerging. There is also need for a parliamentary committee to supervise the execution of the law and exercise independent control over the state organizations responsible for privatization.

The press will have an important role to play. A genuine business press is needed to provide potential buyers and sellers with information. It is not enough to publish make-believe auction announcements here and there. Business publications should make today's market-jungle far more transparent. The public should know the price at which state-owned flats, realties, or factories are sold and bought. There is generally no room for business secrets in cases when the state acts as the seller. Even in the exceptional cases when secrecy is justified, the parliamentary committee should still be allowed an inside view. Other branches of the media and the political opposition will also have important roles to play in exposing the occasional abuses.

To sum up, we may say that the sale of state property should *not* be governed by the principle of speed. To say "enough of it, away with it" is irresponsible. State ownership in some places is more efficient than private ownership; no one, for example, would propose turning the highways over to private owners. But even in cases where it is difficult to decide whether state or private ownership is the more efficient, specific analyses are needed to explore whether the transaction at issue is efficient in light of the requirements discussed above. State property should be sold to private owners if the deal is advantageous from a macroeconomic point of view, and if there are guarantees that from the microeconomic perspective the new owner will do better than the old one. Let us not forget that the prime purpose of privatization is to bring about the *incentive force* which private ownership provides.

All these changes will evolve in a prolonged organic process. This process should be energetically accelerated, but it should not be rushed hysterically, or executed in a sudden operation.

The Relations Between the State and Private Sectors

There can be no "Berlin Wall" between the state and private sectors.[25] Various kinds of relations between them develop, some healthy and worthy of support, others harmful and needing defeat. It is high time to repeal the legal provisions restricting or in some instances prohibiting business dealings between state-owned firms or other state organizations and the private sector. I am convinced that close economic ties with the private sector can help state-owned firms work more flexibly and fill gaps left by the shortage economy. It would be desirable in a high proportion of cases for private traders to handle the transfers of goods produced by one state-owned firm to another state-owned firm that used them. Private traders should be allowed to import materials for state-owned firms and to export their products.

In all societies corruption may arise in contacts between private enterprise and the government sector, including state-owned firms. This has been experienced already, and as the private sector strengthens, will become more frequent. There is no watertight way to prevent this damaging and repellent, yet inevitable accompaniment of the transformation process, but it is worth making strenuous efforts to minimize the problem. That entails suitable legal measures and codes of ethics that distinguish the correct, honest forms of these relations from those legally prohibited and ethically reprehensible. The struggle to enforce the legal regulations and ethical norms must be waged both by the criminal investigative authorities and the general public.

Perhaps the more important measure against corruption is for privatization to proceed successfully. Once the state sector has lost its dominance, the discipline imposed by market competition will tighten, and there will be fewer chances for certain elements of the private sector to gain special advantages through their relations with the state sector. In addition, economic changes like a unified system of free prices, a unified convertible currency, and the elimination of inflation and the shortage economy will all help to lessen temptations and opportunities for corruption.

Special mention must be made of those with a foot in each sector, like a worker in a state-owned firm who does private repair work in his spare time. This is not reprehensible in itself, and we can understand

25. I have borrowed the simile from András Nagy.

his wanting to retain the security the state sector has offered so far while augmenting his income in the private sector. Individuals have a sovereign right to lead this double life, which usually entails extended working hours and self-exploitation. But legal measures and the pressure of public opinion must ensure that no one abuses this dual affiliation. That goes for a worker who feels tempted to expropriate the state-owned firm's means of production or to use them without paying a rent. More serious and more reprehensible still is the case of an executive who plays a double role, acting at once as head of a state-owned firm or institution, and as owner, employed manager or consultant of a domestic or foreign private firm. Strict regulations are needed to define accurately and prohibit conflicts of interest and ethically incompatible dual affiliations. Such regulations are found in the legal systems of all developed Western democracies; careful study of them would help greatly in preparing similar measures here.

Other Forms of Ownership

Three other forms of ownership will be discussed here:

1. Cooperative. Cooperatives could be fairly advantageous if they observe the following principles: members are free to enter and exit; upon withdrawal, they take out not only their own original capital, but also their share of the increased capital; the cooperative has a freely elected self-government. This kind is in fact a special type of private partnership; it is not an independent "great sector" of the economy, but part of the private sector taken in the broad sense defined in the first section. Such cooperatives already exist, and I would welcome their spread, although I doubt that they will. Let us wait and see.

I view the various forms of pseudo-cooperatives differently. These bear all the negative characteristics of bureaucratic state ownership. Ideally, these pseudo-cooperatives should transform themselves voluntarily into either genuine cooperatives or other units that operate according to the organizational or legal forms of the private sector. At a minimum, pseudo-cooperatives should, dropping all pretense, be openly acknowledged as state property. In any case, the Hungarian economy must ultimately rid itself of the pseudo-cooperatives.

2. Local state ownership. The status of an economic unit owned by the county, city, or village government (i.e., the council in the present state structure) cannot be evaluated with universal validity. The question is: to what degree is the local government able to behave as an authentic owner? In this context there are two other questions: first, is the local legislature truly representative, and is it democratic? If the answer is negative, then we are bound to find the bureaucratic traits that characterized the classical nation-wide state ownership. The other question concerns the size of the area and of the population administered by a particular local government. A village council would probably perform its duty as owner of a firm within its relatively narrow jurisdiction better than would the Budapest municipal council as owner of the large number of firms located in the nation's capital. Indeed, the industrial administration of the capital is more likely to exert the type of control practiced by the bureaucratic national ministry.

Only time will tell to what extent local state ownership preserves the bureaucratic characteristics of the earlier form of state ownership, and to what extent it engenders genuine proprietary interests comparable to those in the private sector. Although I would not exclude that genuine proprietary interest might emerge, the odds will be unfavorable for a long time to come. Moreover, I would add that it is out of the question to expect this form to grow into a huge sector that embraces a considerable part of social production.

3. Labor-management. I do not propose that this form become the dominant form of ownership, or that today's state sector be transformed into one with a labor-management character. The situation is in any case ambiguous: a form of quasi labor-management already prevails in a significant portion of state-owned firms. Several authors have argued in favor of developing this currently ambiguous form into genuine labor-management.

The pros and cons of labor-management are numerous. In today's Hungary I regard two counterarguments as conclusive. One of them has to do with the enforcement of *wage discipline.* This is in fact an Achilles heel in the process of dismantling the Stalinist model of the command economy. In a command system, mandatory administrative constraints are prescribed both for the level of wages and for the total wage costs of the state-owned firm. Indeed, this is one of the few among the countless plan directives that are enforced with utmost vigor: the observance of the wage regulations is rewarded and their violation punished. The further reform goes towards the liberalization of wage administration, the more quickly do wages start to escalate. Bureaucratic compulsion is no longer enforced, but the counter-interest created by private ownership has not replaced it.

The natural interests of the *private* owners are against excessive wage raises. The owner starts with the feeling that each forint he pays to employees comes from his own pocket, and that each additional forint has to suit his own interest as well (in microeconomic terms: the marginal productivity of the worker is not less than the wage). On the other hand, this kind of automatic involvement does not occur in publicly-owned firms, since the manager is not spending his own money (nor that of the private owners either), but merely transfers the money of an impersonal state to his workers. In fact, the manager seeks popularity with the workers, which he can easily achieve by paying higher wages. The most effective way of dissolving tensions inside a firm is to announce a pay increase. In the wake of liberalizing reforms, the publicly-owned firm operates in a no-man's land—neither a command economy, where wage discipline is enforced through bureaucratic means, nor a genuine market economy, where private ownership stimulates this discipline. As a result, wage inflation evolves in all the reform countries. This phenomenon is observed in China, the Soviet Union, Poland—and in Hungary as well, as the data unambiguously prove.

Labor-management can only weaken wage discipline further. Let us examine the situation where the boss is elected by his own staff. Why should he take measures against his subordinates, or make himself unpopular by putting a curb on wages? The recently introduced elements of labor-management in Hungary have indeed contributed to pushing this country towards wage relaxation. This phenomenon is far more marked in Yugoslavia, where labor-management has for decades been the basic and officially declared form of ownership, and where, no wonder, wage inflation is at a terrifying rate.

The other major argument against labor-management is of a *political* nature. Several opposition forces urged, and Parliament recently codified a ban on shop-floor party branches, stressing that production should not become embroiled in party wranglings. But if, under present conditions, genuine labor-management asserted itself in Hungarian firms, elections of managers and company councils would turn into a stage for party struggles. In Yugoslavia, which is still a one-party state, this problem is not manifest, since the elections there are in any case not genuine, but manipulated by the Communist party and its subordinate trade union. But if we envisage a genuine multiparty system for Hungary, then we can expect the free election of managers to open the factory doors to party rivalry.

Moreover, the principle of "direct" democracy has been championed primarily by those who wanted it as a substitute for genuine political democracy, or more precisely, for one of its most important elements—a choice between parties. Those who thought of labor-management as a permanent substitute for parliamentary democracy will sooner or later have to see that this is but an inappropriate "forced substitute". And those who did so out of purely tactical considerations, lacking a better alternative in the absence of genuine pluralism, should now rest assured that we no longer need such ineffective substitutes.

Summary: Dual Economy

In my opinion we shall have to reckon for the next two decades with the *dual* economy that has emerged in Hungary over the past ten to twenty years, and with its two constituent parts: the state sector and the private sector.

To begin with, the share of the state sector can be decreased only gradually, and we should strive to make it more efficient, but we should not entertain vain hopes. There is no miracle cure which will transform it into a sphere of genuine entrepreneurship. Like it or not, it will retain many negative features. Therefore we should strive to minimize these negative features through strict financial discipline and appropriate parliamentary supervision, and try to prevent the state sector from siphoning off excessive resources to the detriment of the private sector.

The operating conditions of the private sector must be liberalized in a consistent manner, and its bureaucratic constraints dismantled. Appropriate fiscal and monetary instruments are needed to help the private sector develop quickly and energetically. Again, however, we must have no illusions, recognizing that this will be a gradual and protracted process. The private sector will continually increase relative to the state's (as fast as possible, one hopes), but they will still have a lengthy period of coexistence. This symbiosis, though replete with conflicts and frictions, will remain inescapable for a good while.