The American Economic Review

PAPERS AND PROCEEDINGS

OF THE

Hundred and Fourth Annual Meeting

OF THE

AMERICAN ECONOMIC ASSOCIATION

New Orleans, LA, January 3–5, 1992

Program Arranged by William Vickrey

Papers and Proceedings Edited by J. David Baldwin and Ronald L. Oaxaca

MAY 1992

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THE AMERICAN ECONOMIC REVIEW (ISSN 0002–8282), May 1992, Vol. 82, No. 2, is published five times a year (March, May, June, September, December) by the American Economic Association, 2014 Broadway, Suite 305, Nashville, TN 37203. Annual fees for regular membership, of which 30 percent is for a year's subscription to this journal, are: $46.00, $55.20, or $64.40 depending on income. A membership also includes the *Journal of Economic Literature* and the *Journal of Economic Perspectives*. In countries other than the U.S.A., add $23.00 for extra postage. Second-class postage paid at Nashville, TN and at additional mailing offices. POSTMASTER: Send address changes to the *American Economic Review*, 2014 Broadway, Suite 305, Nashville, TN 37203.

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VOL. 82 NO. 2 | MAY 1992

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THE purpose of the American Economic Association, according to its charter, is the encouragement of economic research, the issue of publications on economic subjects, and the encouragement of perfect freedom of economic discussion. The Association as such takes no partisan attitude, nor does it commit its members to any position on practical economic questions. It is the organ of no party, sect, or institution. People of all shades of economic opinion are found among its members, and widely different issues are given a hearing in its annual meetings and through its publications. The Association, therefore, assumes no responsibility for the opinions expressed by those who participate in its meetings. Moreover, the papers presented are the personal opinions of the authors and do not commit the organizations or institutions with which they are associated.

RICHARD T. ELY LECTURE

The Postsocialist Transition and the State: Reflections in the Light of Hungarian Fiscal Problems

By JÁNOS KORNAI *

I deal here with only one of the innumerable problems that arise during the transformation of the postsocialist countries: the role of the state in the economy. My treatment is based on the experiences of Hungary, but I believe the problems I discuss are quite general and will arise sooner or later in all postsocialist countries, though they may vary in intensity and form. Although my illustrations are from Hungary, the lecture is not intended to offer an overall survey of the Hungarian economy. One feature, perhaps, is worth noting: while several countries in the region face grave economic problems and may even be threatened by chaos, the transition in Hungary is taking place under orderly conditions, and there are signs of promising economic development.

I. The Suggestions in Western Writings

Of course the first trip that academic economists like ourselves make in search of guidance is to the library, where the body of writing on the division of labor between the state and the market is certainly abundant, even embarrassingly so.

Many economists in the postsocialist region, disillusioned with central planning, are prone to make an uncritical, mythical cult of the market. One effective cure for this disorder is to read Western writings on the shortcomings of the market mechanism. They convincingly prove the existence of several fundamental problems to which the market alone has no reassuring solution: for example, preserving the macroequilibrium of the economy, ensuring a fair distribution of income, accounting for the effect of externalities, supplying an adequate quantity of public goods, and limiting the power of monopolies. The writers suggest that, where market failure occurs, the state should actively intervene.[1]

There is another strand of Western literature, however, that persuasively shows how political action, politicians, and bureaucrats, perhaps even more significantly than the market, can fail to coordinate the economy. This doubt, voiced long ago by the Austrian school and then reformulated in the arguments of public-choice theory, has induced

*Harvard University and the Institute of Economics, Hungarian Academy of Sciences, Budaörsi ut 45, 1112 Budapest, Hungary. Great assistance was given to me by E. Erdélyi, M. Kovács, M. Móra, L. Muraközy, M. Z. Petschnig, A. Seleny, I. Gy. Tóth, and A. Vacroux in gathering the information that serves as the background for the analysis, and I take this opportunity of thanking them for their support. I am grateful to B. McLean and J. Parti for translating the text, which was originally written in Hungarian. I received valuable comments on the first draft of the study from Francis M. Bator, Tamás Bauer, Zsuzsa Dániel, Martin S. Feldstein, George Kopits, Álmos Kovács, Michael Marrese, and László Urbán. Of course, the author alone bears the responsibility for any errors that remain. The research was supported by the Hungarian National Science Foundation (OTKA).

[1]Earlier summaries of the theories of market failure can be found in the works of Francis M. Bator (1958) and William J. Baumol (1965). For a present-day survey, see Joseph E. Stiglitz et al. (1989). As research progresses, light is shed on the shortcomings of an unfettered market in more and more areas. Consideration, for instance, of imperfect competition and economies of scale leads to several alterations in the earlier concept vindicating free trade and suggests that, under certain conditions, the state may be justified in playing a more active role. An overall account of the wide-ranging research that followed the pioneering work by Paul R. Krugman, Elhanan Helpman, and others can be found in Helpman (1990).

economists to reconsider the problem (see James Buchanan and Gordon Tullock, 1962; William A. Niskanen, 1971). Are those who intervene in the economy in the state's name intent only on serving the public interest? The question strikes a strong chord in anyone who has lived under the socialist system. Similarly relevant is the analysis critical of the welfare state for imposing a high level of redistribution that dulls the incentive for investment, innovation, and enterprise (see e.g., Assar Lindbeck, 1988).[2]

However, when an Eastern European economist comes out of the library, he stops in confusion. He is still unfamiliar with capitalism from within; he would like to rely on the professional literature, but at least at first glance it seems to be giving him strongly conflicting directions. What should he be fighting for after all: a more or a less active state?

This confusion can be contained to some extent by studying the literature more thoroughly. The normative proposals to be drawn from the theoretical literature are always *conditional*. The conditions under which the arguments apply are either stated explicitly or implied. Any Western expert giving advice to a postsocialist economy or any economist in a postsocialist country using Western literature when reaching his position has a duty to clarify these assumptions very carefully before citing "authoritative" Western economic writings. Let me mention just two typical assumptions.

1. The cited literature refers to a mature market and a stable, deeply rooted, and well-established democratic state that operates in the advanced capitalist countries of our time. The trouble is that the market and state in Hungary and the other postsocialist countries differ from this situation in several respects: the private sector is still immature, and the democratic institutions are weak and not yet fully developed.

2. The literature assigns roles to the state and to the market assuming a capitalist system with permanent or slowly changing institutions and operating under robust rules of behavior. In contrast, the postsocialist system is in the midst of a revolutionary transformation: institutions vanish at breathtaking speed, others are just appearing, the legal system is changing at a very rapid rate by historical standards, and the behavior of every player in the economy keeps changing accordingly. So, a special kind of dynamic analysis is needed.

II. The Political and Governmental Spheres in Postsocialist Hungary

Let me try to outline briefly, in almost telegraphic style, the characteristics of the political and governmental sphere in Hungary today.[3] I do not give a similar description of the present state of the market here, because this will emerge in the later part of the lecture.

Although a measure of political liberalization had begun earlier, the turning point in Hungary came in 1989–1990. The communist party's monopoly over government ended, other parties became free to organize, and free elections were held for the first time in 43 years. A government with a parliamentary majority was formed. The main roadblock to the development of a market economy, the political domination of a communist party that had liquidated or sought to liquidate capitalism, was removed

[2]An account of left- and right-wing criticisms of the welfare state is given by Claus Offe (1984).

[3]Rather than using an overall, comprehensive definition of "the state," I will try to break the political sphere down into its components. Different approaches to this can be distinguished in political science, among them functionalist models, the public-choice theory of economics referred to earlier, analyses that examine the conflicts between groups and classes, and the various institutionalist approaches. In my view, these are, for the most part, complementary, rather than mutually exclusive explanations, and I have tried to draw on the ideas of all the trends in this lecture. Summaries can be found in the works of Joel D. Aberbach et al. (1981) and Peter A. Hall (1986).

by this radical change in the structure of power.

The legislature, executive administration, and judiciary were only formally separate under the socialist system. In fact, the officials filling all the posts in each branch were selected by the communist party, which directed their activities. The separation of the branches of state power only became institutionalized after the political turning point.

Parliament is now mastering its new role. The myriad of rules required for a constitutional state evolved in the developed democracies over a long historical period, while in Hungary the most essential laws are being drafted at a forced pace. The sluggishness and constant delay with which the government drafts legislation and the rate at which Parliament can cope with its legislative load form one of the most distressing bottlenecks in the advance toward a modern market economy. Most members of Parliament are political novices; they do not have enough time or a sufficiently large staff of experts and advisers to conduct a thorough study of the bills, let alone to devise legislative proposals of their own. Therefore, Parliament cannot really be said to be supervising the work of the administration closely. The courts too are inexperienced in imposing law and order on a market economy.

Before the political turning point came, the anticommunist forces were united in the face of a common enemy. This cooperation between them has been replaced by bitter political clashes between the governing and opposition parties, and even within the governing coalition. There is nothing surprising about it, as the same phenomenon occurs under all parliamentary systems. However, the absence of a broad political consensus almost precludes the possibility of resolving the grave problems on the agenda, such as curbing inflation, bringing about budgetary stability, and restructuring production, because they all involve unpopular measures that require serious sacrifices. I hardly need to explain here, to my American economist colleagues in 1992, that when the political rivalry for power becomes acute, politicians aim to maximize their electoral chances, not a "social welfare function."

According to the normative theory of a classical democracy, there should be a clear demarcation line between the politicians directly responsible to the electorate and the bureaucracy that loyally serves each successive constitutional government, regardless of political program. Political appointments and "civil service" positions should be clearly distinguished by law or respected convention. In the postsocialist political system, this distinction is not yet made unambiguously. The governing parties of today have thoroughly learned the oft-quoted slogan of Vladimir Ilyich Lenin: the question of power is the fundamental question. Political loyalty is a far more important criterion than competence when a great many posts are to be filled.

The bureaucracy has greater expertise in Hungary than in other postsocialist countries because the partial reforms commenced in 1968 induced it to adapt to the requirements of a market economy. Yet it has nothing like the knowledge or experience required to perform the administrative tasks of a modern capitalist economy. The change of system, moreover, puts the bureaucrats' livelihoods at risk: who knows who will be dismissed when? Servility spreads. Many of the more-talented specialists leave the state service for more lucrative and secure jobs in the private sector. State discipline is lax due to inexperience and uncertainty, and there is great friction in the process of enforcing the laws and state regulations.[4]

We are dealing neither with the philosopher-statesmen of Plato, who rise above all selfish criteria, nor with the expert, law-abiding, punctilious bureaucracy of Max Weber. Nor are we dealing with the political decision-makers described in studies of

[4]Theda Skocpol (1985) pointed out that the "capacity" of the state, defined as its actual ability to perform specific tasks, is an important determining factor of state activity. The scarcity of this capacity, which I mentioned in connection with drafting and enacting of legislation, also hinders law enforcement.

welfare economics, who exclusively serve the public interest. Therefore, any economist arguing that market forces should be curtailed must soberly consider that *this* is the kind of state to which he now wishes to assign a function, and this is the kind of state it will remain for some time to come.

The only components of the political sphere discussed so far have been the organizations of the state and the political parties. Two other important phenomena that can affect the operation of both the state and the market must be mentioned.

First, it is inestimably important that the press, often called the fourth arm of government in the mechanism of checks and balances, is now free in Hungary.[5] Anyone trying to abuse the state's power or to mismanage the state's money runs a risk of being exposed in the press.

Second, what political scientists call the "civil society," the public's capacity to organize itself, is steadily awakening. Organizations embodying certain strata, groups, and occupations are forming in succession and are making their voices heard. Such special-interest groups are often referred to disparagingly in the United States and can certainly play a detrimental part as well, but the citizens of a country where all kinds of voluntary and spontaneous association were persecuted are better placed to value the advantage of people's freedom to associate and apply political pressure. It must be added that, in the economic sphere, the expression of civil society remains obscure. The rearguard actions of the unions surviving from the old order, combined with the weakness of the new unions, leave employees without a mature and effective system of representation. The employers' organizations are immature as well. In other words, the kind of European extraparliamentary representative associations capable of overriding narrow professional interests and negotiating with each other with a sense of responsibility for the nation have yet to develop or gain strength. There is a danger, therefore, of populist organizations winning over large numbers of people and impeding the process of political and economic consolidation. This is one of the vulnerable points in the new democracy, for such populist movements can prevent the conclusion of a "social contract" among broad layers of society willing to show moderation in order to help overcome the economic difficulties.[6]

My general position on the division of labor between the state and the market is supported strongly by the current situation in Hungary's political and governmental sphere. (In fact, I could call it my prejudice, since my opinion is clearly based on a value judgment.) I am ready to ask for government intervention so long as it is clear in the case concerned that the market left to itself will decide badly and there is a very strong likelihood that state intervention will improve matters. I must be convinced that the authority concerned is in expert, impartial, and honest hands, and that in this particular case it is really possible to ensure a public scrutiny which will force the state to act wisely. However, if I am in doubt about which to leave the decision to, an ill-operating market or an ill-operating state, and I can only make a random choice, my instincts tell me to choose the market. One factor here is certainly that I am an Eastern European, for my compatriots and I have been disappointed very often by the state, and our confidence is not easily restored. This preference will be the underlying philosophy of the rest of the lecture.

III. Four Fiscal Problems

Socialism before the reforms was marked by totalitarian power, in other words, by a

[5]The increasing freedom of the press ties in with the fact that a sizable proportion of the press has passed into private ownership.

[6]In 1990, one small group in Hungary, the taxi drivers, who were well organized through their radio links, managed to cripple the capital with a blockade to protest a rise in gasoline prices. Many employees were sympathetic to the taxi drivers, with whom members of the government negotiated before television cameras.

TABLE 1—SUMMARY OF GENERAL GOVERNMENT OPERATIONS: INTERNATIONAL COMPARISON (as a Percentage of GDP)

Country	Year	Revenue	Expenditure
Austria	1989	46.9	49.7
Canada	1989	40.3	43.9
Denmark	1989	59.6	59.4
France	1989	46.2	47.8
Greece	1988	32.7	46.3
Netherlands	1989	51.1	56.6
Portugal	1988	40.7	45.0
Spain	1987	35.0	38.6
Sweden	1988	59.1	56.9
United States	1988	34.3	36.5
West Germany	1989	45.7	45.9
Hungary	**(1989)**	**61.3**	**63.7**

Notes: The data refer to consolidated general government revenues and expenditures (i.e., they include revenues and expenditures of central and local governments and extrabudgetary funds).
Source: Compiled by L. G. Kopits and L. Muraközy, based on International Monetary Fund (1990).

TABLE 2—SUMMARY OF HUNGARIAN GENERAL GOVERNMENT OPERATIONS (as a Percentage of GDP)

Year	Revenue	Expenditure	Deficit (−) or surplus (+)
1981	61.0	63.9	−3.2
1982	59.1	61.2	−2.1
1983	60.9	62.0	−1.1
1984	60.8	59.4	+1.4
1985	60.0	61.2	−1.1
1986	63.2	66.0	−2.9
1987	60.3	64.1	−3.9
1988	63.7	63.6	+0.0
1989	61.3	63.7	−2.5
1990	61.5	61.5	+0.0
1991	62.2	66.4	−4.2
1992	60.1	62.3	−2.2

Notes: The data refer to consolidated general government revenues and expenditures (i.e., they include revenues and expenditures of central and local governments and extrabudgetary funds). The methodology used to compile the IMF data and that used by Hungarian sources are slightly different. Data for 1991 and 1992 are official government forecasts.
Source: Compiled by L. Muraközy. Figures for the period 1981–1989 are based on International Monetary Fund (1990); those for 1990 are based on Központi Statisztikai Hivatal [Central Statistical Office] (1991); and for 1991 and 1992 are based on projections by Magyar Köztársaság Kormánya [Government of the the Hungarian Republic] (1991).

hyperactive state which sought to control all activity in society. Although the process of partial reform that began in 1968 produced some reduction in the role of the state in many respects, the new democratic system has still inherited "big government."[7]

The weight and scale of the state can be measured in several ways, one of the most important measures being the ratio of the government budget to GDP. Table 1 shows that the government in Hungary withdraws and redistributes almost two-thirds of GDP, whereas the typical proportion in Western Europe is 40–45 percent, and it is even lower, in fact, in countries with a level of development similar to Hungary's. Table 2 does not register any clearly perceptible tendency toward a decline in this ratio, which is stubbornly stuck at a size close to two-thirds.

As the subtitle of this lecture suggests, I am primarily concerned here with fiscal questions. What policy would be required in order to reduce the proportion of production withdrawn and spent by the state? Given political, social, and economic conditions, what is the probability of a policy producing "smaller government?" For reasons of space, I do not even intend to cover the whole sphere of fiscal problems.[8] I will

[7]The role of the state under the socialist system is dealt with in my (1992a) book.

[8]Let me mention specifically two subjects that are omitted from this lecture even though they tie in closely with a discussion of the role of the state. One is the restoration of macro equilibrium and macro management of the economy in general; the other is the role of the state in the privatization of firms hitherto under state ownership. Discussion of them has been avoided not because I consider them unimportant, but because there is already a wealth of literature analyzing them both. I have also attempted to discuss them myself, for instance in my 1990 and 1992b works. I prefer in this lecture to bring up a few questions that have received less attention so far.

discuss the following four topics: administrative expenditures, assistance to loss-making firms and unemployment benefits, taxation of the private sector, and welfare expenditures. Although all four topics are connected with the budget, I would like to go beyond the scope of public finance in the narrow sense and examine each problem in its political, social, and general economic context; and to that extent the subject of my lecture falls under the category of *political economy*.

A. *Administrative Expenditures*

Demands for cuts in administrative spending are heard in every budget debate in every parliament in the world. They are particularly apposite in Hungary, where spending on general public services and public order and safety in 1990 was equivalent to 8.8 percent of GDP, which is inadmissibly high. For comparison's sake, the same item accounted for 5.5 percent of GDP in 1988 in West Germany, 5.1 percent in Chile, and 4.4 percent in Denmark.[9] The government of the new democracy promises to cut such expenditures year after year, and the opposition, rightly, calls for a far more vigorous reduction in the overall size of the budget.

Two opposing trends can be observed. On the one hand, earlier administrative expenditures have ceased or decreased, while on the other, new administrative expenses have appeared. Let me give four examples.

1. The vast bureaucracy of the communist party, which almost duplicated the state apparatus in size, has been disbanded. At the same time, a new professional political apparatus, made up of the employees of all the parties and the staff assisting all the members of national and local assemblies, has been formed.
2. Many institutions of the centralized planned economy are being eliminated; for example, the planning and price offices have shut down, and several ministries that previously controlled production amalgamated, with a smaller combined staff. The new system, however, requires some new agencies: offices for privatization, bank regulation, insurance regulation, monitoring the observance of anti-monopoly legislation, an agency dealing with small business, an auditor-general's office to supervise the financial affairs of the state bureaucracy, and so on.
3. The secret police, a pillar of the old system, has been disbanded, but there is a demand for more police to combat an appalling increase in common crime. Among the reasons for the crime wave are the dissolution of the nationwide network of informers, the easing of the obligation to register changes of residence with the police, and the opening of the borders, which makes drug trafficking easier. In other words, the increase in crime is partly explained by the harmful side-effects of a healthy process, namely the abolition of the police state.
4. Under the old system, many disputes were settled arbitrarily by the party secretary or some administrative organization, but in a constitutional state this becomes mainly the task of the courts. As the private sector and the prestige of the law increase, so does the number of court cases.[10] The backlog of undecided cases will continue to grow unless the present staff of the courts is enlarged.

To sum up point A, an effort must be made to cut back administrative expenses, but high hopes cannot be placed on this effort contributing to a substantial reduction of the budget:GDP ratio in the near future.

[9]Calculated by L. Muraközy based on data from the International Monetary Fund (1990).

[10]The Budapest courts received 9,000 new civil cases in 1988 and 16,400 in 1990. The numbers of requests for payment injunctions received by the courts in the same two years were 31,000 and 64,000, respectively (statement by the president of the Metropolitan Judiciary in the daily paper *Népszabadság*, 23 November 1991).

TABLE 3—SUBSIDIES AND TRANSFERS TO FIRMS: INTERNATIONAL COMPARISON (as Percentage of GDP)

Year	Bulgaria	Czechoslovakia	Hungary
Total current expenditures:			
1985	48	51	53
1989	52	55	57
Subsidies and transfers to firms:			
1985	13	15	21
1989	15	19	16

Notes: Subsidies and transfers to firms include product-specific price subsidies, explicit interest-rate subsidies, and debt servicing on behalf of firms and institutions. Subsidies and transfers constitute one component of total current expenditures (i.e., the data in the first lines of the table).
Source: George Kopits (1991 pp. 22–3).

B. *Assistance to Loss-Making Firms and Unemployment Benefits*

It is apparent from Table 3 that the subsidies and transfers to firms in Hungary have been showing a tendency to fall for a long time (unlike those in Czechoslovakia and Bulgaria, also shown in the table, where they tended to grow before the political changes). However, a further, more vigorous dismantling of assistance brings up some sensitive problems that require detailed analysis.

The socialist system produced a curious phenomenon which I termed in my earlier writings the syndrome of the *soft budget constraint*.[11] In this situation the firm's spending is not strictly constrained by its financial position or, ultimately, in a dynamic context, by its revenues. Even if it should land in serious financial difficulties, make steady losses, and become insolvent, it can count on help from the state. Such a firm will be given tax concessions or allowed to postpone payment of its taxes, it will receive a subsidy, or it will gain access to soft loans. It is quite safe in building into its expectations a state bail-out to ensure its survival. This softness of the budget constraint has a number of baneful consequences, among them that it leads to toleration of inefficiency, postponement of adjustment to demand, and mistaken investment decisions.

It is a widely accepted view that this harmful phenomenon is incompatible with a market economy, so that in the postsocialist transition period the budget constraint on state-owned firms must be hardened at last. The question is: to what extent will this requirement receive only lip service and to what extent will it be acted upon? No clear answer can be given because at present there are conflicting tendencies at work, and it is unclear which of them will prevail.

The situation of firms varies, and so does their behavior.[12] Some have moved toward privatization, converting themselves into joint-stock companies or planning to do so in the near future, and have negotiated with prospective Hungarian or foreign private owners. However, I wish to focus attention here on the ones that have not yet taken any practical steps towards privatization. Some of these have adapted quite successfully to the new situation, but others are facing serious problems, and in the latter cases the typical attitude is to try and muddle through. That means on the physical or real side of production that they utilize stocks hoarded under the shortage economy without replacing them, neglect maintenance and renewal, and perhaps sell off a plant or an office building. There is continual disinvestment; in other words, the firm eats itself up by consuming its own assets. Parallel events occur on the monetary side, where the steady losses increase the firm's indebtedness. It no longer makes punctual or full payments of its taxes and social-security contributions, or of the interest and repayments on its debts to the commercial banks.[13] Most commonly of all, the firm

[11] For an explanation of the concept see Kornai (1986).

[12] On the position of loss-making state-owned firms, see the article by Mária Móra (1991) and the more detailed study (Móra, 1990) on which it is based.

[13] The sum of the first two debts (unpaid taxes and social-security contributions) in mid-1991 was greater than the entire budget deficit planned for 1992.

stops paying the bills of the firms that supply its inputs. There is no voluntary credit contract in any of these cases; the debtor is forcing the creditor to lend by refusing to pay. This brings me to the other side of the problem: how the creditor reacts to this kind of behavior by the firm.[14]

Softness of the budget constraint actually means that the involuntary creditor tolerates the debtor's default. In postsocialist Hungary, the present situation is ambivalent, as mentioned earlier, because the accustomed tolerance continues to be shown in some of the cases, but the opposite also occurs. Already there are, albeit infrequently, instances of the tax or social-security authorities or the banks taking measures to wind up a debtor firm. More commonly, the suppliers initiate liquidation proceedings against firms that are unable to pay their bills (see Kamilla Lányi, 1991 p. 64).

Although firms had also been liquidated earlier, that constituted *administrative selection*, because the death sentence or the reprieve came from the bureaucracy. Now one can see the first signs of *natural selection*. The latter, once it really develops to the full, will take place as a decentralized market process. Instead of matters of life and death being decided by an arm of the state, proceedings against defaulting debtors will be taken by creditors acting in their own best financial interest.

In fact, there has been liquidation legislation on the statute books in Hungary for some time, and the legal framework for the exit of insolvent firms was available in other respects as well. These were not taken advantage of before, but it now seems as if there is a movement to do so. A surge of liquidations in the state sector is forecast for this year, and if it takes place, it will be accurate to say that the budget constraint has hardened.

How this change should be appraised is the subject of much debate. For my part, I consider it painful but healthy. Let me recall Joseph A. Schumpeter's well-known concept of *creative destruction*.[15] Renewal and reorganization of production, technical progress, and innovation are normally accompanied by destruction of the old product lines, organizations, and institutions. This cleansing is essential for development. For a number of reasons, the socialist system was incapable of it. The old industrial dinosaurs, the distended, sluggish, clumsy giants, survived, and the softness of the budget constraint served as the financial mechanism for warding off creative destruction; but the destruction has now begun, in the form of various corrective measures. Five closely connected processes can be cited:

1. Anti-inflationary monetary policy inevitably entails a contraction of production. In some cases this means the total closure of firms, and in others it means curtailment of production. The Schumpeterian interpretation of the business cycle seems to be justified in this context; a macro recession accelerates natural selection and the destruction that clears the decks for creation. There was no way that the planned economy, with its drive for continual expansion and forced growth, could perform this selection.
2. There is a restructuring in the sectoral composition of production. The share of manufacturing in total output is falling, and the share of services is rising. This involves a halt or cut in the activity of certain manufacturing firms.
3. Closely related to the previous process is the restructuring of exports. The collapse of the Comecon market has brought dire problems for firms that specialized in

[14] Hardening the budget constraint is partly a *fiscal* matter, since it is closely related to state subsidies and to taxation. However, the problem is far more complicated in nature than that, and so I must go beyond the subject-matter of this lecture outlined earlier, for instance by touching briefly on aspects of *monetary* policy as well.

[15] Schumpeter (1912) wrote about the benefits of destroying loss-makers in his first classical work. The expression "creative destruction" was introduced in his 1942 book (see Schumpeter, 1976 pp. 81–8). The Schumpetarian aspect of the transition process is emphasized in the work of Peter Murrell (1990).

supplying it and prove to be incapable of satisfying the demands of new markets.

4. Restructuring takes place in the size distribution of firms. There was an excessive concentration of production under the socialist system in Hungary, as there was in the other socialist countries. Firms were oversized, even in branches where there were no economies of scale to justify it. Moreover, small undertakings were almost completely eliminated under prereform classical socialism, and too little scope was left for medium-sized firms. Part of the corrective process consists of closing a good many firms that are oversized to the point of being inviable and cannot be broken down into smaller units.
5. The majority of the bureaucratically controlled state-owned firms under the socialist system operated at a low level of efficiency. Unemployment on the job was widespread. Efficiency has to improve as a result of the corrective process. Even if the volume of production were to stay the same, it could be made with a far smaller workforce.

All five corrective processes have serious side effects: jobs are eliminated on a massive scale. However, some of these processes (numbers 2–4) create as well as destroy: they provide new jobs, mainly in the private sector, and primarily in the small and medium-sized segments. This will be discussed again later. All that needs to be said in advance is that the creation of new jobs is failing to keep pace with the loss of old ones. Therefore, unemployment rises. This is a shattering experience under any system, but it is doubly painful under postsocialism, for people in Hungary's part of the world have been used not only to full employment but to absolute job security and even a chronic shortage of labor for a long time. Table 4 presents a short time-series. May 1991 was the particular moment in history when the number of unemployed persons exceeded the number of vacancies for the first time and the labor market switched over from a state of excess demand to one of excess supply. The rate of unemployment reached 7.3 percent in November 1991, which is quite high even for countries accustomed to unemployment. Unfortunately, there will be a further rise in unemployment this year, according to the forecasts.[16]

TABLE 4—VACANCIES AND UNEMPLOYMENT IN HUNGARY

Month	Number of registered vacancies	Number of registered unemployed persons
1/1990	37,711	23,426
2/1990	38,335	30,055
3/1990	34,048	33,682
4/1990	35,191	33,353
5/1990	37,938	38,155
6/1990	37,859	43,506
7/1990	36,222	50,292
8/1990	33,732	51,670
9/1990	26,969	56,115
10/1990	22,763	60,997
11/1990	17,150	69,982
12/1990	16,815	79,521
1/1991	12,949	100,526
2/1991	14,721	128,386
3/1991	13,583	144,840
4/1991	16,478	167,407
5/1991	14,919	165,022
6/1991	14,860	185,554
7/1991	15,186	216,568
8/1991	14,124	251,084
9/1991	15,351	292,756
10/1991	15,389	317,692
11/1991	13,021	351,285

Source: Data for the period January 1990 through August 1991 are in Országos Munkaügyi Központ [National Labor Center] (1991a p. 20); for September 1991, data are from Országos Munkaügyi Központ (1991b p. 4); for October and November 1991, data are from Országos Munkaügyi Központ (1991c p. 4).

What should the government do under the circumstances? Before trying to answer that question, let me say just a few words on what it should *not* try to do. It should not, in my opinion, yield to the pressure to relax its monetary policy at the macro level and use casually dispersed loans and export subsidies, rashly raised nominal incomes, and

[16]On the present state of the Hungarian labor market and unemployment, see the studies by János Köllő (1990, 1991).

budget-financed grand investments to whip up aggregate demand, particularly not in the state sector. The Hungarian inflation rate, which has been curbed with great difficulty and still lingers around 35 percent, would suddenly take off, with frightening consequences.

Another warning is needed, concerning the micro level. Now, amid the first signs that the budget constraint on firms is hardening, the government should not relapse into softening it again. I am convinced that it is better to accept the serious problem of unemployment openly (giving effective assistance, of course, to those losing their jobs) than to continue the policy of trying to cover up the superfluity of many inefficient workplaces by artificially sustaining terminally ill firms and perpetuating unemployment on the job. The danger of a relapse into the earlier soft-budget-constraint syndrome persists even under the present political conditions. The image of a politician intervening to bail out a firm in financial trouble is not unknown in the United States; nor is the prospect of interest groups lobbying for a protectionist policy to favor some sector or another. Another danger is that some of the banks may be ready to grant soft loans irresponsibly, calculating that their survival will be ensured no matter what, even in the last resort, at the taxpayer's expense. This attitude, recently observed in the Savings-and-Loan sector and parts of the banking system in the United States, is prevalent and deeply embedded in the postsocialist economy and its financial sphere.

It is desirable for many reasons that the ownership of the overwhelming majority of formerly state-owned firms should pass into private hands; but let no one think that the problem just outlined, the task of "creative destruction," can be comfortably solved by privatization. No buyer, domestic or foreign, willingly purchases a hopelessly insolvent firm with a view to carrying on its operations. At most there will be a buyer for the physical assets and human capital that belong to the firm. In some other instances, it will not be clear from the outset whether the privatized firm has any chance of financial recovery. If it does not succeed, the new owners (be they individual shareholders, mutual funds or other institutional owners) will no doubt shut it down as soon as it becomes apparent that the firm cannot operate at a profit. This is no less bitter a pill for those concerned, and it may be even more brutal than if the liquidation had preceded the privatization. Another possibility is that, after the privatization, the employers and employees of the private firm together may set about salvaging it by lobbying the connections they have built up under the new regime. This possibility brings us back to the starting point, the softness of the budget constraint.

I will now turn to the advisable measures. *A one-time*, *temporary* subsidy or loan could be granted to firms that the government wishes to give a last chance, just in case they can adapt to actual market conditions after all. However, it must be strictly stipulated that the subsidy is to be phased out and that the loan will not be repeated if the adaptation does not succeed. I feel somewhat uncertain about raising this possibility at all, because there remains the danger that all the phenomena that emerged in connection with the soft budget constraint may arise here as well.

The state must establish an adequate system of unemployment insurance. This should provide temporary assistance to cushion the shock, but it should not be allowed to weaken the incentive for the jobless to seek work and be prepared to adjust to the demand for labor. One favorable feature of the economic transformation in Hungary is that the organization of unemployment insurance was begun much earlier than in other postsocialist countries. The present system, however, leaves much to be desired; the amount, duration, and conditions of the benefit are all questionable.

The insurance must be accompanied by the organization of employment exchanges and retraining. This is undoubtedly a task for the state. It is laudable that it has begun in Hungary, although performance thus far leaves much room for improvement.

Finally, there is the most important task: job creation, primarily in the private sector.

This leads to the problem discussed in the next section.

To sum up point B, the policy of hardening the budget constraint sets a *fiscal trap*. On the one hand, the state budget reduces expenditures by withdrawing subsidies for state-owned firms that are incapable of surviving. The tougher fiscal discipline applied to state-owned firms should bring about an increase in tax revenues, assuming that firms will be capable of paying taxes at all. On the other hand, the hardening of the budget constraint may cause economic activity to contract more sharply, thereby reducing the tax base and, therefore, budgetary revenue. Meanwhile, spending on unemployment benefits represents a growing burden on the budget.[17] There is no way of predicting the net result of these conflicting trends accurately: will they improve or aggravate the overall fiscal situation? I consider a deterioration to be the more likely outcome in the next few years, but I think nonetheless that the grave short-term drawbacks must be accepted in order to gain the longer-term, lasting advantages: the development to be expected from the "creative destruction."

C. *The Taxation of the Private Sector*

Perhaps the most important tendency in the process of the transition is the very fast growth of the private sector. Mention was made in the last section of the destructive side of Schumpeter's "creative destruction." The mushrooming of new private enterprise forms perhaps the most conspicuous manifestation of the other side, creation. The private sector is the most likely source of mass job creation, the introduction of innovations, better supply to the consumer, and the winning of new export markets.

Unfortunately, given the system of statistical records in Hungary (and in the other postsocialist countries), for the time being it is not possible to measure the expansion of the private sector.[18] Expert estimates vary, but most of them fall inside the range of 25–35 percent for the private sector's contribution to GDP.[19]

Part of the private sector operates within the framework laid down by law. The tax authorities had records of 111,700 economic organizations in August 1991 (see Pénzügyminisztérium, 1991 p. 848). For comparison's sake, one should recall that a decade earlier there were some 3,000 large state-owned firms and a few thousand other large, quasi-state agricultural cooperatives in operation. The number of registered private undertakings has certainly grown very rapidly.

Private businesses have appeared in particularly large numbers in the service sector and in domestic and foreign trade. The latter observation is supported by Table 5. It is worth noting the appearance between 1989 and 1991 of more than 4,500 exporters that were not exporting at all in 1989. The change is still more conspicuous if a comparison is made with earlier periods. In the prereform, classical socialist economy, the entire foreign trade turnover was monopolized by about two dozen giant, state-owned foreign trading firms.

Alongside the legal private undertakings there is a very extensive semilegal segment. This informal economy existed even under prereform classical socialism and grew very

[17] Unemployment benefits in Hungary are paid out of an extrabudgetary insurance fund formed out of contributions from employers and employees. This separate handling is expedient, but it does not alter the fact that this is *ultimately* a fiscal problem in two senses. Contributions to the fund are compulsory, not voluntary, and a kind of tax. If the fund should fall into deficit, the state budget guarantees to make it up out of other tax revenue.

[18] Researchers are trying to gain a picture of the true extent of the private sector through confidential interviews, but they run up against great difficulties. Nóra Esti (1991 p. 23) writes in her report on a survey of private entrepreneurs that when questions were asked about income in the interviews, "it occurred on several occasions that an entrepreneur who had been patient so far declared the interview to be over at that point." In the main it was precisely those doing well who refused to respond.

[19] The production of the private sector is compared here with the true GDP, in which both officially recorded production and the unrecorded contribution of informal private undertakings are included.

TABLE 5—HUNGARIAN FIRMS ENGAGING IN HARD-CURRENCY EXPORTS

Size classes	Number of firms		Volume of trade (million $)	
	1989	1990	1989	1990
> $10 million	136	158	4,422	5,268
$0.5–10 million	668	1,115	1,700	2,554
< $0.5 million	1899	5,108	172	347
Total	2,703	6,381	6,294	8,169

Source: Lányi and György Oblath (1991 p. 76), based on figures drawn from the data bank of KOPINT-DATORG.

fast during the reform process. Defining real crime as black and undertakings that meticulously observe all the laws and regulations as white, the sphere I would like to mention here can be depicted as various shades of gray. Since the political turning point, there has been a considerable expansion of the "gray segment," to which a variety of kinds of activity belong. These include "moonlighting," the activity of people who have one foot still in the state sector, but who have stepped into the private sector with the other. There are others whose entire working time is spent in the private sector, but they evade the legal regulations. Many officially registered private undertakings operate partly in the white and partly in the gray segment.[20]

However varied the forms of gray activity may be, they have one feature in common: they involve *invisible earnings* that the tax authorities are unable to get their hands on. That brings me to the fiscal side of the problem.

It was comparatively simple under the classical socialist system for the financial authorities to "get hold" of a large state-owned firm. The business accounts were easily checked, and the monobank simply deducted the sum due to the budget from the firm's account. These days, as I have mentioned, it is not easy to collect money even from state-owned firms. As far as the private sector is concerned, the "dark gray" part of it entirely evades its tax obligations and the "light gray" part evades at least some of them. This is not confined to personal income tax and corporate profits tax, for it extends to total or partial evasion of value-added tax, social-security contributions and all other kinds of payroll tax. It seems that as Hungary moves towards a market economy, citizens and authorities have adopted an "Italian style" attitude to taxation, rather than a Dutch or Swedish one, in which people dutifully pay their taxes.

This evaporation of tax returns is one of the gravest obstacles to budgetary equilibrium. This situation, moreover, turns into the most serious infringement of the principle that taxation should be fair. The main factor in progressivity is not the formula used to decide the rates of taxation on visible earnings. The highest degree of regressivity results from the fact that the direct burdens of taxation are placed on visible earnings, while invisible earnings escape being taxed at all.

One task under these conditions is clearly to improve the efficiency of tax collection, which involves a great many things: more in situ inspections, more frequent and thorough audits and accounting requirements, and legal action when rules are broken (see Milka Casanegra de Jantscher et al., 1991). This task creates one of the great political and economic dilemmas. On the one hand, both fiscal and fairness criteria demand forceful tax collection, but on the other, it must be recognized pragmatically that a large proportion of the new businesspeople are emerging into the twilight world of a curious "early capitalism." Nothing will be

[20]A further indicator of the growth of the informal and formal private sector is the rapid increase in the hard-currency bank deposits of individuals. The source of such deposits is not asked of the depositors, but it is widely believed that a large part originates in private business activities, like exports or services to tourists in Hungary.

In the first nine months of 1991, the net increment of individuals' hard-currency deposits (called "net unrequited transfers" in official statistics) contributed 40 percent of the total positive balance of the current account. (National Bank of Hungary, 1991 p. 24).

gained here by brutal crackdowns or harassment of private entrepreneurs. That would only push some people deeper into illegality and discourage others from private enterprise altogether.

The measures against those breaking the law must be strict but within the bounds of legality and the norms of a civilized constitutional state, and as a complement there must be a range of changes to make it *advantageous* to abide by the law. A growing proportion of the private sector must be guided to legality by combinations of stick and carrot, as in the following examples of appropriate incentives.[21]

A businessman thinking of stepping out of semi-legality into the light of day might consider his choice as a kind of "deal." The service he receives is the rule of law, and the price he pays is tax. One major factor in the growth of the private sector is the impressive speed at which the legal system has developed. A range of new laws have been passed, including company, bankruptcy, banking, and accounting acts. A succession of others are being drafted, but it would be desirable to speed up the process. Let us hope that this legislative process will be accompanied by reinforcement of the courts and acceleration of their work. Private entrepreneurs will be attracted toward legality if that is the only way they can gain legal protection for their property. They will also be able to count on the just treatment of their complaints at court if they come into conflict with the bureaucracy.

Legalization of business transactions helps in enforcing private contracts. This benefits both the entrepreneur and the other party to the contract, which provides grounds for hoping that the state can find allies among the public. Here, however, all parties to a contract encounter a dilemma. Let me give two illustrations.

The rate of value-added tax is very high at present. If no receipt is provided by the seller or requested by the buyer, both sides can gain at the state's expense. However, a buyer who wants to complain later, for instance, because the quality is poor, has no legal redress. The more active the legal protection of buyers becomes in the future, the more common it will become for buyers to demand a receipt, even if that means paying a higher price, covering the value-added tax.

For the second example, consider that nowhere else in the world do the employer and the employee together have to pay a higher sum for social security, pension contributions, and unemployment insurance than they do in Hungary. It amounts to 55 percent of gross wages at present, and there are plans to raise it further to cover the increasing expenditures on unemployment benefits.[22] If employers fail to register employees or if wages are underreported, then employers and employees can divide the saving in wage-related mandatory contributions between them. In many cases, employees do not lose much by it, since they can still qualify for many social benefits.[23] However, if a higher proportion of social benefits depended on the employer's and employee's own contributions, employees could become the treasury's allies in legalizing employment.

All these issues tie in with the question of the citizens' relations with the law and the state. The suspicion, indifference, and even antagonistic feelings toward the state which are very prevalent among citizens are a legacy from the old order. A sizable part of

[21] The economic development in Italy and Spain is enlightening in this respect. The legalization process there continued for some years and has probably not ended yet (see Charles Sabel, 1982; Lauren A. Benton, 1990). The problems of legalizing the Hungarian informal private sector are analyzed by Ildikó Ékes (1992) and Anna Seleny (1992).

[22] In comparison, the social-security contributions as a proportion of wages are in the range of 30–40 percent in Austria, Portugal, Spain, and Sweden, and 20–30 percent in Greece (U.S. Department of Health, 1990 pp. 12, 98, 208, 238, and 246).

[23] There are a great many opportunities for this. People may be on sick leave, paid maternity leave, or registered as unemployed, and they can receive benefits on that basis. Or, they may spend some of their working time in the state sector, which qualifies them for social-security benefits, while doing work illegally, without registering, in the private sector as well, thus saving part of the wage-related taxes.

the population does not consider tax evasion to be immoral.[24] For a long time it was a form of civil courage to defy the state, and that attitude cannot be altered by ceremonial pronouncements alone. Experience has to prove that the state will be a good steward of the taxpayers' money; it must win the public's trust by its actions.[25]

The private sector will be drawn towards legality if it can expect far greater *economic* advantages than it does at present. Here let me mention just one example: access to the legal credit and capital market. The large commercial banks, for instance, treat small private firms quite ungenerously because they are used to links with the large state-owned firms, with which they are closely bound up, and because they consider it riskier to lend to the private sector. If the behavior of the financial sector changes, and banks show more readiness to extend credit to legal private businesses, including small and medium-sized undertakings and new ventures, private businesspeople will have one more reason to become legal.[26]

To sum up point C, the transition sets yet another *fiscal trap*. The larger the private sector's share of production, the harder it becomes to collect taxes. To put it another way, the more successful the transformation of property relations, the greater is the risk of budgetary troubles. All incentives that help to increase the relative weight of the law-abiding, tax-paying segment within the private sector as a whole must be used. This may bring with it an increase in tax revenues. Regrettably, I cannot rule out the possibility of the process being protracted and, thus, plagued with severe fiscal problems caused by loss of budget revenue in the meantime.

D. *Welfare Expenditures*

One of the largest items in the consolidated budget, which also includes for statistical purposes various funds handled separately, is "welfare expenditures," under which the following can be grouped: (i) benefits in cash such as old-age pensions, disability pensions, maternity and child-care allowances, sick pay, family allowances, student scholarships, social assistance, and unemployment compensation; (ii) benefits in kind, such as medical care, medicines, public education, training, nursery schools and after-school centers, nursing homes, and labor-market services provided free or at concessionary prices; and (iii) price subsidies on consumer goods and services, including the prices (and rents) of housing.[27] Most of the observations in this lecture refer to welfare spending as a whole; there is no room to deal here with special problems posed by education, culture, and housing.

Tables 6 and 7 use international comparisons to show that welfare expenditures are very high in Hungary. Considering only the aggregate figures as a proportion of GDP, such spending in Hungary exceeds the level in the group of countries close to it in terms of economic development (Greece, Spain, and the lower-income OECD countries as a whole). Although the ratio is lower than in the developed "welfare states" (Sweden or Denmark), it approaches those in such developed European countries as West Ger-

[24]A public-opinion poll of the Hungarian Gallup Institute found that 44 percent of respondents agreed with the following statement: "People prosper in whatever way they can, and so they should not be blamed if they hide some of their earnings from the tax authorities" (Robert Manchin and Lajos Géza Nagy, 1991a pp. 8–9).

[25]Hungary still has a long way to go in this. People were asked in one survey whether various institutions really served the public interest. Only 42 percent of respondents said this was so of the government, while the churches, the press, the Constitutional Court and the parliamentary opposition received far higher confidence ratings (Manchin and Nagy, 1991b pp. 10–11).

[26]Erzsébet Gém (1991) provides a thorough description and analysis of the credit-supply situation of private firms.

[27]Several thorough studies of these issues have been made in Hungary. I recommend in particular the works by Zsuzsa Ferge (1991, 1992) and the report by the company Fraternité Rt. (1991). The descriptions and analyses prepared under the auspices of international agencies are extremely instructive, particularly the studies of the World Bank (Kessides et al., 1991) and the International Monetary Fund (Kopits et al., 1990). My lecture draws many ideas from these studies.

TABLE 6—SOCIAL EXPENDITURES: INTERNATIONAL COMPARISON (Government Expenditure as a Percentage of GDP)

	Total social expenditures		Health		Pensions	
Country	1980	1986	1980	1986	1980	1986
GR	12.6	19.5	3.6	3.7	5.8	10.6
IT	23.7	26.4	5.6	5.2	12.0	12.2
NO	24.2	24.8	6.5	6.6	7.9	8.8
SP	15.6	17.0	4.3	4.3	7.3	7.6
SW	33.2	32.0	8.8	8.3	10.9	11.4
US	18.0	18.2	3.9	4.5	6.9	7.2
WG	26.6	25.2	6.3	6.3	12.1	11.4
HU	**21.8**	**24.4**	**3.3**	**4.1**	**7.8**	**9.1**

Notes: In line with OECD definitions, the Hungarian data on total social expenditures do not include consumer and housing subsidies. Countries: GR = Greece, IT = Italy, NO = Norway, SP = Spain, SW = Sweden, US = United States, WG = West Germany, and HU = Hungary.

Source: Christine Kessides et al. (1991 p. 7). Statistics for OECD countries are based on OECD data bank sources; Hungarian data are extracted from Central Statistical Office *Statistical Yearbooks* (Központi Statisztikai Hivatal, various years), information provided by the Social Security Administration, government officials, and estimates by World Bank staff.

TABLE 7—NET SOCIAL INSURANCE TAX AND TRANSFERS: INTERNATIONAL COMPARISON (as a Percentage of GDP)

Statistic	OECD lower-income states,[a] 1986	OECD welfare states,[b] 1986	Hungary, 1989
Total social insurance contributions (employees + employers)	8.3	12.0	15.2
Total social expenditures	21.0	31.0	25.4[c]

Source: Kessides et al. (1991 p. 13). Statistics for OECD countries are based on OECD data bank sources; Hungarian data are extracted from Central Statistical Office *Statistical Yearbooks* (Központi Statisztikai Hivatal, various issues), information provided by the Social Security Administration, government officials, and estimates by World Bank staff.

[a]Average of Greece, Ireland, Portugal, Spain, and Turkey.

[b]Average of Belgium, Denmark, Finland, France, Netherlands, Norway, and Sweden.

[c]In accordance with OECD definitions; see note to Table 6.

TABLE 8—MAJOR SOCIAL-SECURITY PROGRAMMES IN HUNGARY

	Expenditure on Benefits	
Year	Billions of forints	As percentage of GDP
1985	167.0	16.2
1986	181.5	16.7
1987	200.3	16.3
1988	255.2	18.1
1989	317.1	18.6
1990	414.7	19.9

Note: The OECD data are compiled in accordance with a definition of social-security programs that is narrower than the definition underlying the World Bank statistics presented in Tables 6 and 7. Nevertheless, both Table 6 and 8 reveal a similar trend of increasing social expenditures.

Source: Organization for Economic Co-operation and Development (1991 p. 67).

many or Italy, which are not normally placed in the "welfare-state" category.

Table 8 presents a Hungarian time-series demonstrating that governmental expenditures on social-security programs are increasing continually. Meanwhile, one hears many complaints from the Hungarian public, and a substantial part of them are quite warranted. For example, though the numbers of doctors and hospital beds per capita are very high, there are serious problems with medical care, such as tragically low life expectancy and high infant mortality. While the system of old-age pensions goes a very long way in some respects, pensions are only partially indexed, so in times of rapid inflation the retired face devastating difficulties. Moreover, inequality is increasing: the postsocialist transition allows some of the population to grow rich, but others are impoverished or actually sink into penury, and the regulations and institutions in existence up to now are insufficient to halt the process of decline. This paradoxical situation presents perhaps one of the gravest dilemmas of all the problems discussed in this lecture.

The Hungarian welfare state was born "prematurely." There is generally a close positive correlation between a country's level of economic development and the scale of its welfare services. Development is not the only factor, but it is undoubtedly among the decisive ones. Hungary was "ahead of itself" in this respect. To a certain extent, the classical, prereform socialist system rushed ahead when it made a constitutional commitment that it would satisfy a number of basic needs free or for minimal recompense. It introduced free medical services and education and introduced a pension scheme covering almost the entire population, it subsidized the prices of foodstuffs, set rents for state housing at an almost nominal level, and so on. Later on it proved incapable of keeping its promises. Chronic excess demand appeared for the free or unrealistically cheaply priced services, and the quality of them was often very poor.

Added to the unkept promises of the classical system were the new concessions introduced during the process of reform that began in 1968. It was one of the characteristics of the Hungarian reform, sometimes referred to as "goulash communism," that it tried to turn its back on the previous policy of forced industrialization and devote greater attention to the needs of the general public. A measure of liberalization was accompanied by a growth in the political influence of the forces known as the "living-standard advocates." However, the gulf between promises and their fulfillment remained and in fact widened due to the slowdown and then the stagnation in economic growth. Some new concessions were granted, while others were withdrawn.

Finally came the political turning point, and the population—understandably from a psychological point of view—expects the new system to fulfill the promises made, but not kept, by the old. People are irritated by the state interfering in their private lives and harassing individuals, but many of them still want a caring, paternalist state as well.

So what can be done? Everyone agrees that the institutions of welfare policy and social security must be reformed. There could also be a substantial improvement in utilization of resources and allocative efficiency.[28] The incentives for the providers of services could be substantially improved, and the administrative costs could be reduced. Detailed proposals have been prepared, and they extend to these details and beyond. It may be that they could all achieve some cost reductions. However, it would be wrong to convey the impression that the problem can be solved by improving administrative efficiency.

Some radical proposals have also been put forward for rapidly and greatly reducing the state's role in this sphere, at least to the scale found, for instance, in the present-day United States. It is argued that a fast rate of decentralization and privatization should take place in both medical care and the pension system, apart from a narrow band financed by the state.

I do not feel it is my task in this lecture to comment on the American situation. There is a debate going on, for example, about whether there should be a national health service or whether the health care of the majority of the population should continue to be based mainly on private insurance. All I would like to underline here, in the spirit of the first sections of the lecture, is this: it is extremely important to remember where one is moving from and to. It is one thing to decide whether a state should give its citizens a right they have not enjoyed before and another to decide to withdraw from them a right they have gained and become accustomed to. A curious *institutional ratchet-effect* can be seen here. The cogwheel of historical development turns one way, but it cannot turn back in the opposite direction. If Britain had not had a national health service already, the government of Margaret Thatcher would certainly not have proposed introducing one; but as it existed before Mrs. Thatcher's time, her government did not suggest closing it down.

The citizens of postsocialist society are suffering many uncertainties they did not know before. I have already mentioned the

[28]For example, there are too few nursing homes for the aged in Hungary, and the majority of them are ill-equipped. On the other hand, the hospitals are used to a great extent to care for old people who in fact do not need hospital care. This is far less beneficial for the old people concerned, and at the same time it is much more costly.

depressing experience of unemployment. Many people's sense of security would be shaken if in addition the medical care, pension system, and other welfare services ensured by the state were to collapse around them.

There is great resistance to the idea of a swift drastic cut in the welfare services provided by the state, along with decentralization and privatization of welfare assignments. In fact, the economic problems of the transition even add new expenditures to the list. Mention has already been made of unemployment benefits. In addition it must be said that the great transformation of society is accompanied by a redistribution of incomes, and there are many sections in society whose material living conditions are rapidly deteriorating. They expect the social-security net at least to save them from crashing to the ground. Unfortunately, the net has big holes, and to weave a denser one would generate additional demands on the state budget at a time when drastic cuts in budget spending are desperately needed.

No easy escape from this dilemma exists, and it will take patience and tact to get closer to a more acceptable situation. The most important guide should be the principle of *voluntariness and free choice*.[29] Let me give a few illustrations of how these principles can be applied in this field.

The evolution of a decentralized network of for-profit and nonprofit insurance companies and pension funds which employers and employees can join voluntarily must be affirmatively promoted, not just permitted. It would be worth introducing a law that specifies that these new institutions should receive valuable, truly income-generating portfolios of securities during the privatization of the state-owned firms, as a free contribution to their initial capitalization.

More leeway must be given to private medical practice and private providers of other social services ranging from child care, through nursing of the sick, to care for the aged. They should receive a market rate of remuneration for their activities.[30]

In other words, it would be worthwhile to ensure that the private sector grows rapidly in this sphere as well, under appropriate governmental supervision. I agree with the view that the desirable *final state* after the transformation would be a combination of three basic forms: a minimal level of certain services must be guaranteed as a civil right; other services must be provided in accordance with contributions paid by the beneficiaries and their employers; and finally, some services can be available to individuals through private insurance or through a direct act of purchase on the market. Let individuals be given as much scope as possible to choose between schemes providing welfare benefits. However, in view of the initial conditions, this final state can only be approached gradually. Those who have no means of making a real choice cannot be presented with a fait accompli.[31]

Something perhaps more important still than providing a choice between various mechanisms for social services is to give citizens the chance to express their will through the *political process*. A far greater role in monitoring the institutions providing social services should be given to various voluntary associations for safeguarding interests. Apart from that, the legislature must have the final word on welfare expenditure and in matters of social insurance and the levies connected with it. The political parties cannot avoid this complex of problems.

[29] In an earlier work of mine (Kornai, 1988), I tried to shed light on how the reforms taking place in the socialist countries have a bearing on the growth of *individual freedom* through the expansion of economic choice.

[30] It is another matter to decide who should pay this remuneration. In some cases, it could be the clients availing themselves of the services or their insurers; in others it could be the state or the social welfare fund; and in still others remuneration could be provided by a combination of the two.

[31] A young man today, for instance, can make a choice between alternative pension schemes, but someone near retiring age cannot be forced to transfer to a private pension fund. The state made a "contract" with him or her under the pension laws in force when they were working, and it cannot be broken arbitrarily and unilaterally.

A far clearer connection must be made between what citizens receive from the state and quasi-state organizations and how much tax they pay for them. Not the least of the economists' obligations in this respect is to protest against cheap prevarication and to expose politicians who promise a cut in taxes alongside an unchanged welfare program. The proportion of the state's welfare spending should decrease to the extent that well-informed voters *consent to* and desire it, in order to lessen the burden of taxation. Conversely, the welfare expenditures can only be maintained in the proportion that the citizens are prepared to finance with their taxes.

To sum up point D, there is yet another fiscal trap ahead, and this may be the most painful one to writhe in. A drastic cut in state welfare spending will bring insecurity and a grave deterioration in the quality of life of many people. However, to maintain current levels of welfare spending, and still more to increase them, would be accompanied by levels of taxation that would discourage investors and therefore hold back economic growth. It is a self-evident truism to say that more production is needed to cover the welfare services provided: a bigger pie is easier to divide.

It is difficult to make a forecast about expected welfare expenditures in the years to come. I believe the likeliest outcome will be that welfare services will be partially decentralized and marketized, but with agonizing slowness.

IV. General Conclusions

I have examined four problems through an analysis of experiences in Hungary. Nowadays there are countries (such as the republic-states being formed in the former territory of the Soviet Union) battling with problems even more staggering and elemental in force than these, such as deciding what to do to ensure that the population has food, that money has real purchasing power, and that the dive in production is halted. There is hope, however, that sooner or later all postsocialist countries will progress beyond the baneful state of chaos and crisis, and then they will all find the questions I have discussed in my lecture on their agendas.[32]

Bitter conclusions can be drawn from this discourse. Even where the elemental tasks of macro stabilization have been more or less accomplished, grave problems are constantly reproduced. Even where there has been some success in approaching budgetary stability, serious pressure on public finances persists. On the one hand, an increase in various kinds of spending is still being urged by a variety of political and social forces, and on the other, the difficulties of collecting taxes are increasing. The danger of budgetary deficit is here to stay. Covering the deficit with loans from the central bank can constitute a perilous contribution to the inflationary pressure. Any success in monetary macro stabilization can easily slip through our fingers. Covering the deficit by issuing state bonds can crowd out productive investments, which will impede growth.

Any kind of quick-fix solution can only be proposed by economic dilettantes or political tricksters. I have repeatedly mentioned potential traps in order to underline that there is no easy way out of any of the problems discussed in the lecture. What present themselves are painful trade-offs and choices between bad and worse.

Strong and persistent efforts must be made to repress the former hyperactivity of the state and concurrently to reduce state spending, while combatting the bureaucratic, centralizing tendencies that constantly revive. The change is likely to occur slowly; it will be a good while before today's big government has been reduced to government on a desirable scale, far smaller than the present one.

Although I cannot make optimistic short-term forecasts, the outlook in the

[32]Among the factors compelling a reduction in state spending and taxation is Hungary's desire, shared with several other Eastern European countries, to join the Economic Community. One requirement for membership is that these rates should not exceed the far lower European norms.

longer term is more favorable. The political change has released the spirits of autonomy, freedom, and entrepreneurship, and these are the primary driving forces of economic progress. It seems justified to expect the low point to be followed by a rise in production, one effect of which will be to make it easier to solve the fiscal problems discussed in this lecture. This will broaden the tax base, which is a precondition for a reduction in the tax rates. The latter stimulates investment, which in turn creates new jobs. A decrease of unemployment ultimately reduces the social-security burdens of the state.

A wise and efficient government can accelerate this development, and governmental errors and omissions can impede it, but the final outcome of the transition is not in the government's hands. Under the new postsocialist system, the state can at most influence the economy. It cannot run the economy, which is propelled by the interests of those participating in it. This is one of the main advantages a market economy has over centrally managed socialism.

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