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JAPAN AND THE WORLD ECONOMY

Aims and Scope

The increase in Japan's share of international trade and financial transactions has had a major impact on the world economy in general and on the U.S. economy in particular. The new economic interdependence between Japan and its trading partners created a variety of problems and so raised many issues that require further study.

Japan and the World Economy will publish original research in economics, finance, managerial sciences, and marketing that express these concerns.

Japan and the World Economy seeks to meet the growing need for comprehensive, impartial and scientific study of trade imbalance and friction, technological competition, internationalization of financial markets, exchange rate variation and macroeconomic coordination, comparative managerial and marketing practices and other related topics. Contributions are solicited from a broad-based, international community of scholars. In addition to empirical and policy-oriented studies, *Japan and the World Economy* also welcomes theoretical analysis that contributes to an understanding of the issues and proposes corrective action.

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CONTENTS

JWECD 8 (2) 125–228
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ELSEVIER Japan and the World Economy 8 (1996) 135–151

Japan and the WORLD ECONOMY

Hardening of the budget constraint under the postsocialist system

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Abstract

The article examines how postsocialist society, which has been accustomed to a soft budget constraint, can learn the financial discipline characteristic of a market economy. Before there can be financial discipline, a new kind of long-term "insurance contract" typical of a market economy must emerge between the state and the firms. The prerequisite for this is the commitment and credibility of the state, which can only play its part of an "insurer" on exceptional occasions and under clearly defined conditions. The new private firms must be imbued with the demand for financial discipline from the moment they are founded: an alteration in the behavior of state-owned enterprises is also possible, but not certain. Hungary has moved in the direction of the new insurance contract, but practical experience suggests that it will be a long time before observance of financial discipline becomes incorporated into enterprise behavior. Both the state and the firms are under a big temptation to revert to their habitual behavior. Meanwhile the imposition of financial discipline poses the bitter dilemma of efficiency versus security. Should the detrimental consequences of tough financial discipline (economic recession, unemployment) imperil the institutions of democracy, the author would recommend a more cautious advance towards reinforcing financial discipline.

Keywords: Soft budget constraint; Financial discipline; Postsocialist transition; Hungary

JEL classification: P21; P26; P31; P34

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1. Introduction

It is a great pleasure and honor for me to be taking part in this conference, whose subject is the "soft budget constraint". I am glad to see from the papers submitted to the conference that this concept, which I first published 15 years ago, has been fruitful in its effects on theoretical thinking. I would like particularly to express my thanks to Professor Eric Maskin, who was one of the first of the theoretical economists who recognized the viability of the concept of soft budget constraint, and who initiated the convening of this conference. The studies submitted to the conference primarily use pure theoretical methods in their approach to the problem. For my part I would like to contribute to better understanding of the phenomenon by starting out from the practical experiences of the postsocialist transition and draw from those more general conclusions.[2]

The analysis rests on Hungary's experiences; other countries are only referred to in a few places. But in my view, the *problems* raised in the discussion are general ones that inevitably arise in other postsocialist countries as well. So I attempt at the end of the study to draw some general conclusions.

The softness or hardness of the budget constraint is part of a broader, complex phenomenon that I would call financial discipline. Financial discipline, as I see it, means the enforcement of four simple rules:

1. *Buyers*: Pay for the goods you buy.
2. *Debtors*: Abide by your loan contract; pay back your debt.
3. *Taxpayers*: Pay your taxes.
4. *Enterprises*: Cover your costs out of your revenues.

Self-evident though these rules may seem in a market economy, they were far from obvious in a socialist command economy. That was based on a quite different kind of discipline, which consisted chiefly of enforcing planning commands, above all the fulfillment of output targets and compliance with input quotas. How postsocialist society should learn to observe the new kind of discipline is the subject of this study.

The state in a socialist economy plays the part of a super-charitable insurance company, on the basis of an unspoken, but tacitly accepted long-term contract whereby it gives a 100% guarantee for all the financial losses of state-owned

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[2] This study, which I presented to the "Soft Budget Constraint" conference (Ninth Annual Japan-USA Technical Symposium, New York, 1994), is a modified version of an earlier piece of writing (*Kyklos*, Vol. 46, 1993, pp. 315–336). Although, much of the new version corresponds with the old, it goes beyond it in several respects, since I have included new data and an assessment of this more recent information. I would like to thank the two discussants of the lecture delivered to the conference, Professors Barbara Katz and Takeo Hoshi, for their valuable observations and to Mária Kovács for her devoted editorial help.

firms.[3] If an enterprise found itself in financial trouble, the state bailed it out unconditionally. A variety of techniques were used for the purpose: extending financial subsidies, granting tax concessions or postponing tax commitments, rescheduling of loan repayments, or providing new soft loans. The state also guaranteed the survival of chronic loss-making enterprises. All these techniques involved constantly breaking rules 2, 3, and 4 of financial discipline (loan discipline, fiscal discipline and market cost-coverage discipline). This is the group of phenomena that I termed *softness of the budget constraint* in my earlier works. Also apparent was a side-effect well known in insurance theory: the so-called moral hazard. If policy-holders know that the insurer will pay for all damage, it is not worth them making efforts to avoid damage, which in this context means that enterprises are insufficiently motivated to avoid losses by raising efficiency.

In a mature market economy there can be no question of losses being covered automatically and unconditionally. Only in certain privileged sectors (like banking) will the state assume a sizeable part of the losses that may occur. Irrespective of whether the state's role as an "insurer" extends only to these privileged sectors or to others as well, the cover will apply only under exceptional, rigorously determined conditions. So the survival of an enterprise is not guaranteed; sooner or later, a chronic loss-maker will have to make an exit from the economic scene. Rules 2, 3, and 4 are rigorously enforced. To use the terminology introduced earlier, *the budget constraint is hard*.

There are several signs that Hungary has moved towards the long-term state characteristic of a market economy. This seems to be confirmed in Table 1, which shows a substantial reduction in subsidies – from 12% to under 3% of GDP. Moreover, Tables 2 and 3 betray a jump in the number of bankruptcy and liquidation proceedings, which means the number of state rescue operations has fallen. Let me recall that an average of 26 enterprises a year ceased activities between 1976 and 1982 (see Kornai and Matits, 1987, p. 100), and even with this tiny number of exits, there were not financial reasons, but other factors behind them in many cases. To make another comparison, more liquidation proceedings were commenced in a single month of 1992 than in a whole year in the period 1986–1988. (It is worth noting that the number of bankruptcy and liquidation proceedings fell substantially in 1993; this will be returned to later.)

Under the old contract, characteristic to the prereform, classical socialism, the enterprise could be sure about what help it would receive from the state in overcoming a financial crisis. But what happens if there is an insufficient basis for long-term expectations because the behavior of one party (in this case the government) has suddenly changed? Neither economics nor social psychology provides adequate reliable information about a dramatic *change* in preferences,

[3] Newbury (1993) analyses in detail the extent to which the state provided insurance services, not only for firms, but for other organizations and for individuals, under the various versions of the socialist economy, before and after the reforms, in Eastern Europe and in China.

Table 1
Flows between the government budget and the enterprise sector

Years	From the enterprise sector to the budget	From the budget to the enterprise sector	Net flow to the budget
	(as a percentage of GDP)		
1987	29.6	12.3	17.3
1988	20.4	9.9	10.5
1989	15.4	6.7	8.7
1990	16.2	4.7	11.5
1991	12.4	2.8	9.6
1992	9.8	2.7	7.1
1993	10.0	2.6	7.4

Source: Muraközy (1993, pp. 25 and 39).

Notes: Figures for 1993 are government projections. The first column includes the net profits surrendered by state-owned enterprises to the government budget, and profit taxes paid both by state-owned and private enterprises. The second column excludes consumer subsidies.

Table 2
Number of bankruptcy proceedings in 1992 and 1993

Months and years	Number of filings	Number of official announcements by the court
January to March	786	285
April	2259	205
May	201	465
June	145	482
July	154	300
August	113	69
September	151	104
October	150	190
November	118	225
December	154	175
Total in 1992	4231	2500
Total in 1993	987	887

Sources: 1992: Pénzügyminisztérium (Ministry of Finance), (1992, pp. 4 and 7) and Szalai (1993, p. 79); 1993: Pénzügyminisztérium (Ministry of Finance), (1994, Table II/3.3).

Notes: The figures in the first column record the initiations of bankruptcy proceedings. The figures in the second column refer to public announcements regarding the start of bankruptcy proceedings. It is the responsibility of the court to publish the announcement in the official gazette.

habits and expectations. This alone makes it very difficult to find an answer to the questions explored in this study.

What has been said so far provides an appropriate structure in which to discuss the problem. Let us first look at government, and then at enterprise conduct.

Table 3
Number of liquidation proceedings

Months and years	Number of filings	Number of official announcements by court
1986 to 1988	n.a.	159
1989	n.a.	141
1990	n.a.	233
1991	n.a.	526
1992		
January to March	2617	120
April	1281	161
May	837	202
June	927	166
July	699	219
August	701	210
September	797	482
October	782	211
November	751	233
December	692	223
Total in 1992	10084	2227
Total in 1993	7242	2593

Sources: Figures for the period 1986–1991 from Móra (1992, pp. 18–23); 1992: Pénzügyminisztérium (Ministry of Finance), (1992, pp. 5 and 9) and Szalai (1993, p. 79). 1993: Pénzügyminisztérium (Ministry of Finance), (1994, Table II/3.3).

Notes: The period covered by the first figure started on September 1, 1986 and ended on December 31, 1988. The figures in the first column record the initiation (filing) of liquidation proceedings. The figures in the second column refer to public announcements regarding the start of liquidation proceedings. As in the case of the bankruptcy proceedings, it is the responsibility of the court to publish the announcement in the official gazette.

2. The conduct of the government

2.1. Conflicting objectives

The prime requirement before a government can change the long-term contract previously in force is the *political will* to do so. This is a function of the political goals. When a government sets its political objectives concerning financial discipline, it has to weigh the benefits and costs to be expected from it. Let us first of all look at the *benefits* of enforcing financial discipline.

(a) A smoothly operating credit system is essential to a modern market economy, but it cannot appear without an assurance that credit contracts will be observed.

(b) Very grave problems arise during the postsocialist transition with balancing the budget. One requirement for overcoming them is to improve the collection of taxes.

(c) Relative prices have been distorted by the system of differentiated, nonuniform taxes and subsidies. Discontinuing these helps more reliable price signals to develop.

(d) Tougher financial discipline will send the chronic loss-making producers out of production. This becomes particularly opportune once the system of relative prices is giving a sufficiently true reflection of the costs and relative scarcities. Apart from that, the discipline encourages the surviving old enterprises and the emerging new ones to reduce costs and adjust better to demand.

To sum up, tightening financial discipline provides a strong incentive to increase *efficiency*. Hungarian experience also shows that some of the benefits appear immediately, but others only after a delay.

The most spectacular result was the rapid adjustment made by Hungarian production to the collapse of Comecon. The threat hanging over Hungarian enterprises was expressed by two World Bank staff members, Dervis and Condon, in their 1994 study as "export or perish". A picture of the export performance is provided in Table 4. The share of exports directed to the European Community increased by two and a half times in a very short time.

Less conspicuous, but extremely important is the effect that imposition of tougher financial discipline has on the reorganization of production, the process known as restructuring and reorganization. Judicial bankruptcy proceedings do not necessarily signify the beginning of the end, since they initially provide legally regulated forms for deferring the settlement of debts. During this period, the enterprise's affairs must be set right, if that is possible. The process is often accompanied by a full or partial change in the top management and the appointment of new, better managers; nor, of course, do the liquidation proceedings bring about an irresponsible destruction of the material and intellectual capital. They promote the sale of as much of them as possible, if only in order to satisfy the creditors to a greater extent. During liquidation, a previously

Table 4
Destination of exports

Year	European community	Countries in transition and nonmarket economies	Other
	Share of total exports (%)		
1987	20.1	56.5	23.3
1988	22.6	51.2	26.2
1989	24.8	47.3	27.9
1990	32.2	37.7	30.1
1991	45.7	23.6	30.7
1992	49.8	23.3	26.9

Source: Központi Statisztikai Hivatal (Central Statistical Office, 1993, p. 106).

vast enterprise is often split into smaller units, and its various assets are sold. Both bankruptcy proceedings and liquidation can create improved conditions for privatizing the original enterprises or the successor firms.

Finally, there is the least conspicuous, longest delayed, but most important effect of tough imposition of financial discipline, which appears in the shaping of people's thinking. I will return to this later.

Let us now turn to the other side of the balance, the *costs*. The tightening of financial discipline, including the wave of bankruptcy and liquidation proceedings, contributes to the fall in production. This is not the sole reason why a recession appears in all postsocialist economies without exception, but it is undoubtedly one of the factors behind the contraction of the economy.

The total closure of factories clearly causes a loss of jobs. Moreover, the surviving enterprises also try to reduce their costs, and lay-offs are among the results. The rate of unemployment rose steadily after 1990, peaked in 1993, and has fallen slightly since then. This is connected with the decrease of the number of bankruptcies and liquidations, although it is obviously not the only explanation. This produces a particularly grave trauma in a country where the labor force has become accustomed over decades to full employment, in fact to a labor shortage. The appearance and growth of unemployment are a great affliction that is only alleviated in part by unemployment benefits. In any case, there is not only the financial loss caused by unemployment to be considered, but the psychological effect produced by the loss of job security.

Moreover, the enterprise under the socialist system, particularly in its prereform stage, was not simply an employer. It provided numerous welfare services: apartments or hostel accommodation, canteen meals, holidays, medical treatment, kindergartens and child-minding centers. As the enterprise turns into a profit-motivated employer, it steadily brushes aside these tasks. So social security provided at firm level is eroded at the same time as job security is lost.

Confrontation of the benefits and costs leads to a difficult choice between conflicting objectives. Much attention is devoted in the economics of macrostabilization to the trade-off between inflation and unemployment. The curbing of inflation, which requires a rigorously observed regime of restrictive monetary policy, is regularly accompanied by an increase in unemployment, and conversely, measures to reduce unemployment increase the danger of inflation speeding up. This trade-off applies also to the postsocialist economy, and places a heavy burden upon it. Hungary's annual rate of inflation has fallen to some extent, but in 1993 it was still 22.5%, while the unemployment rate is already around 12–13%. But underlying this there is another trade-off that is even more serious because it has a deeper effect: that of *efficiency versus security*. Improvement of efficiency, in the short, medium and long term, goes hand in hand with abandonment of full employment and job security, and erosion of the social security originating from the welfare services provided by the enterprise.

International comparison shows that in terms of facing this serious dilemma, Hungary has gone furthest in imposing financial discipline and hardening the budget constraint, and consequently in promoting an improvement in efficiency. Poland, the Czech Republic, Slovakia, and Slovenia have taken steps in the same direction, but so far they have hesitated, for example, about introducing a modern bankruptcy law or applying it consistently. To give the ultimate counter-example, Russia's central bank in the second half of 1992 was extending almost incalculable sums in credits to sustain state-owned enterprises on the brink of bankruptcy, or at least to make sure they could keep on their workers and pay their wages.

2.2. *Credibility and commitment*

Let us return to a more general level of discussion. Let us assume there comes a point when the government decides that from now on it will rigorously impose financial discipline and harden the enterprise's budget constraint. The question is, will it have the perseverance to continue this policy consistently? And even if it promises to do so, will the enterprises believe this promise? One condition for applying the new contract mentioned at the beginning of the study is that the government should have *credibility*, in general terms, and in the specific context of our discussion, credibility for its "no bail-out" commitment. The theory of conflicts and contracts draws attention emphatically to credibility, above all to the central importance of the credibility of threats. Here, the picture Hungary presents is far from clear; a curious ambivalence can be found instead.

There are a great many influences on the government tempting it to loosen the financial discipline and soften the budget constraint. The political forces behind the government can use financial bail-outs to win clients by playing the part of a patron. They can make concessions to political pressure and the requests of industrial or regional lobbies. They will clearly have in mind the next parliamentary and local-government elections, so that bail-outs can serve to gain them a cheap popularity.

This constitutes a very real political temptation whose effects can actually be observed. Since the period of tougher financial discipline began, exceptional procedures have been followed in several cases, in many of which the bargaining led to agreement. The process of hardening of the budget constraint came to a halt; this is apparent also from the more recent information in Tables 2 and 3. The remnants of the soft budget constraint are plainly visible. There is a danger that the frequency of the exceptions will undermine the credibility of the government's pledges concerning the tough financial discipline.

In Hungary the so-called "bank consolidation" designed to improve the financial position of the hard-pressed banking sector, is taking place in 1994. A substantial part of the stock of poorly performing debt is being taken over by the state, which is distributing secure state bonds in its stead. Those who advocate this campaign argue that without it, grave solvency problems would arise at several large banks. It is generally recognized how much damage the failure of one large bank can do to the financial position of a country. So there were very weighty considerations in favor of a preventive bail-out. True, but the solution entails the risk of a resoftening of a budget constraint that has only just hardened. Similar rescue operations already took place earlier in the same banks, when they pleaded a need to be relieved of a bad debt portfolio inherited from the socialist system. The new campaign entails writing off or leniently rescheduling debt that has arisen since then, under the postsocialist system. The consolidation campaign covers not only the lending banks, but the borrowing firms. There is a danger of the conclusion being drawn that what has happened once or twice will happen again the third and fourth time, and it is not so dangerous to be a bad debtor after all, because the firm will be rescued in the last resort.

It is the *constraints and precommitments* that bind the government's hands. An absolute, doctrinaire application of the "no bail-out" principle cannot be expected, because of the macroeconomic requirements and the efforts to defuse political tensions, but the government must ensure that the financial bail-outs are infrequent, i.e., they occur only on very rare occasions. The criteria and procedures for bailing out enterprises must be laid down by law, not left to ad hoc administrative bargaining processes. Only temporary financial assistance is permissible, and whatever form the assistance may take (postponement of tax arrears, debt rescheduling, budgetary subsidy, etc.), it must follow a clear timetable that extends the assistance over a strictly determined and not too distant deadline. Instead of confidential agreements reached behind closed doors, there should be full publicity for each bail-out, so that it takes place under the public scrutiny of a parliamentary committee and the press.

Regrettably, politicians usually behave in a different way from the Ulysses of Homer. There is no question of them telling their sailors to bind them hand and foot. On the contrary, they do all they can to keep a free hand, feeling they need room to maneuver and improvise. "Unpredictability is power," as Albert Hirschman put it (Hirschman, 1977, p. 50). Obscurity suits politicians much better than clarity.

The outcome depends greatly on whether the public, particularly the economists' profession, can extract binding pledges from the government and make sure it keeps them. Whatever happens, the test of the credibility of the government's promises about financial discipline will be the practice it pursues in the years to come.

2.3. The mechanism for imposing discipline

Let us now assume the existence of the political will to apply financial discipline continually and consistently. That still leaves open the question of whether the *means* are available to perform the task.

Discipline under the socialist economic system was imposed by the bureaucracy itself, often by arbitrary and brutal means. Postsocialist society must become a *constitutional state*, and that applies in connection with financial discipline as well.

Let us begin with *legislation*. Hungary has made significant progress: modern accounting, banking and bankruptcy laws that meet the requirements of a market economy are already in place. The legislative process is itself an instructive one of experimentation. A particular law may be full of mistakes, and sooner or later need amending, which makes it harder for the effect of it to be incorporated into the awareness of the actors in the economy.[4]

But although the necessary legislative steps have been taken, there is a problem with *enforcing* the law. The work load of the courts dealing with business cases has grown by leaps and bounds. The number of competent professionals is too small. There is a shortage not only of judges, but of receivers, chartered accountants, lawyers, economic analysts and business administrators with the qualifications and experience to conduct bankruptcies, liquidations, auctions, mergers, demergers, and reorganizations.

Let us take another example, in which an enterprise has broken rule 1 of financial discipline: it has not paid for what it has bought. The seller requests the court to issue a warrant of payment. This is a warning which is followed, if the payment has still not taken place, by an official auction. Table 5 shows that

Table 5
Warrant for payment cases at the Budapest Court

Years	Number of cases	Total value of claims (HUF bn.)
1988	11 000	6
1989	31 000	19
1990	64 000	45
1991	61 645	43
1992	31 470	38

Source: Communication by S. Piskolti, the former head of the Economic Bench of the Budapest Court.

[4] One of the regulations on bankruptcies and liquidations, particularly worth noting was the measure known ironically as the "harakiri clause". The responsible manager of an enterprise was obliged to file for bankruptcy once it was clear that the firm would be unable to fulfill its payment commitments. If the manager failed to do so and this could be proved to cause loss, he or she could be sued personally for damages in the civil courts. This provided a very strong inducement to file for bankruptcy if the enterprise got into financial straits.

The "harakiri clause" exacerbated the wave of bankruptices to such an extent that it was withdrawn at the same time as other, lesser amendments were made.

the number of such cases has multiplied by six in four years. It can be three to four months before the court issues the warrant of payment and the official bailiff begins auctioning the debtor's sizable assets.

It is hardly surprising that some entrepreneurs feel they must take the law into their own hands. There have been reports in the press on the existence of one or two obscure firms that specialize in debt collection by curious means: a few strong young men with a resemblance to boxers are sent to a debtor's home to remind him, at least in menacing words, of his obligation to pay.[5] There have also been cases where the message was underlined by beating up the debtor or warning him that his property would be damaged or his dependants attacked. So there we have the mafia method of imposing financial discipline. This is alarming and intolerable. But, unfortunately, such methods must be expected to appear as well, because it will be some time before the legal infrastructure for enforcing financial discipline has developed.

Although legal enforcement of financial discipline is essential, it is by no means sufficient in itself. It must be augmented by a change in the moral attitude of the public towards financial transactions.[6] This leads to the second part of the study, which concerns the conduct of enterprises.

3. The conduct of enterprises

3.1. An example: Forced credit between enterprises

The new contract between the state and the enterprises, determined in the spirit of a market economy, requires a change not only in government conduct, but in the behavior of enterprises. To see how this second change has failed to occur sufficiently in Hungarian business, let us look at the phenomenon of forced credit between enterprises. Enterprise *B* has delivered goods for production to enterprise *A*. The buyer has received them, but it has not then paid the bill. One could put it like this: enterprise *A* forces enterprise *B* to extend credit without prior

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[5] See, for instance, the news report in the daily paper *Népszabadság* on October 19, 1992.

[6] Economic history shows that private contracts based on the honesty and mutual respect of the parties to them were widely made *before* the legislative regulation and legal enforcement of them. When the first commercial laws were then passed, they dealt unceremoniously with those who failed to pay their debts. England's Lex Mercatoria (Law Merchant), passed in the 13th century, stipulated that if a debtor did not pay his debts, the creditor first had to seize his moveable property: "And if the debtor have no moveables whereupon his debt may be levied, then shall his body be taken where it may be found and kept in prison until he have made agreement, or his friends for him." The quotation is from Mitchell (1969). For more on the history of commercial law, see Trakman's book (1983).

So from the Middle Ages onwards, there were strict laws to induce respect for private contracts and financial discipline among the actors in the commercial world. Only centuries later, when the need for discipline had been historically fixed in their minds, did the legal sanctions become "tamer".

agreement, and then does not pay its debt. By doing so, enterprise *A* commits a grave breach of rules 1 and 2 of financial discipline. In a similar way, enterprise *C* is not paid for its goods by *B*, one of whose troubles is that it has not been paid by *A*. The neglect of payments and debt settlements spills over onto other enterprises, to form long, interlocking chains of forced credits.[7] It was continuously growing until April 1992, as shown in Table 6.

Various attempts are made to resolve the problem with the cooperation of the banking sector. It would be possible, for instance, to settle some of the reciprocal debts, even in several different chains, through a clearing system. Some of the interfirm trade credit could be converted into bank credit. Although the amount of forced credits decreased considerably, the reoccurrence of an increase of forced credits is not excluded as long as fundamental and lasting changes do not occur in

Table 6
Forced credit

Years	Number of involuntary creditor enterprises	Total forced credit (HUF bn.)
1979	52	7.9
1980	25	3.8
1981	27	4.7
1982	85	15.2
1983	167	33.8
1984	159	38.4
1985	127	28.3
1986	82	14.0
1987	82	14.0
1988	208	45.5
1989	314	72.8
1990	432	90.5
1991	1017	159.8
April 1992	1143	197.0
December 1992	642	104.0
December 1993	638	99.0

Source: Period 1979–1991: Várhegyi and Sándor (1992, p. 25); 1992 and 1994: Communication by Várhegyi. The figures are based on the data of the Hungarian National Bank.

Note: 1991 figures refer to data for November 30, 1991. All other figures refer to the volume of involuntary credit on December 31 of the year stated. The figures for the volume of involuntary credit only cover credits larger than HUF 25 mn. The total volume, including small-scale involuntary credit, would presumably be much larger. For the sake of comparison, consider the volume of total outstanding bank credit to all enterprises, in billion Hungarian forints: 144.3 in 1990, and 121.4 in 1991. The ratio of forced credit to bank credit was 63% in 1990 and 132% in 1991.

[7] This means that the creditors wait in line in front of the debtor firm to have their debts settled. So the expression *queuing* has become widespread in Hungary for this phenomenon.

the observance of financial discipline. To ensure that forced credit is at most sporadic, instead of ubiquitous, enterprises must accept the following two prohibitions.

"*Buyer*: Never leave goods unpaid for without the seller's prior agreement. If a debt should remain, you may well be in legal trouble: the seller may take you to court and have your assets seized. Apart from the legal complications, there will be a blot on the business reputation and goodwill of your firm, and your creditworthiness rating will fall."

"*Seller*: Refrain from delivering your goods until you are convinced that the buyer will pay for them and is really creditworthy."

The second warning is particularly worth emphasizing. The extenders of forced credit are often presented as "innocent victims" who demand justice. They think they have a right to expect the state to rush to their aid, as if they were the victims of a natural disaster. I think this argument is faulty. It must be accepted that the market is not "just". Entrepreneurs, as their name suggests, take a risk. If the deal goes well, they can make a lot of money, but if it comes out badly, they suffer a loss. If the buyer happens not to pay, they must try to collect their debt by legal means. If they do not succeed, that is their problem alone. If they have not lost heart, they will be more cautious next time about who they deliver their goods to.

The learning of this lesson is seemed to be confirmed by the fact that in the second half of 1992 and in 1993 the amount of forced credits decreased substantially. It seems to indicate that the wave of bankruptcies have already had a favorable effect on the strengthening of financial discipline.

The attitude of the firms' managers must get used to the change. In a socialist economy, what counted was how much a firm managed to *produce*. Once the production had taken place, it could be reported to the statistical office, and the quantity of products was chalked up as a contribution to the fulfillment of the plan. What actually happened to the goods was quite immaterial from the enterprise's point of view. In a market economy, however, the sole thing that counts is what the firm manages to *sell*, how much money it can get for its products.

Having considered the instructive example of interfirm credits, it is time to analyze the conduct of enterprises on a more general plane. Here it is worth examining separately the two segments of the economy: the new private enterprises, and the old state-owned enterprises.

3.2. The new private sector: "Imprinting"

To shed light on the behavior of the new private firms that arise during the reform-socialist period and the postsocialist transition, I would like to borrow a concept from evolutionary biology: the expression "imprinting" (Hess, 1973; Sluckin, 1973). (The dictionary definition is to impress or stamp, and the figurative meaning to impress indelibly on the memory.) Observations of animals provide firm evidence that habits acquired in the *initial, particularly sensitive stage* of life have an extremely strong influence. They become impressed deeply and almost irreversibly in the memory, and prompt the animal concerned to repeat the experience.[8]

It is most important for the new private firms to learn from the outset that they must observe the rules of financial discipline strictly. Resistance appears to this requirement. Private entrepreneurs may argue that if state bail-outs are still being instituted for state-owned enterprises, why is the same not done for them? I think it would be a big mistake to yield to this pressure.[9] Disregarding some rare, truly justified exceptions (mentioned already), private enterprises must not be rescued financially with the help of the state. Let them struggle to survive. There is no cause for alarm if even 10–15% of new businesses, especially small and medium-sized firms, cease trading each year. The healthy, natural process of evolution and selection requires a large number of entries and exits.

3.3. The old state sector: Education by trauma

The same argument makes people skeptical about what can be expected of state-owned enterprises if they remain in state hands. The knowledge that loose financial discipline was tolerated and the budget constraint was soft has been deeply "imprinted" in the minds of those running state-owned enterprises and many of those employed by them. Is it possible to alter this imprint at all?

It may be possible to change it, at least to some extent, if (and only if) the state is strict and steadfast about abiding by the new market economic contract.

State-owned enterprises have become dependent on the paternalist helping hand of the state and the constant availability of a bail-out, just as many weaker-willed individuals become addicted to the relief of smoking, alcohol or drugs. This is worth pondering upon as an analogy. How do those who actually manage to stop smoking, drinking or taking a narcotic go about giving up their addictive habit? The most important step is to recognize it is *harmful and dangerous*. In most cases the recognition comes through the influence of explanatory writings or lectures, while in many the final push comes from a shattering experience, for instance, when the toxic habit causes a tragedy in the immediate

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[8] Goslings follow the mother goose on their walks in single file. One of the discoverers of "imprinting", Konrad Lorenz, observed that if goslings hatched in an incubator became acquainted with him, a man, in the first hours of their lives, they would follow him in single file when he went for a walk, instead of their real mother, even though the goose was nearby. This habit of theirs remained, despite the presence of their mother.

[9] The state rescue operations have extended to private firms as well in the last couple of years, see Voszka (1994).

environment of the hesitant subject, or serious illness in the addict himself or herself.[10]

Tables 2 and 3 showed that chronic loss-making and grave insolvency have become mortal dangers to the survival of enterprises in Hungary. If this pressure becomes permanent, managers will come to believe sooner or later that observing financial discipline is a matter of life and death.

This is what *may* happen, but it is not certain the situation will really develop in this way. Observation of addictive habits, in fact, shows how easily any temptation can cause an old habit to recur. Every recurrence of the state's old conduct – toleration of infringements of financial discipline, softening of the budget constraint – may be taken by the managers of state-owned enterprises to mean that they need not take the matter so seriously after all. Then they too will revert to the old conduct. That is another reason why the bail-outs performed in 1993 and 1994, discussed in Chapter 2 of the study, have such harmful misguiding effects.

So there is a chance of new expectations, accompanied by new habitual behavior, developing in state-owned enterprises, but it cannot be fully relied on. This can serve as an extra argument, alongside the other well-known ones, for privatizing state property, as the new kind of conduct can really be expected only from enterprises based on private ownership and accustomed to financial discipline right from the start.

4. General conclusions

A number of general conclusions emerge from an analysis of the situation in Hungary.

A long preparatory phase was needed before the government and judiciary really set about imposing financial discipline with a firm hand. A range of prior conditions were required for this to happen. There was a need for the private sector to attain a critical mass, so that it could become, both as a supplier and an employer, capable of at least partly replacing the state-owned enterprises, if they disappeared in large numbers. There was also a need for the market institutions and legal infrastructure to attain a critical mass, for an apparatus to handle unemployment, and above all for organizations to distribute unemployment benefits and to act as a labor exchange.

[10] A study by Swenson and Dalton (1983) of the factors inducing the cessation of smoking contains the following figures: 67.9% of the sample of former smokers cited the fact that they had been deterred by learning of the statistics on the mortal dangers of smoking; in 57.6% of cases they mentioned damage to the respondent's own respiratory system, and in 29.2% of cases the smoking-related death of a family member or friend. Similar findings are reported by Curry et al. (1990).

Later, when financial discipline is being applied more forcefully, another quite a long period must pass before the actors in the economy start believing that the state's conduct in this respect has changed for good and all. The expectations of managers are shaped above all by their own experience, not just by the pledges the government makes. Once they can see *in retrospect*, over a period of years, that a new, tough and consistent regime of financial discipline has really come into being, the new enterprise conduct will consolidate as well.

The two lessons drawn so far point to a common conclusion: consolidation of financial discipline is a lengthy process of evolution that extends over several years.

This is a painful process that cannot take place smoothly or without grave social costs. This is chiefly because it has painful side-effects like falling production and lay-offs, but also because the upheaval and trauma are themselves part of the education process.

The imposition of stronger financial discipline inevitably becomes a *political issue*. It can only be done if there is enough public support behind it. It assumes the presence of a consensus on a certain scale, at least in an implicit and passive sense. The requirement for its development, in other words, is that no significant force in the political arena attack the policy of reinforcing discipline from the rear.

The final lesson is that forceful steps taken towards financial discipline entail a *risk*. Tension is caused by the negative side-effects, the falling production, the unemployment, and the weakening of social security. A marked rise in this tension can exercise a destabilizing effect and undermine the still fragile democratic institutions. More than one alarming warning has already been heard in Eastern Europe and especially in the successor states of the Soviet Union about the danger of "Weimarization", where populist demagogy, extremist nationalism and racial hatred find a response in the discontent caused by the economic ills.

I would like at this point, at the end of the study, to make my own position clear on this issue. While the conflict remains one between various economic and welfare goals, I for my part would lay very great emphasis on raising efficiency and imposing financial discipline to that end. But if a sober, objective political analysis revealed that democracy was threatened by the drastic economic measures being taken, I would accept a more cautious advance towards reinforcing financial discipline in order to avert that danger. If it comes to a conflict between efficiency and the cause of democracy, I am sure that defense of the institutions of democracy is the supreme task.

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