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3

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Table of Contents

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Paying the Bill for Goulash Communism: Hungarian Development and Macro Stabilization in a Political-Economy Perspective*

JÁNOS KORNAI

Introduction: Four Characteristics

THE Hungarian economy's road from a centralized, planned economy to a market economy displays a number of features that distinguish it from other post-socialist countries despite the underlying similarities. Without aiming to provide a

* My research was supported by the Hungarian National Scientific Research Foundation (OTKA), Collegium Budapest, Institute for Advanced Study, and by the World Bank. I am most grateful to my colleague Mária Kovács for her help in gathering the data and clarifying the problems discussed in the study. I express my gratitude to Brian McLean for his translation of the Hungarian text. I am also thankful for the research assistance of Mónika Lukács. Among those with whom I consulted during the research were László Akar, Zsolt Ámon, Rudolf Andorka, Francis Bator, Tamás Bauer, Lajos Bokros, Katalin Bossányi, Michael Bruno, Richard Cooper, Zsuzsa Dániel, Tibor Erdös, Endre Gács, Alan Gelb, Béla Greskovits, Stanley Fischer, Eszter Hamza, György Kopits, Almos Kovács, Judit Neményi, András Simonovits, Robert Solow, György Surányi, Katalin Szabó, Márton Tardos, and László Urbán, all of whom I thank for their valuable advice. Naturally I alone am responsible for the ideas expressed.

complete picture, I will pick out four features. Any one of these may occur singly in other countries in the region as well or, more precisely, in a few countries in particular periods. The specific feature of Hungarian development is the lasting coexistence of these four characteristics:

1. Hungary, in its economic-policy priorities, placed great weight on raising today's material welfare and, in the subsequent period of mounting economic problems and stagnating or declining production, on curbing the fall in living standards. Conditions in Hungary had earlier been christened "goulash communism." The policy for several years after the change of political system continued in this respect and can aptly be called "goulash post-communism."

2. A paternalist "welfare state" covering the entire population was developed over several decades. Hungary can vie with the most developed Scandinavian countries in the range of codified entitlements to benefits and in the proportion of GDP laid out on social spending, whereas per capita production is only a small fraction of theirs. Although similar tendencies arose at the time in all Eastern European countries, Hungary went furthest by far and in this respect stands alone in the region.

3. The process of transformation in Hungary has extended over several decades; the initial steps were taken back in the 1960s. Though a few milestones can be mentioned, the process as a whole has been notable for its gradualism. Similarly gradual development in this respect has only occurred in Slovenia.[1] In the eyes of those who distinguish "shock therapy" or "big-bang" strategy from "gradualist" strategy, Hungary represents one extreme of the second and in many ways a special case of it: "gradualism Hungarian style."

4. Hungary has been marked for decades by a relative political calm. While the transformation in some countries has been accompanied by civil warfare, there not a shot has been fired. While the change of political system in some

countries took place at lightning speed amidst spectacular circumstances (collapse of the Berlin Wall, mass demonstrations on the streets of Prague, execution of the Romanian dictator), Hungary had restrained negotiations over an extended period, with the ruling politicians of the old order and the hitherto repressed opposition reaching agreement on free elections and a new constitution. For decades there were hardly any strikes or street demonstrations. Though the economic problems have worsened, successive governments have preferred to muddle through rather than to enact measures that would rouse strong opposition and entail a risk of political destabilization.

These four characteristics together form the specific difference of the Hungarian transformation. This study sets out to contribute to an understanding of why these four characteristics came about, how they have affected each other, and what favorable and detrimental effects they have exerted.

I employ the approach of political economy to examine the economic phenomena. The thinking of politicians and the mentality of the public are shaped by history, in which politics and the economy are imbedded. This context and the interaction between politics and the economy are often ignored in economic-policy analysis and recommendations characterized by technocratic approaches. The study would like to contribute to offsetting this biased approach.[2]

In some places the study draws comparisons with other countries. These, however, are designed solely to shed light on some feature of Hungarian development. I also refrain from judging which country is following the better road, and which country's politicians have been making wiser decisions.

A Survey of Political History

The period divisions in the last four decades of Hungarian history that are pertinent to my subject appear in Table 1.

Table 1

Periods in the Last Four Decades of Hungarian History

Events	Periods in the Political Sphere	Periods in the Economic Sphere		
		Economic-Policy Priorities	Transformation of Property Relations and Institutions	
October 23, 1956 Outbreak of revolution	Revolution			
November 4, 1956 Beginning of Soviet intervention	Reprisals			
March 22, 1963 Political amnesty				
January 1, 1968 Beginning of "New Economic Mechanism"	Softening of dictatorship			Reform-socialist phase
June 13, 1989 Beginning of negotiations between communist party and opposition	Change to multi-party system	Priority given to current welfare, security and calm	Gradualist transformation	
May 23, 1990 First sitting of democratically elected Parliament	Parliamentary democracy			Post-socialist phase
March 12, 1995 Announcement of stabilization program		Measures to restore macro equilibrium		

The Revolution of 1956 and the Years of Reprisals

Singled out in Table 1 as a date of great import from the socialist period is October 23, 1956, the day the Hungarian revolution broke out. Hungary was the only country in the history of the socialist world in which an armed rebellion broke out against the prevailing political order and Soviet occupation.[3] The revolutionary forces took power, if only for a brief period. Those few days of freedom sufficed for parties to organize. A multi-party government that revived the coalition before the communist assumption of power was formed under the leadership of a reform communist, Imre Nagy.

Though sporadic, there were cases of anti-communist lynching during the revolution. Harassment or replacement of the heads of many factories and public offices began. The fear engendered by all this left indelible memories in the minds of the party-state's leading stratum.

Hardly two weeks later, the revolution was crushed by the Soviet army. A one-party system with the communist party holding a monopoly of power was reimposed under the leadership of János Kádár. Armed resistance to the Soviet tanks lasted a short while, and a general strike went on for some weeks before that was abandoned as well. Then came the reprisals. Imre Nagy and his associates and many other active participants in the revolution were executed; altogether 229 death sentences were carried out.[4] Thousands were imprisoned or detained in internment camps, and tens of thousands lost their jobs. The intimidation extended to a large part of the population. Hundreds of thousands had expressed their sincere opinions and had begun to organize into non-communist and anti-communist movements and parties during the days of revolutionary freedom. Now they all felt that reprisals might strike at any minute.

Memories of 1956 and the ensuing period have to be recalled, for as we shall see later, they explain much about the characteristics of Hungary's process of reform.

"Softening" of Dictatorship and the Political Turning Point

Let us jump ahead a few years to the period when the fear gradually relaxed and the brutality and mercilessness of the repression eased. In 1963, some years after the mass executions, a general amnesty was declared; those who had been imprisoned for the part they had played in the revolution were released. A "softening" of the dictatorship began. The name of János Kádár, the man who had directed the reprisals, is also linked to this policy of gradually easing the political repression.

But as this curious, inconsistent, hesitant "liberalization" continued, so did the erosion of the communist system, founded on repression. The process sped up in 1989, when even those in power felt that the political monopoly of the communist party could no longer be sustained. Negotiations began with the opposition forces, which were now organizing themselves openly. In a few months, if not a few days, enormous strides were taken in the political sphere: The one-party system was replaced by a multi-party system; a new constitution came into force. In the spring of 1990, free elections with the participation of rival parties were held for the first time in 43 years; a government chosen by the new Parliament was formed; the governing parties and the parliamentary opposition stated their intention of protecting and developing private ownership, freedom of contract, and a market economy.

The commencement of parliamentary democracy is dated in Table 1 from the day of the first sitting of the democratically elected Parliament. In the *political* sphere, this point in time (or, to be more accurate, the 1989-90 period of talks on changing the political regime, the drafting of the constitution, and the holding of the first free elections) marked a real turning point. But the initial and terminal dates of the characteristic periods in the *economic* sphere fell at different times than those in the *political* sphere.

Priority for Today's Welfare, Security, and Calm

One of the main propositions of this study (as seen in the macroeconomic column of Table 1) is that a curious continuity prevailed in the priorities motivating Hungarian economic policy, extending beyond the political turning point of

1989–90. The same orientation persisted for 25–30 years. Only the announcement of the stabilization program on March 12, 1995 broke this continuity.

Avoidance of Upheavals and Conflicts

From the outset, those directing and playing an active part in Hungary's economic transformation, both before and after the political turning point of 1989–90, have been guided by a resolve to avoid upheavals and conflicts.

The roots of this stance go back, in my view, to 1956. The days of revolution and subsequent years of reprisals caused a grave trauma. The ruling elite of the time, the communist "cadres," looked back in terror on the revolution, the mass demonstrations before October 23, the street fighting and the popular fury vented against the secret police and party functionaries. They felt they had to be on much better terms with the masses in the future lest they rebel again. The multitude of average people, if not the heroes who had worked actively for the revolution and stood by its ideals, had also been scared by the "upheaval," by both the revolution and its subsequent suppression. They were intimidated by the harassment and persecution of relatives, friends, and colleagues. Thus, there was an intense desire for peace and calm among the leading stratum and the millions of ordinary people alike. This climate of public opinion explains the psychological motivation behind Hungarian economic policy. Euphemistically this could be called moderation and ability to compromise, the pursuit of consensus. A pejorative description would be appeasement and cowardice. Both verdicts contain elements of truth.

That was the motivation at the beginning of the process, when those who had been through '56 were still present and active. But this climate of opinion, routine of behavior, and system of moral norms caused by the grave national trauma became ingrained, persisting even after '56 had become a remote historical event in the minds of younger people.

So what is the prime factor here? Is it a mass concern to avoid upheaval, to which politicians react? Or is it the other way round: politicians fearful of possible mass protest and open confrontation with their opponents seeking to forestall them? Do cringing, bargaining politicians bring society up to behave the same way? Presumably, there are effects in both directions.

Poland in 1956 did not go as far as an armed uprising and bloody street fighting, but 20–25 years later millions were prepared to strike, and Solidarity was formed, with a militancy that not even military intervention could stifle for good. The struggle began with the customary trade-union demands in defense of real wages and jobs. Confrontation between those in power and the masses heightened. Concurrently in Hungary, 20–25 years after a defeated revolution, the attention of the leading stratum and the millions of ordinary people turned not toward strikes and political struggles, but calmly toward the economy. Ordinary people chased around after extra earnings, built houses, and grew vegetables.

There was an almost logical continuation of this after 1990. Poland might undergo another great flare-up under a Solidarity-led government prepared to implement a radical package of stabilization and liberalization demanding great sacrifice. Hungary's governing coalition was not so prepared. Indeed, the victorious party in the first free elections, the Hungarian Democratic Forum, had declared in its campaign that it would follow the policies of a "calm force," which had been one of its electoral attractions.

In October 1990, early in the new government's term, a peculiar mass demonstration broke out. Taxi drivers protesting against a gas price increase planned by the government blockaded Budapest's main intersections and brought traffic to a halt. Bargaining between the representatives of the taxi drivers and the government took place before the television cameras. The opposition of the day, instead of supporting the legitimate government intent of maintaining law and order and imposing an unpopular but necessary price increase, backed the organizers of the blockade instead. Eventually the government retreated and a compromise was reached.[5] The episode acted as a precedent. The Antall and Boross governments of 1990–94 never again took action that would elicit mass opposition, and the Horn government that took power in 1994 behaved the same way for several months.

Looking back on a period of three decades since the mid-1960s, it can be seen that whenever an economic conflict threatened, whether it was a strike or a mass demonstration, the tension would practically always be defused by bargaining and compromise. Confrontation was avoided more successfully, in fact, than in many established market economies.

The successive governments were imbued with very different ideologies. In the final years before 1990, the reform wing of the communist party was in power. In 1990–94 there was a coalition with a national and Christian democratic orientation. Since 1994 there has been a coalition of socialists and liberals. Yet, there was almost complete continuity until March 1995 in maintaining the tradition of compromise and conflict evasion based on making concessions to the dissatisfied.

The Now-or-Later Problem

Hungarian economic policy from the early 1960s onward was "pro-consumption." This marked a sharp break from the Stalinist, classical socialist priorities of economic policy. Under Stalinism, investment, a forced pace of growth, and the fastest possible acquisition of strong industrial and military might were the top priorities, which in Hungary, for instance, entailed a relegation of consumption.

It is not my province to analyze the psychology of individual politicians. What induced them to be consumption-oriented? Sincere concern for people's material welfare or political Machiavellianism? It is clear from what has been said so far that the prominence given to material welfare would again be related to the trauma of '56. If the communist power wanted to be on good terms with the masses they ruled, they had to pay much more heed to their material standard of living; they had to content them. That would smooth over the conflicts; that is the best way to prevent protests, demonstrations, and uprisings. Ultimately, the degree to which the two posited mentalities applied to politicians is immaterial to the economic effect.

This new economic policy orientation had a "golden age" between 1966 and 1975, with household consumption rising year after year without recession or stagnation by an annual average of 5.3 percent (see Table 2). This was the time in many families' lives when they bought their first refrigerator, their first Trabant car, and later on took their first trip to the West. This was when the most of the Hungarian public came to associate reform with growing welfare. This was when the West began to develop a partly true, partly distorted picture of the Kádár regime as "the happiest barrack in the camp." This was the *offensive* phase of consumption-oriented economic policy.

Production at that time was still growing fast—faster than consumption. However, under Stalinist economic policy the gap between the growth rates of production and consumption would have been much higher. The leadership would have used the upswing of growth to achieve a higher investment rate, and thus a much higher growth rate of GDP, and would have been content with a far more modest improvement in consumption. One more remark (and that will be discussed later in the study): the growth in production, and with it consumption, began in the 1970s was achieved partially at the cost of accumulating foreign debt.

The proportions of the domestic utilization of GDP began to

Table 2

Absorption of GDP in Hungary, 1960—93

Period	GDP	Final consumption		Gross investment	
		Total	Of which: Total household consump-tion	Total	Of which: accumulation of fixed assets
		(Annual average growth rate, %)			
1961—65	4.4	3.7	3.4	5.2	5.1
1966—75	6.3	5.3	5.3	8.5	9.1
1976—87	2.7	2.3	2.2	0.1	0.8
1988—91	-4.0	-2.5	-2.9	-7.3	-5.1
1988—93[a]	-3.3	-0.7	-1.7	-4.1	-3.7

Source: Central Statistical Office (1995c, p. 2).

Note: a) The 1993 figure for total final consumption includes arms imports from Russia received as debt repayment.

change in the late 1970s, with consumption's share rising and investment's falling. The growth in production steadily slowed down, remaining near to stagnation for a long time and then starting to fall seriously in 1991. This is just the sort of situation that tests what weight consumption has in the priorities of economic policy. The consumption-oriented economic policy continued persistently against a stagnating and even shrinking economy. This it did before, during and after the change of political system, by then in a *defensive* manner. "If a fall in consumption is inevitable, let it fall as slowly and as little as possible," was the attitude (see Table 3).

Table 3

Trends in GDP, Consumption, Real Income and Real Wages in Hungary

Year	GDP[a]	Per capita consumption	Per capita real income	Real wages per earner[b]
		1987 = 100		
1988	100	100	99	95
1989	101	106	102	96
1990	97	100	101	92
1991	85	91	99	86
1992	83	91	95	85
1993	82	93	91	81
1994	85		95	87

Source: Central Statistical Office (1995c, p. 2 and 11).

Notes: a) The GDP figure is not for GDP per capita. b) Up to 1990, the figures refer only to the category of workers and employees, excluding workers in agricultural cooperatives; from 1991, they are included.

This aim was plainly apparent in the period 1988–93, when GDP fell by an average of 3.3 percent a year, while the fall in total household consumption averaged only 1.7 percent a year (see Table 2). Investment, not consumption, acted as the residual variable under the "pro-consumption" policy of the late Kádár period and in the first five years of parliamentary democracy. This can be seen clearly in Table 2, where the accumulation of fixed assets first slows down more and then declines faster than GDP.

This presents a special case of the well-known time-preference problem of "now or later." The main aim of

Hungarian economic policy for at least two decades could be described as seeking at any time to maximize consumption in the present and immediate future at the expense of debt that would devolve on later periods. Initially this ensured a rapid growth of consumption, but it was already beginning to backfire to some extent after a decade: the rise in production, and with it consumption, began to slow down. Later, a decline in production and consumption set in, partly because of the policy resulting in debt accumulation in previous years. Yet the objective function, maximization of short-term consumption, was still unchanged. It continued, of course, with its sign changed, as minimization of the fall in consumption, and the price of this aim was still accepted: further accumulation of debt.

Here I use the concept of "debt" in its broadest sense. This comprehensive interpretation has already been employed by several authors (Kornai, 1972; Krugman, 1994).[6] Let us look at its main components:

1. Debt is what the country owes abroad. With this kind of debt, the connection is obvious: consumption today is being financed abroad, but this will have to be repaid tomorrow at the expense of tomorrow's consumption.[7] This kind of debt is oppressively large in Hungary's case (see Table 4). The defensive policy of curbing the reduction of consumption has been implemented primarily at the expense of foreign debt.

Among other factors contributing to the build-up of foreign debt is the fact that the exchange-rate policy pursued has tended to overvalue the currency, which weakened the incentive to export and allowed excessive import demand to develop. It was apparent in several periods, most recently from 1993 up to March 12, 1995, that the financial authorities were postponing an increasingly inevitable devaluation.[8] This fit in well with the economic policy of always postponing unpopular measures to the last minute. Devaluation, especially when coupled with a tighter wage policy, is known for cutting deep into living standards.

Table 4

Indices of Hungary's Convertible-Currency Foreign Debt and Debt Servicing

Year	Gross debt (USD bn)	Per capita gross debt (USD)	Debt servicing/ Goods exports (%)
1975	3.9	369	25.3
1980	9.1	850	41.4
1985	14.0	1,326	85.6
1990	21.3	2,057	62.7
1993	24.6	2,393	44.5
1994	28.5	2,782	

Sources: Column 1, 1975—81: United Nations, Economic Commission for Europe (1993, p. 130), 1982—93: National Bank of Hungary (1994, p. 137); Column 2: Central Statistical Office (1994b, p. 1) and (1995a, p. 9); Column 3: National Bank of Hungary (1994, p. 269). 1994: National Bank of Hungary (1995b, p. 108).

2. Let us start by assuming it is possible to determine what proportion of GDP must be invested to ensure (i) the maintenance and a modest but acceptable expansion of national wealth and (ii) a modest but acceptable expansion of production.[9] If the proportion is less, some tasks that should be done now will be omitted and left for later. The "arrears" formed by the postponed acts of investment are a form of debt, which a later generation will have to pay. So they can be considered as part of the debt in the broader sense.

Since no exact calculation has been made of the size and trend of the investment proportion required for lasting growth and technical development, I can give no estimates of the size of the investment "arrears." All I can do is convey the gravity of them indirectly.

- Table 5 compares the trend of persistently high investment

Table 5

Trends in Gross Domestic Investment in Fast-growing Developing Countries and in Hungary, 1980–93

	Gross domestic investment as a percentage of GDP					
Year	Hungary	Indonesia	South Korea	China	Malaysia	Thailand
1980	30.7	24.3	32.0	30.1	30.4	29.1
1985	25.0	28.0	29.6	38.6	27.6	28.2
1990	25.4	30.1	36.9	33.2	31.5	41.1
1991	20.4	29.4	38.9	32.7	37.0	42.2
1992	15.2	28.7	36.6	34.4	33.8	39.6
1993	19.7	28.3	34.3	41.2	33.2	40.0

Source: The World Bank (1995c, pp. 58–61).

proportions in some medium developed, fast-growing countries with the declining trend over time in Hungary's investment proportion. I am not saying Hungary should necessarily have maintained its high earlier proportion of investment,[10] but the great decrease demonstrates the line of thinking above: an accumulation of investment "arrears."

- Expenditure in Hungary on maintenance and renovation of housing and infrastructural facilities (roads, railways, bridges, and so on) has fallen sharply. Let me take housing construction as an example. This has been falling sharply for two decades, and in recent years the volume of housing constructed has positively plunged. This is offset in part by the fact that far fewer dwellings than before are being removed from the housing stock: dwellings ready for demolition are being retained.[11]
- Especially menacing is the drop in certain slow-return

investment projects which have a long gestation period. Infrastructural investment and the development of scientific research can be grouped here.[12]

3. Another component of debt in the broader sense is formed by legislative commitments to future consumption. These include promises of legally guaranteed pensions, family allowances, maternity benefits, sick pay, and all other welfare payments. These are promissory notes from the present generation, which the next generation will have to redeem. When these are eventually redeemed, they too will compete for resources with the investment required for economic development, and so it is justified to consider them a component of debt.[13]

In what follows I am going to call these three kinds of debt *social debt.*[14]

I spoke at the beginning of the section of pro-consumption economic policy. These remarks have helped to show that a *short-sighted* pro-consumption stance and a very high social discount rate prevails. By pushing a snowball of social debt before us, we prevent a higher standard of consumption later.

All this sounds familiar to older generations of Hungarians. Once upon a time, Mátyás Rákosi, the leading figure in Hungarian Stalinism, argued in these terms for the very high proportion of investment in the economic plan: let us be sure not to kill the hen that will lay the golden eggs. The Kádár regime gained popularity by laying this "Rákosi-ite" doctrine aside and setting about "consuming the hen." Much of the public still greets any call for sacrifice with suspicion and rejection.

Table 6 cites an opinion poll that reflects very well the despondency, the mood of "no thought for the morrow," and the mounting tendency toward hedonism. Even when the bitter outcome of the short-sighted, short-term preferences applied earlier have appeared, with a slower growth and then a decline in consumption, attitudes do not change. In fact, they

Table 6

Opinions on More Distant Goals in Life and on Ideals and Values

Statement	Year	Respondents			Total
		disagree	partly agree	wholly agree	
		with statement (percentage distribution)			
Everything is changing so fast people do not know what to believe in	1978	46	33	21	100
	1990	17	35	48	100
	1994	13	38	49	100
People live from one day to the next; there is no sense in making plans in advance	1978	69	17	14	100
	1990	17	35	48	100
	1994	20	34	46	100

Source: Rudolf Andorka (1994, Table 5.4).

undergo a self-destructive enhancement: people become yet more impatient and still less willing to make sacrifices.[15]

How does the relationship between the main characteristics of Hungarian development apply? How do the gradual nature of the transformation, the marked preference for "now," and the desire for political calm fit together? The compromises and conflict avoidance required for gradualism require the pursuit of an *attractive* policy. Politicians are not prepared to put forward unpopular "belt-tightening" programs. The Ceausescu regime used brutal repression. This allowed it to repay its previous debts, even at the cost of grave public deprivation. The "soft dictatorship" of the Kádár regime, however, eschewed brutal means of oppression for its last decade or two, which partly explains why it had to pursue an economic policy of courting popularity.

The same macroeconomic dilemma faced the new, democratically elected parliaments and governments. The politicians who came to power in Poland and Czechoslovakia judged this historic moment of euphoria to be a time when the public would be willing to make great sacrifices. The opportunity had to be seized to rectify the macroeconomic proportions.[16] The Hungarian government, however, was not prepared to do the same. Why not? Perhaps it was guided by political realism, finding that the Hungarian public was accustomed to repression easing and thought extensions of its rights and freedoms only natural, so that it displayed no marked euphoria over the change of political system, simply noting it with calm satisfaction. Perhaps it was also because the new government's behaviour was obeying the old reflex—by no means alien to experienced politicians in parliamentary democracies either—in not undertaking anything that was going to be unpopular or elicit mass protest. Whatever the case, the Hungarian government rejected all versions of shock therapy, radical stabilization surgery, or "belt-tightening" programs of cuts, in favor of continued maximization of consumption (or, more precisely, minimization of the fall in consumption). Table 7 shows the trend in real wages, signifying the essential degree to which Czechoslovakia and later the Czech Republic and Slovakia accompanied by Poland and Slovenia differed in this from Hungary, where gradualism applied. To this day I cannot get over the idea that the first democratic Hungarian government missed a historic, unrepeatable opportunity in 1990.[17]

Since then there has been another great historical occasion: the sweeping electoral victory of the Socialist Party in 1994.

Table 7

Real Wages: International Comparison, 1990—93

Countries	Real wages (% change over previous year)				1993 as percentage of
	1990	1991	1992	1993	1989
Czech Republic	-5.4	-23.7	10.1	4.1	82.7
Hungary[a]	-3.5	-6.8	-1.5	-4.0	85.0
Poland	-24.4	-0.3	-2.7	-1.8	72.0
Slovakia	-5.9	-25.6	8.9	-3.9	73.3
Slovenia	-26.5	-15.1	-2.8	16.0	70.4

Source: 1990—93: United Nations, Economic Commission for Europe (1994a, p. 79 and 1994b, p. 41); Hungary: 1990—93: Central Statistical Office (1994b, p. 11); Czech Republic and Slovakia, 1990—91: World Economy Research Institute, Warsaw School of Economics (1994, p. 37).

Note: a) The figure for 1990 refers only to the category of workers and employees, excluding workers in agricultural cooperatives; from 1991, they are included.

The Socialist Party, along with its liberal coalition partner, which was prepared to support radical measures, won a 72 percent majority in Parliament. The "now-or-later" dilemma posed itself more sharply than ever when the new government came to power. There is a well-known rule of thumb in parliamentary democracies that a government faced with unpopular measures should take them at the start of the parliamentary cycle. By the next elections the voters will have forgotten them, and it may even be possible by then to discern the benefits of the rigorous measures taken several years before. Of course, this was not such a dramatically historic opportunity as 1990, when democracy arrived. This was just a normal chance offered by the beginning of a new parliamentary cycle. Nonetheless, the new government let the opportunity slip again, hesitating for another nine months. All the leading party of the coalition, the Socialist Party that had grown out of the reform wing of the old communist party, did in this case was obey the established reflexes of its predecessor. For months there was a tug-of-war, between the trade-union and party opponents of further sacrifices, on one side, and the more radical economist reformers, prepared for a tougher economic policy, on the other. In the end, the latter made all the concessions, and the economic policy of "muddling through" continued as before.

Analogies with populism inevitably spring to mind (Bozóki, 1994; Bozóki and Sükösd, 1992; Dornbusch and Edwards, 1990; Greskovits, 1994; Hausner, 1992; Kaufman and Stallings, 1991). The economic policy described—subordination of the long-term interests of economic development to the requirements of political popularity and the unilateral concern for living standards—bears a clear resemblance to it. Still, I do not think it would be right to see this simply as an Eastern European version of populism. Latin American populism (and earlier populist trends in Europe) employed aggressive demagogy and pursued economic policies of unbridled irresponsibility. The economic policy I have described as typical of Hungarian development for decades was less reckless. It was cautious rather than tub-thumping, attempting repeatedly to strike a compromise between the public's living standard expectations and the legitimate long-term macroeconomic requirements. Yet, it can be said that the economic policy incorporated steadily features resembling populism,[18] and a leaning toward populism always haunted and strongly influenced political decision-makers.

Redistribution and Paternalism

The last section examined economic-policy priorities as aggregate categories, focusing on the question of "consumption versus social debt." Now let us examine what redistribution processes govern consumption.

Table 8 shows that if household income in Hungary is taken as a whole, the proportion of income earned from work is steadily falling. Meanwhile, the proportion of income received through state and social-security redistribution is tending to rise.

Table 9 presents another cross-section. Attention was drawn in a study by Assar Lindbeck (1990) to a dangerous trend in the Swedish economy: the proportion of employed whose income derives from the market is falling fast, while the proportion of those whose income derives from the state budget is rising. Hungarian figures for 1993 were compiled for a comparison with astonishing results: the Hungarian ratio of 1:1.65 far exceeds the Swedish ratio of 1:1.32 that Lindbeck found alarming. Not even the country to go furthest of any mature market economy in state and social security redistribution attains Hungary's ratio of those "living off the state budget" to those "living off the market."

Earlier I mentioned the defensive period of economic policy, when the aim was to slow down the fall in living standards. This attempt was not directed at real wages, which fell to roughly the same extent as production (see Table 3). However, while the country's economic situation steadily deteriorated, the system of transfers tended to expand. Family allowances grew more ubiquitous; maternity allowances became generous, at least in the length of entitlement. The system of unemployment benefits in Hungary has provided a wider range of entitlement than in many developed market economies. Hungary's proportion of welfare spending to GDP far exceeds the OECD average.[19]

Table 8

Household Income by Main Sources of Income in Hungary, 1960—92

Year	Income from work	Social income			Income from other sources
		In cash	In kind	Together	
	(Percentages of total household income)				
1960	80.4	7.0	11.4	18.4	1.2
1970	76.1	11.3	11.3	22.6	1.3
1975	71.5	15.5	11.7	27.2	1.3
1980	68.0	18.9	13.1	32.0	0.1
1985	65.6	19.9	14.1	34.0	0.4
1990	58.1	22.6	16.6	39.2	2.7
1992	52.8	25.0	16.4	41.4	5.8

Sources: 1960: Central Statistical Office (1971, p. 387); 1970 and 1975: Central Statistical Office (1981, p. 356); 1980 and 1985: Central Statistical Office (1986, p. 240); 1990 and 1992: Central Statistical Office (1994a, p. 30).

Note: "Income from work" means the sum, within the net income of households, of income in money and in kind directly connected with the performance of work. It covers income from employment, cooperative membership and household, auxiliary and private farming, including personal income from entrepreneurial activity and the value of work done by households on their own homes. "Social benefits in cash" are the part of the net money income of households received under social insurance and other social-policy measures and financed out of social insurance, central and local-government budgets, and to a lesser extent by business organizations. "Social benefits in kind" are the part of consumption by households for which they do not pay, it is being financed out of the budget, social insurance or business organizations. (See Central Statistical Office 1994a, p. 232.)

To use an expression I coined in an earlier piece of writing, Hungary became a premature welfare state.[20] The countries with very high proportions of welfare spending surpass Hungary in economic development many times over.[21] So why did Hungary undertake to finance state welfare transfers

Table 9

Number of Participants in Market and Non-market Sectors in

Sweden and in Hungary

Activity	No. of participants (1 000)		
	Sweden		Hungary
	1970	1989	1993
1. Public administration and services	806	1,427	875
2. Pensioners	1,135	1,899	2,647
3. Unemployed	59	62	694
4. Employed in labor market programs	69	144	54
5. On sick leave	264	317	150
6. On parenthood leave	28	126	262
7. Total of 1-6	2,361	3,975	4,682
8. Employed in market sector	3,106	3,020	2,842
9. Ratio of 7 to 8	**0.76**	**1.32**	**1.65**

Sources: Sweden: Lindbeck (1990, p. 23.). Hungary: Rows 1 and 2, Central Statistical Office (1994b, pp. 14 and 54); Rows 3 and 4, Munkaügyi Kutatóintézet (1994, p. 45); Row 5, Central Statistical Office (1994b, p. 54), (1994c, p. 22); Rows 6 and 8, Central Statistical Office (1994b, p. 54).
Notes: Row 1: For Hungary, the figure refers to employees at government institutions. Row 2: Figures include old-age pensioners and early retirees; for Hungary the figure omits employed pensioners (223, 000 in 1993), who are not included in any of the market and non-market categories either. Row 3: For Hungary, registered unemployed only. Row 4: For Hungary, the figure is the sum of those undergoing retraining and in public-works employment. Row 5: For Hungary, the proportion of employees and industrial-cooperative members on sick leave (5.1%) was projected onto active earners in the market sphere. Workers in the budget-financed sector on sick leave do not feature among those on sick leave so as to prevent double counting. The figure for active earners in the market sphere does not include those on sick leave. Row 8: This includes public sector corporations (state-owned firms) and public utilities.

beyond its capabilities? It was most important to the government at any time to reassure people. The paternalist redistribution certainly has a soothing effect, compensating to a large extent for the reduction in and uncertainty about real wages earned legally in the market sector.

I would like to emphasize the problem of uncertainty. The characteristic feature of Hungary in the last two or three decades was not simply that more weight was given to the economic-policy priority of *consumption*. Similar weight was attached to the requirement of socio-economic *security*. The market economy, which increases uncertainty, and the paternalist redistribution system, which decreases it, developed in parallel.[22] Increasing redistribution fit in better with the prevailing socialist ideology and the power aspirations of the leading group than putting higher income at the disposal of households would have done. It left it to the central authorities to decide who should share in the redistribution transfers, when, and to what extent.

The shift in proportions just described did not derive from a forward-looking, long-term government program. It arose out of improvisation, through rivalry between distributive claims. First one group, stratum, or trade then another would demand more or at least struggle against curtailment of its existing rights. This was done by every ministry and every office in the bureaucracy, every trade union and other special-interest group, and, on behalf of their district, by members of Parliament and party officials. A great many dissatisfied groups could be silenced if the state undertook a new legal obligation that would always apply in the future, not just in the following year. In many cases the discontented could be pacified by a recurrent softening of the budget constraint: a firm, bank, or local government would be saved from bankruptcy by a fiscal grant or a soft bank loan.

This *distributive appeasement* of dissatisfaction is one of the main factors explaining the financial disequilibria and tensions in the economy.[23] The budget deficit is augmented by pushing welfare spending up to levels that tax revenues cannot cover, and by using state subsidies to bail out firms, banks, and local authorities in distress, so as to save jobs. Weakening of wage controls and softening of the budget constraint with soft loans fuel inflation and, of course, so does monetization of the budget deficit, that is, financing of it by the central bank. The growing cost of servicing the external debt contributes to the deficit on the current account. The connection between this and the one-sided consumption-orientation of economic policy was discussed in the last section.

There is a connection in the opposite direction as well. Once the financial disequilibria have emerged, it becomes impossible for a government whose policy is hallmarked by "consumption protection," paternalist state care, and distributive appeasement to bring itself to take the drastic restrictive measures required.[24] Here again there was continuity after the 1990 change of system,[25] right up to March 12, 1995.

The steady spread of redistribution, with a steady stream of successive little concessions, also led to "gradualism Hungarian style." The changes were made in tiny fragmented concurrent and consecutive stages, step by step. All this saved the political sphere as well from traumatic upheavals and contributed to the relatively calm political atmosphere.

A Departure: The Stabilization Program of Spring 1995

The Hungarian government announced a stabilization program on March 12, 1995. I do not attempt in this study to analyze this program from the economic point of view.[26] I examine the question exclusively with an approach based on political economy, analyzing, in other words, the mutual effects of politics and economic policy. As a reminder, let me sum up the main components of the program.[27]

1. There was an immediate, substantial devaluation of 9 percent followed by introduction of the system of a "preannounced crawling peg." A substantial surcharge of 8 percent was placed on imports.

2. Restrictions on budgetary spending were laid down, including cuts in certain items of welfare spending.

3. The government sought to achieve a sharp reduction in real wages. It therefore placed strict limits on the incomes paid in the public sector and on wages in state-owned firms. It was assumed that this would curb wage rises in the private sector as well.

The implementation of the stabilization program has been going on for more than a year now. However, it is too early to give a full assessment of the program from the point of view of political economy.[28] The other parts of the study analyses the general features of a period of 20–30 years; it would be out of proportion and hasty to examine the experiences of a short period in the same depth. The mere announcement of the program is a significant development, and the government has been following its declared policy quite consistently. The program marks a clean break with the four main features that have typified the Hungarian road of reform and systemic change hitherto:

1. Consumption is replaced as the top priority by the aim of restoring the seriously upset macroeconomic balance, so as to establish the conditions for lasting growth and at a later stage for growing consumption. The defensive action to ward off the decline in consumption has been suspended. A sudden change has been made in the time preference of economic policy. So far the future has been sacrificed to the present. Now sacrifices are being demanded of the present for the sake of the future. So far the accumulation of social debt has been accepted for the sake of present consumption (slowing of the fall in consumption or possibly stagnation or a slight rise in consumption). Now a reduction in present consumption has been undertaken to prevent a further build-up of social debt.[29]

2. The paternalist welfare transfers by the state and the welfare entitlements of the public were taboo until March 12, 1995. There was no political force ready to recommend a well-specified reduction in them. Now a turn has occurred. It

has been shown that it is possible not only to grant entitlements, but to revoke them as well. Since the announcement of the stabilization program the issue of reforming the welfare state has come to the fore of political debates and intellectual discussions. Furthermore, the first steps to reduce welfare entitlements have been taken; for instance, a tuition fee was introduced for higher education, the principle of need became a guiding principle in distributing certain welfare benefits, and so on.

3. In sharp contrast to the gradualism, hesitancy, and piecemeal policies characteristic of recent decades, a package of measures with traumatic effects has been introduced with dramatic suddenness. True, this is a far less comprehensive program than the earlier shock therapy in Poland, the Czech Republic, or Russia, but that is partly justified by the difference in Hungary's situation in 1995. Yet a degree of similarity remains: the break with continuity, the sudden turn, and the trauma.

4. The stabilization package has brought the political calm to an immediate end. No one could imagine the March 12th measures had a consensus behind them. On the contrary, they have been greeted by the widest variety of interest groups and political forces with doubts and criticisms at best and at worst with vehement protests.

Why did the government that took office in July 1994 hesitate for nine months (Gombár, 1995; Kéri, 1994; Lengyel, 1995). To answer this means going back to the results of Hungary's last general election in May 1994, and asking the following question: Who voted for the winning Socialist Party and why?[30] Why did the coalition that had won a large parliamentary majority four years before suffer a grave electoral defeat? Let me select just a couple of the factors. One of the motives was undoubtedly negative in character: a major part of the electorate simply wanted to vote *against* the ruling coalition because of the bad economic situation. Contributing to this was the arrogant tone adopted by many government members and leading politicians. The Socialists were expected to display more modest, rather plebeian behavior. Many politicians in power were amateurs at governing. The Socialists with experience in administering the state and the economy were expected to show more expertise.

The Socialist Party's constituency was varied. They gained backing from many employees, mainly (though not exclusively) blue-collar workers. Large numbers of pensioners voted for them. So did many members of the intelligentsia, either from social democratic conviction or because they were repelled by the nationalist, anti-Semitic, pro-Horthy manifestations under the previous government.[31] Also among the Socialist supporters were many entrepreneurs and managers, whose transfer from the party *nomenklatura* into the business world of the market economy had taken place not long before, so that they had retained their connections with their old associates. This list, which is far from complete, shows that the party's constituency included groups not only in agreement with each other, but also with strong conflicts of interest between them.

The Socialist Party's campaign was ambivalent. Its professional technocrats tried frankly to point out to voters that the country was in a difficult position and miracles could not be expected. But certain statements by party speakers left room for the assumption that the Socialist Party could promise a swift improvement in life. What is more important, whether such an improvement was promised to the voters or not, is that many people voted for the Socialist Party hoping that it stood for socialist ideas. The party would be "left-wing." It would take sides with the poor, not the rich. It would soon set about improving the living conditions of the workers, the needy, and the pensioners. They hoped the party would defend the state system of paternalist care and perhaps even restore full employment and job security. Similar expectations in several other post-socialist countries have given electoral success to socialist and social democratic parties derived from communist parties. It is all the more understandable that this should have been expected in Hungary, since Hungarian reform socialism went furthest in serving the interests of material welfare and social security.

After the elections, the Socialist Party went into coalition with the Alliance of Free Democrats, whose history goes back to the dissident movement before the change of system. It is a quirk of history that the opposition and their successors and those who harassed them and their successors should now be in the same cabinet, voting together. The Free Democrats had called for a radical restoration of macroeconomic equilibrium in the previous two years, and they said the same during the elections. They did not disguise the fact that the country had grave economic difficulties and that restrictive measures demanding sacrifices would be required. Their ideas mainly cover European liberal thinking, but some of the party's supporters are not averse to social democratic principles either.[32]

The coalition of the two parties has 72 percent of the seats in Parliament. This is enough to vote through the government's proposals even on legislation requiring a qualified, two-thirds majority. Looking just at the proportions of seats, it might be thought that the coalition parties could immediately push through anything they set their minds on. But it was just this—the need for governmental resolve, agreement between the two parties, and above all the need for unity within the Socialist Party—that caused problems in the nine months after the election. This returns us to the question of stabilization.

It is clear from what has been said that the Socialist Party did not have a mandate from its voters to introduce a stabilization program of severe restrictions and austerity. Most of the Socialist politicians tried to avoid the task through the kind of routine behavior imprinted on them in the past. They dared not face their voters. Not only was division apparent at discussions within the Socialist Party and negotiations with the trade unions, but the opponents of a radical program of stabilization appeared to be stronger than the supporters. For months the government was dogged by hesitation, equivocation, and almost total incapacity on fundamental questions of economic policy.

The government finally decided it could hesitate no longer. It had to begin paying the bill for the over-consumption by previous generations. One might ask why this had to happen only in March 1995 and why precisely in March 1995? Why did the present leadership not try to continue with the policy of "muddling through?" I do not know what went on behind the scenes of the political process, and so I can only outline some hypotheses. Perhaps the disquieting economic statistics had a sobering effect. To mention just one, Hungary's deficit on the current account in 1993 was equal to 9 percent of GDP; despite hopes of improvement, it increased to 9.5 percent in 1994. Perhaps the events in Mexico caused the alarm. The Hungarian situation is certainly more favorable in many respects, for example, the debt consists mainly of long-term credits. Yet the sight of a crash in the finances of a country that was seemingly developing well may have spread fear among Hungary's leaders. Finally, there was another factor: the foreign assessment of Hungary was becoming increasingly negative. As long as the leaders of the Hungarian economy were only in dispute with the IMF, it was possible to think of this as just the usual kind of dispute between the IMF insisting on rigor and a small country with difficulties. But condemnations began to multiply in the international financial press, in analyses by prestigious credit-rating institutions and large foreign private banks, and in conversations with leading politicians of other countries. Hungary, the "model pupil" of Eastern Europe, more and more frequently received a bad report. All these, and perhaps some other factors as well, led the Hungarian political leadership to take a sudden turn and make up its mind to announce a strict and very unpopular program. After decades of conflict avoidance, it undertook to face the inevitable mass indignation.

Having chosen its course of action, the government went about it almost like a coup. It did not submit the March 12 announcement beforehand to wider forums in the Socialist Party. It did not request prior agreement from the Socialist faction in Parliament or the unions sympathetic to the party. It did not consult with social-policy experts in the state bureaucracy. Deterred by the example of earlier barren negotiations, the government tried to present its supporters with a *fait accompli.*

So what kind of rearguard political defense can the program expect? To an extent it can rely on groups of technocratic experts as well as some sections of the liberal intelligentsia with influence over public opinion. The entrepreneurs more or less agree with the program, with many reservations and criticisms, and can be expected to support it as long as it opens up the road to growth, from which they expect greater and safer earnings. It can hope for tolerance, if not support, from employees in expanding branches and firms and at work places where surplus labor has already been shed; in other words, from employees who do not feel their direct interests are infringed. Will this level of support or passive endurance suffice?

A dispassionate observer cannot give any other answer to this decisive question than to say it is uncertain. The first year brought encouraging initial results in the most important *macroeconomic* indices: the monthly budget deficit fell, inflation slowed down again after the initial spurt of price increases, and the monthly deficit on the current account decreased substantially (see Table 10). These, however, are all the kinds of sign that only economists tend to respect. The public does not feel them in their daily lives, whereas the fall in real wages is already hurting, and they are bitter about the reduction in some redistributive benefits. The *political* and *social* reaction to the program by broad sections of society is rejection. The various professional groups and representative bodies are protesting one after the other. The program is being attacked strongly by the opposition, inside and outside Parliament,

Table 10

Macroeconomic Indicators of Hungary, 1993—1995

Indicators	1993	1994	1995
1. **GDP** (annual growth rate, %)	-0.6	2.9	1.5[a]
2. **GDP per capita**[b] (US dollar)	3,745	4,061	4,300
3. **Household consumption**[c] (annual growth rate, %)	1.3	-0.4	-5.7[a]
4. **Gross fixed investments** (annual growth rate, %)	2.0	12.5	1.2[a]
5. **Exports**[d] (annual volume indices)	-13.1	16.6	8.1
6. **Imports**[d] (annual volume indices)	20.9	14.5	-4.0
7. **Trade balance**[e] (million US dollar)	-3,247	-3,635	-2,442
8. **Balance on current account** (million US dollar)	-3,455	-3,911	-2,480
9. **Net convertible currency debt**[f] (million US dollar)	14.927	18,936	16,817
10. **Convertible currency reserves**[f] (in percentage of annual imports in the current account)	59.4	60.2	79.0
11. **Unemployment rate**[g] (%)	12.1	10.4	10.4
12. **Employment**[h] (employees in percentage of population)	42.2	40.2	39.5

(continues)

Table 10

(continued)

Indicators	1993	1994	1995
13. **Balance of the general government** (GFS balance[i], in percentage of GDP)	-5.2	-7.4	-4.0
14. **Inflation** (annual consumer price indices)	22.5	18.8	28.2
15. **Gross average earnings**[j] (annual growth rate, %)	22.0	24.7	16.8
16. **Net average earnings**[j] (annual growth rate, %)	17.9	27.1	12.6
17. **Real wage per wage-earner** (annual growth rate, %)	-3.8	7.0	-12.2

Sources: Row 1, 3, and 4: 1993—1994: Central Statistical Office (1996c), 1995: Central Statistical Office (1996a) and direct communication of the Central Statistical Office; Row 2: Central Statistical Office (1996a); Row 5 and Row 6: 1993—1994: Central Statistical Office (1995c, p. 253), 1995: calculation of the National Bank of Hungary on the basis of data from the Central Statistical Office; Row 7 and 8: 1993: National Bank of Hungary (1995a, p. 109), 1994—1995: Central Statistical Office (1996b, p. 41); Row 9: 1993: National Bank of Hungary (1995a, p. 111), 1994—1995: Central Statistical Office (1996b, p. 41); Row 10: Calculation of the National Bank of Hungary; Row 11: National Bank of Hungary (1996a, p. 57); Row 12: Central Statistical Office (1995d, pp. 4—5); Row 13: National Bank of Hungary (1996c); Row 14: 1993—1994: Central Statistical Office (1995c, p. 286), 1995: Central Statistical Office (1996b, p. 37); Row 15 and Row 16: Central Statistical Office (1996d), 1995: Central Statistical Office (1996b, p. 38); Row 17: 1993—1994: Central Statistical Office (1996d), 1995: Ministry of Finance (1996, Table 14).

Notes: a) Preliminary data. b) Converted from Hungarian forints by the annual average of the official commercial exchange rate. c) Actual final consumption of GDP by households. d) The exports and imports data are based on customs statistics. The imports data include 1993 arms imports from Russia in repayment of earlier debt. e) Trade related payments of the current account. f) December 31. g) Registered unemployed at the end of the year in percentage of the active (employed and unemployed) population in the previous year. h) January 1. i) For more detailed fiscal data and explanation see János Kornai (1996, table 4). j) Gross average earnings of full time employees. 1993—1994: indices are calculated from the data of organizations with more than 20 employees. 1995: indices are calculated from the data of organizations with more than 10 employees.

while there is much dissension and criticism from within the ranks of the main governing party. The Constitutional Court has annulled several essential components of the stabilization act.

The criticism and protest has come in many forms. There are those who only object to the details of its implementation and, above all, the way it was announced. They were not convinced that the "package" was compiled with sufficient care. Many people thought that the decisions on the trade-offs were mistaken: the reduction of the fiscal deficit by a certain amount of *forint* did not compensate for the mass protest provoked by the cut. Many were angry because the government failed to explain patiently and convincingly why the measures were necessary. The restrictive measures were announced in unfeeling style lacking any compassion for the losers. There was indignation in the leading ranks of the Socialist Party and among the trade-union bureaucracy, which is tied to them by many strands, because these weighty measures were taken almost in the form of a coup, without the prior consultation to which they claimed an entitlement.

The question remains: Would the rejection have been so intense if the mistakes of detail and of communication with the public had been avoided, but the essence, the restriction, and the start made on whittling down paternalist welfare expenditure had remained? The answer to this is all the more decisively important because the country is still only at the beginning of the program. Releasing macroeconomic tensions that have built up over twenty or thirty years is not a job to be done by a single, energetic action over a few months. Correcting the deeper disproportions behind the constant reproduction of current-account and budget deficits, reducing the debt, permanently and substantially curbing inflation, and undertaking a comprehensive reform of the welfare sector—these are tasks that will take years and will often demand sacrifices from many people.

The atmosphere is calming down, and people are getting used to the new situation. Could a large part of society come to see the economic need for the measures or at least put up with them without strong protest? Or will the mass protest grow stronger again, leading to comprehensive, long-lasting strike movements and large street demonstrations that undermine the economic results of the stabilization? These questions conclude my initial comments on the political background to the stabilization program. I return to these questions in the final section of the study.

Gradual Transformation of Property Relations and Institutions

Reform of the Hungarian economy's property relations and institutions began in the second half of the 1960s, after the relaxation in the political and ideological spheres. Let us look again at Table 1. Preparations for the first measures of reform took several years. On January 1, 1968, a milestone was reached when the classical command economy suddenly ended, and a curious hybrid form of economy took over.[33]

This was the only sudden "leap" in the history of Hungarian economic reform. Ever since, the transformation of property relations and institutions has taken place gradually, in a series of small steps. The slow economic reform had been progressing for 22 years when the tempestuous political change of 1989–90 occurred. This, however, did not end the gradualism of the transformation taking place in the field of property relations and institutions, although the changes sped up considerably.

Bearing in mind this political turning point, the course of institutional change in the economy can be divided into two phases: a slow and less radical, "reform-socialist" phase (1968–89) and a faster, more radical "post-socialist" phase that still persists.[34] The border between the political periods, however, did not bring a sudden, dramatic change to the institutional structure of the Hungarian economy.

The Historical Conditions and Political Background

At the beginning of the post-socialist transition, a debate broke out over the desirable speed of transformation.[35] Two extreme positions emerged. One was represented earliest and most consistently by Jeffrey Sachs (1990, 1993; Lipton and Sachs, 1990), who believed that most of the transformation should be implemented over a very short period. He himself borrowed the expression "shock therapy" from psychiatry for the program he recommended, but the term "big bang," known from cosmology, became widespread as well.[36] In the early stage of the debate, the most prominent representative of the other position was Peter Murrell, who argued that the transformation would take place gradually, by an evolutionary path, and this was as it should be (1990).[37] This program is usually called "gradualism" in the literature on the subject.

The debate at the time covered both the speed at which to overcome the inherited macroeconomic disequilibria and the speed at which to transform property relations and institutions. Since the first of these has been covered in the previous section, discussion here will be confined to the second.

Some participants in the debate of the time declared allegiance to one of the two "pure" programs. Others took up intermediate positions. Different speeds were recommended for the various dimensions of the transformation,[38] or the choice of the time schedule was made dependent on various specific conditions.[39]

Five or six years have gone by since the post-socialist transition began. Experience already shows that the transformation of property relations and institutions has been taking place at different speeds in the region's various countries.[40] Hungary's road to transforming property relations and building up the institutions of a market economy can be described in various ways: organic development, cautious, moderate, considered progress, or hobbling toward a market economy hampered by frequent hesitation and protest. It is debatable which description fits best (all of them do to some extent), but no one could ever say Hungary had taken a *leap* toward a market economy.

It is tempting to put the differences between countries down to different philosophies among leading figures or perhaps leading groups of a few people, or even to the schools to which the advisers whose recommendations were adopted belonged. These certainly had a part to play. I am inclined to think, however, that the decisive influences were the dissimilar historical antecedents, and the political power relations, structure of society, and public mentality; in other words, factors that limited and affected the choice of political leaders between alternative courses of action. Before entering into more practical detail about Hungary's transformation, let me say something about these historical and political factors. Once again, the intention is not to offer a complete analysis, simply to pick out a few of the many factors.

The "reform of the economic mechanism," the gradual process of transforming Hungary's property relations and economic institutions began in the 1960s, was part of the reaction by the leading political stratum and by the whole society to the trauma of '56. Perhaps only the blindest of party cadres could believe that people had been brought to rebellion in 1956 solely by the incitement of counter-revolutionaries. Many members of the governing elite at the time were shaken in their faith as they set about restoring the socialist system. This was the intellectual soil that the idea of a market-socialist reform managed to fertilize. Right up until the system collapsed in 1990, this kind of thinking led to a search for some acceptable hybrid. They wanted to take market coordination (or some of it) over from capitalism and perhaps something of property relations (as long as it is on a small scale) without giving up their power. The last entailed maintaining the political and military alliance with the Soviet Union, sole rule by the communist party, dominance by the state in controlling the economy, and state ownership of enterprises. There remained in the leading political and economic stratum an extremist type of diehard Stalinist, but this became rare after 1956 and its numbers steadily fell. The vast majority of the elite showed ambivalence or, one might say, political schizophrenia. On the one hand, they wanted to save the communist system, to which they were bound by conviction and self-interest. On the other, they realized the system had to be changed. So, erosion of the system's political base took place first of all inside the minds of these people, as more and more of them abandoned the original, classical communist view on more and more issues in favor of the ideas of reform.

A contribution to formulating this idea was made by a semi-deliberate, semi-unwitting change of world political orientation. Though the party cadres knew they had been restored to power by the armed might of the Soviet Union, anti-Soviet feelings arose in many of them. They looked down on the primitive nature of the Soviet system and felt embarrassed by its barbarity. Concurrently with the domestic reform, the country opened up progressively to Western influence. The public and the *nomenklatura* alike began to travel. They would have liked somehow to marry the efficiency and wealth they saw in the West with the Eastern system on which their power rested.

This curious erosion of old faith is the main reason why the change began early and took place gradually, in many small steps. The relatively most enlightened reformers would put forward specific proposals. Initially these had to be less radical. Later the opposition weakened, and they could apply more radical proposals as well. Many changes took place spontaneously rather than by government order.

There is one further dimension in which the reform ties in with the response to '56. The revolution had broken out as a political, not an economic protest. The post-56 political leadership welcomed developments that distracted the attention of the public from politics, particularly the intelligentsia. One good substitute for politics was for economists, lawyers, engineers, state officials, and managers to rack their brains about reforms and push fervently for their introduction. It was better still if the intelligentsia and the other strata in society concerned themselves with how to earn more money by extra work in the first economy and by various kinds of semi-legal but tolerated activity in the second economy. This was probably the main mechanism for defusing the tensions, as it tied down the energies of society's most active members.

Amidst all these changes, many people also changed their personal course. Within the old socialist society another capitalist society began to take shape. Many individuals began to shift, partly or wholly, across to a position consistent with the new society. The impetus may have come from a change in personal thinking or from the attractions of an entrepreneurial life style. There was a wide distribution in terms of who began to change careers and when and when the change was complete, which meant that for the whole set of the elite there was a continual, gradual transfer.

By the time the political liberation came in 1990, many things were already half-prepared for the development of a market economy. Table 11 shows changes had taken place in Hungary before 1990, of a kind that most countries in the region had to make after 1990. Perhaps more importantly still, far more people in Hungary had gained experience of how a market operates, in the "market-socialist" state-owned enterprises, in the private sector, or the grey economy, or possibly by studying or working abroad.

The transformation sped up considerably after the political renewal. The ideological barriers came down, and there was no more need for euphemism in discussing private property or capitalism or to conceal private ownership of production assets. People were positively encouraged to become entrepreneurs and owners, and the passage of legislation to conform with a market economy sped up enormously in the new democratic Parliament. Yet, this huge acceleration still did not produce a "leap," most of all because leaps cannot be made in this field. Constraints on the "mass production" of legislation are imposed in a constitutional state by the "capacity" of the drafting and legislative organizations. It

Table 11

Chronology of Reform Measures Introduced Before 1990 in Hungary

Reform measures	Hungary	Poland	Czecho-slovakia[a]
Abolition of compulsory delivery system in agriculture	1956	1971	1960
Abolition of mandatory plans	1968	1982	1990
Abolition of central quotas	1968	1991	1990
First steps in price liberalization	1968[b]	1957, 1975[c]	1991
Uniform exchange rates	1981	1990	1991
Entry into IMF and World Bank	1982	1986	1990
Considerable freedom for entrepreneurship and founding private companies	1982	no restrictions	1991
Bankruptcy legislation 1992	1986[d]	1983[e]	1991, 1992
Two-tier banking system	1987	1988	1990
Personal income tax system	1988	1992	1993
Value-added tax system	1988	1993	1991
Legislation on incorporated companies	1989	1990	1991
Liberalization of trade	1989	1990	1991
System of unemployment allowances	1989	1990	1991

Notes: a) Reform measures of the "Prague Spring" that were withdrawn during the Husák restoration are not indicated in the table. b) E.g., 58% of industrial producer prices became market prices, and market prices applied to 21% of spending on consumer goods in 1968. c) Gradual liberalization after 1957; with wave in 1975, when 40-50% of prices were liberalized. d) The first Bankruptcy Act went unenforced; a new act was passed in October 1991. e) This act was not enforced; although it was tightened up in 1988, very few firms went bankrupt.

takes time to abolish old organizations and institute new ones. Even the far more violent communist change of system had taken years to do it. Moreover, the abolition of each organization and position of power evokes opposition of those with a vested interest attached to it, which again slows the process down.

In this respect, the Hungarian transformation backs up the gradualist principle that a coherent system of institutions and customs cannot be transformed all at once. If the "half-ready" market economy of Hungary has taken years to mature and is still not fully developed, the same must be even more true of the others, which had not gone so far as the Hungarian one initially. There is no country whose experience can refute this hypothesis.

"Gradualism Hungarian style" in transforming property relations and institutions was not a result of a grand "master plan." But it would not be correct to accept the pace of Hungary's transformation uncritically as inevitable and determined just by blind fate. Many aspects of it should have been started and completed earlier. The blame for every case of hesitation and protraction rests with those running the process and ultimately with the government of the day. But the retarding factors, like vacillation among the leadership, professional incompetence, inexperience, pliancy in the face of opposition, and, of course, the opposition itself, born of vested interest of various kinds, are all parts of historical reality.

Privatization of State-Owned Enterprises[41]

By the abolition in 1968 of compulsory plan directives, part of one of the fundamental property rights, that of control, passed to the management of the state-owned enterprise. Yet the central authorities continued to intervene in enterprises in many indirect ways. Most importantly, selection, appointment, promotion, and dismissal of managers remained in the party-state's hands (Kornai, 1986). But the managers became a much more influential force, and they became capable of asserting their own ownership interests in the later, post-socialist period as well.

When privatization came onto the agenda after 1990 and new private firms arose on a mass scale, more and more strands tended to combine and merge the sociological groups of managers of state-owned and private firms and owners of independent firms and joint stock or limited companies. A passage opened up between the roles of managers and owners. Ultimately these people together form the "business class." The former army of submissive party stalwarts carrying out plan directives gradually yields candidates for the business and manager stratum of today, which new people also join, of course. This transformation of the leading stratum takes place without bigger interruptions over a period of decades, and speeds up in the 1990s. A good view of the process emerges from Table 12. Sociologist Iván Szelényi (1994) and his fellow researchers have shown the extent of continuity in the

Table 12

The Origin of Hungary's New Elites and New Economic Elite

Position held in 1988	All new elites (1993)	New economic elite (1993)
Nomenklatura	32.7	34.8
Other high officials	47.5	54.7
Non-elite	19.8	10.5

Source: Iván Szelényi (1994, p. 39).

Note: Based on life-history interviews with members of the economic, political and cultural elites in 1993. Samples: 783 (all), 489 (economic).

economic elite,[42] despite the strongly anti-communist rhetoric of the coalition that took office in 1990 and its attempts to implant its party supporters in many business positions. In fact, most of its own business people came from the old economic elite as well.

Hungary in 1988 was the first socialist country to pass a so-called Company Act whereby state-owned enterprises could commercialize and convert themselves into modern company form. The first privatizations took place before 1990, but only after 1990 did privatization become one of the prominent features of government policy. Both the governing and the opposition parties agreed that the privatization should fundamentally take place by sale on the market, not free distribution,[43] and this is what happened.[44] So the Hungarian road to privatization differs sharply, in its prior announcements and programs and in the actual course of events, from that in other countries, above all the Czech Republic and Russia, where much of the state property was handed free of charge to citizens or to managers and employees of firms.[45]

Let me pick out some characteristics of the Hungarian privatization process.[46]

Many commentators on events in Eastern Europe, politicians, journalists, and sometimes even representatives of international financial organizations, have dwelt on a single index: What percentage of the original state sector has been "privatized," that is, no longer counts as state-owned enterprise. Taking this figure alone, roughly half the state-enterprise sector in Hungary had been privatized by July 1994 (see Table 13). For about a year under the new government there had been no further substantial progress made that would change this aggregate index (Mihályi, 1995). At the end of 1995, however, the process accelerated spectacularly when large parts of the electricity, gas, and oil sector, and telecommunication had been privatized, mostly to foreign investors, and also the privatization of the banking sector

Table 13

Degree of Privatization in Hungary

June 30, 1994

Method of privatization or decreasing of state assets	Percentage of book value of state assets in 1990[a]
1. Total assets of companies 100% sold	11.5
2. Total assets of companies in majority private ownership	10.1
3. Shares in private hands of companies in majority state ownership	4.5
4. Assets sold by enterprises or companies managed by State Property Agency (ÁVÜ) or State Asset Management (ÁV Rt.), and assets they invested in new companies	4.4
5. Small-scale "pre-privatization" sales[b]	0.9
6. Assets of firms in liquidation[c]	15.8
1—6. Degree of privatization; the assets of the ÁVÜ and ÁV Rt. affected by privatization	**47.2**

Notes: According to Crane (1996), based on the information provided by the Hungarian privatization agency, ". . . over 85 percent of Hungary's productive capital stock should be in private hands by the end of 1997" (p. 14). a) The book value of the state's assets was established in 1990 by methods agreed with the World Bank; the total was put at HUF 2000 bn at the time. b) State assets sold under the pre-privatization act of 1990 (some 10,000 establishments, mainly commercial and catering premises). c) Assets of firms that underwent liquidation proceedings; there has been practically no privatization revenue from these.

gained momentum. The present government has promised to complete privatization by 1998.

This single index in itself says little, however, for it may distort the true property relations and poses many problems of measurement. A private owner with a mere 20–25 percent of the shares may play a dominant role in a joint stock company if he or she sets the tone on the board and the representative of the state's stake remains passive. There also may be cross-ownership; the state as such is no longer the owner of the company, but there is a big stake and influence held by a state-owned bank.[47]

The main issue is not the proportion of assets privatized, but the results (permanent, not momentary) some privatization strategy generates. I would like to contribute to clarifying this by describing a few experiences in Hungary:

1. *Recombination of property; variety of forms.* Privatization in Hungary is often linked with reorganization and restructuring. Many enterprises break down into smaller firms. Some of these pass into private ownership and some into mixed ownership. The remainder continue to be owned by the state, perhaps indirectly, with the reorganized firm becoming the property of other state-owned firms or banks (cross-ownership). There is a real proliferation of the most diverse property constellations, to use Stark's (1994) apt expression, a recombination of property.

Privatization takes place in various legal and organizational forms through a variety of "techniques." The largest and most valuable enterprises are sold by the central agencies by competitive bidding or auction. For smaller and medium-sized firms there are several simplified procedures for transferring the property rights. Where possible, shares are sold for cash, but there are various credit schemes as well, some of which charge market interest rates. There are also credit schemes with preferential interest and repayment terms designed to promote purchases by domestic entrepreneurs. With some firms, all or the majority of shares are sold at once, while with others they are offered gradually, in stages. There are special procedures to facilitate management or employees' buy-outs. Although it has rarely happened so far, there are plans for investment companies to take over the shares of several state-owned firms so that buyers will be able to purchase mixed portfolios. All these forms have arisen by trial and error, not out of any preconceived, uniform plan or central directive. Sometimes consideration for the government's political popularity has caused some form or other to be promoted or relegated.

Hungarian privatization can certainly not be accused of proceeding in a "constructivist" manner (to borrow Hayek's phrase). On the contrary, it is full of improvisation. Previously determined concepts may be withdrawn, and a campaign launched to speed events up, only for the delays to begin again, and so on. The experimentation, on the one hand, creates legal uncertainties and delay, protracting the privatization process, which dampens the enthusiasm of buyers and investors. On the other hand, it allows lessons to be learned from mistakes and new methods to be tried, which many people consider one of the main advantages of evolutionary development (Murrell, 1992).

Unfortunately, long months passed after the formation of the new government in mid-1994 before it had assembled its privatization ideas and submitted a new privatization bill, which Parliament then enacted.

The privatization process is a curious mixture of centralized and decentralized, bureaucratic and market actions. Gigantic central bureaucracies were created, and they are seeking to seize control for themselves in repeated campaigns or at least to obtain strict supervision over them. Yet time and again, events slip from their grasp.

2. *"Crumbling away."* In fact, some former state-owned enterprises in their original form have a negative market value, because they can only be run at a loss. This state property worth a minus sum has been "crumbling away" along the

Hungarian road to privatization. The enterprise is wound up by judicial proceedings, and only its material assets are sold. Or part of the true commercial value, particularly the intangible parts of it (commercial goodwill, expertise, or the routine of production, buying, and selling), is siphoned off into private firms in legal or illegal ways. Both these processes form important components of the formal and informal privatization of the state's wealth. In evaluating the crumbling-away process, two closely connected aspects of it must be distinguished. One is the decline in *real* wealth. Some physical productive capital is lost irrevocably in the process of liquidation and change of ownership, while some intellectual capital becomes unusable as well. There are no reliable estimates for this, but expert observers are unanimous in stating that the loss of real wealth is very significant. It is far more common and on a greater scale than the structural change in the economy renders inevitable. The other, completely separable aspect is the *loss of wealth by the state as owner*. The wealth may remain, but the new, private owner has not given adequate compensation to the old owner, the state. To put it plainly, the state has had its pocket picked, even though the new owners may make good use of the appropriated wealth for their own benefit. I will return to this phenomenon, confining myself here to underlining that the process of crumbling away provides clear opportunities for squandering the state's property on the seller's side and for legalized theft of it on the buyer's (Bossányi, 1995).

3. *Revenue from privatization.* Privatization has yielded substantial fiscal revenue, which have amounted to USD 7,427 million by the end of 1995[48] (see Table 14). This is a major advantage of the sales strategy over free distribution, although the proceeds have been less than hoped for, with much being deducted by the high costs of privatization and the central agencies. Nonetheless, the revenue makes no small contribution to a state with serious fiscal problems. Some of the most important acts, including the privatization of electricity and gas

Table 14

Privatization Revenue, 1990—95

Sources and forms of revenue	Direct privatization revenue from sales of existing assets (USD million) 1990—93 (total)	1994	1995	**1990—95 (total)**
From foreign clients	1,528	123	3,122	**4,773**
From domestic clients (cash)	609	228	195	**1,031**
From domestic clients (credits)	354	279	30	**663**
Compensation bonds	209	611	140	**960**
Total	**2,700**	**1,241**	**3,486**	**7,427**

Source: State Property Agency (ÁVÜ), State Asset Management (ÁV Rt.) and State Privatization and Property Management (ÁPV Rt.); Communication by Péter Mihályi.

production and distribution and the sale of oil and oil products, generated significant revenue.

The most important advantage, though, is not the "tangible" fiscal revenue, but the favorable changes described in the next point.

4. *Real owners; injections of capital.* Because assets of the state must be paid for, a high proportion of cases involve the immediate appearance of real owners (individual or corporate, domestic or foreign) who exercise real control over the managers. (In the comparatively rare cases of management buy-out, the management and the owners become the same.) Even when a majority is not obtained, a strategic investor's influence will be much stronger than the shares held, in many cases even against a majority shareholding by the state. The presence of the new owner is felt particularly where full or partial ownership has passed to a foreign firm or individual.

Privatization by sale produces favorable conditions and strong incentives for reorganization and a new, effective style of corporate governance. This contributes to the fact that privatized Hungarian firms soon surpass state-owned firms in their performance (see Table 15).

Many state-owned enterprises are run-down and in great need of a "capital injection": the investment they require for restructuring. A commitment by the buyer to invest new

Table 15

Profitability of Privatized Companies in 1992

Branch	Gross profitability[a] Privatized companies	Branch average
Mining	1	-8
Metallurgy	-2	-12
Engineering	2	-11
Non-metallic ores	5	-1
Chemicals	15	5
Textiles and garments	9	-2
Timber, paper and printing	6	12
Food, beverages and tobacco	7	-1
Other manufacturing	-2	2
Construction	8	3
Agriculture	0	-4
Commerce	8	1
Accommodation, services	6	6
Transportation, warehousing	5	2

Source: Mária Vanicsek (1995).

Note: a) Index of gross profitability employed: cash flow (profit plus depreciation) over total assets.

capital within a short time often appears in the terms of the sales contract. Where there are several potential buyers, the amount of new investment promised is often a selection criterion alongside the price offered. Even if this is not spelled out in the contract, the owners will normally be aware when they buy that the firm needs development and set about it quickly. Countless examples of this have occurred in Hungarian practice. This is one of the most important advantages over free distribution, which transfers ownership to penniless people unwilling and unable to invest.

5. *The shorter side: the privatization supply.* One argument often brought up against the idea of privatization by sale is that the savings accumulated by the public were too small for them to buy the state's wealth. Disconcerting calculations appeared at the time showing how many decades it would take to sell all the assets given the low initial stock of savings.

Experience has shown this is not the real bottleneck in the privatization process. There are potential foreign buyers with sufficient purchasing power, and savings have meanwhile been accumulating in the hands of Hungarian entrepreneurs and more widely by the Hungarian public.

The real problem throughout has been to make the privatization supply attractive enough, and it worsens as the privatization process in Hungary proceeds. Most of the coveted items in the supply have gone, apart from a few more large public utilities, which have been purposely held back. Many of the foreign investors, even so far, have preferred to make a "green-field" investment in a new plant. Many domestic investors prefer to buy safe, high-yielding Hungarian government bonds with their money, put it in a foreign-currency account at a Hungarian bank, send it abroad illegally, or invest it in a newly established private Hungarian firm, rather than buy shares in firms under privatization. Even if the most favorable credit conditions and the biggest concessions are offered, bordering on free distribution, the demand for the less attractive enterprises is thin. This suggests that the viability of many state-owned enterprises is questionable.

6. *The purity of privatization.* Events are constantly being infiltrated by politics. Every political force that gains governmental power also constitutes a community of interests intent on helping its clients to gain good positions. Augmenting this are similar endeavors by other political strands and various groups in the bureaucracy. In Hungarian society, as in every living social organism, there operate networks of various kinds, whose members are intent on helping each other's careers in the hope of reciprocal assistance (Stark, 1990). The owners of every newly privatized firm, and new private firms, are glad to bring onto their boards both members of the old *nomenklatura* and members of the new, leading political groupings, for they know such people have valuable connections.

There is widely thought to have been a lot of corruption during the privatization process. This is presumably true, although no specific exposure of a single case of corruption has been made. Certainly, the suspicion of corruption and opaqueness in the process have helped cause a further fall in the popularity of privatization from an already mediocre initial level.[49]

I will not venture, even with hindsight, a simple yes or no answer to the question of whether Hungary's privatization strategy has been better or worse on the whole than others. To sum up, I can say only that the gradualism applied to privatization in Hungary, as a spontaneous, wildly proliferating, evolutionary process, presents clearly favorable and unfavorable, attractive and unattractive features. The expression "gradualism of privatization, Hungarian style" contains a modicum of national pride and at least as much of self-mockery. But it certainly seems that the strategy *works* and will result, in the foreseeable future, in the privatization of the enterprises that are viable and not expedient to retain in state ownership. Certainly, the process might have been faster, even supposing the same general strategy had been employed, if the administration at any time had been more forceful and skillful and had shown greater confidence in the decentralized mechanisms. However, even if these weaknesses of Hungarian privatization and the resistance to it mean it is not completed for another few years, it will still have taken place at lightning speed when compared with other changes of ownership relations in world history.

New Private Businesses

Like many other economists, I was convinced from the outset that the key factor in changing property relations, at least in Eastern Europe's smaller countries, was the appearance of new private undertakings (Kornai, 1986, [1989]1990, 1992a). This was different from the ideas of those who wanted to concentrate attention on privatizing the hitherto state-owned enterprises. I argued that even if the new private businesses only accounted for a time for a smaller proportion of production, their vigor would make them the real engine of post-socialist transformation.

An appreciable development of Hungary's private sector had begun before the change of political system (see Tables 16 and 17). Hungary was not alone in this, for East Germany, Poland, and Yugoslavia also had sizeable private sectors, but the development in Hungary had gone further by 1990 than it had elsewhere. The process was moving along two parallel paths.

One path is development of the legal private sector (Gábor, 1979, 1985; Laky, 1984; Seleny, 1993). The rigid anti-capitalist prohibitions of classical, Stalinist socialism began slowly and, if possible, imperceptibly to ease in the reform-socialist period. The process began to speed up in 1982, when it became possible to found various forms of private companies and conditions for self-employment also became more favorable.

Table 16

Number of Active Earners Engaged in Individual Businesses or

Non-incorporated Business Associations in 1981–94 (1,000)

Year (Jan. 1)	Self-Employed	Family Members assisting	Employees	Alto-gether	In percentage of active earners
1981	118.[illegible]	61.8	0.3	180.3	3.6
1989	21[illegible]	81.0	48.0	347.4	7.2
1992	[illegible]	97.4	144.0	707.4	16.7
1994				805.1	21.7

Forrás: [illegible]z Laky (1995, p. 686).

There was a huge increase in the rate at which private businesses appeared after 1990 (see Tables 16 and 17).[50] This brought with it a structural transformation of production. The excessive concentration of production lessened; masses of small and medium-sized firms came into being. The relative proportions of the branches changed with a rise in the weight of the services after decades of neglect.

The other path by which the private sector develops is through the expansion of semi-legal and illegal activity. This was viewed kindly by advocates of the market economy before the political turning point as the only way, in many fields, of circumventing the restrictions imposed by ideological bias. The "shadow economy" was a kind of civil-disobedience movement against the bureaucratic constraints. The moral and political standing of the grey and black economy changed increasingly after 1990. It could be interpreted not as acceptable civil disobedience any longer, but as evasion of civic responsibilities, taxes, customs duties, and social-insurance contributions.

According to the latest estimate, compiled with particular pains, 30 percent of "real" (registered and unregistered) GDP

Table 17

Trend in the Numbers of the Main Types of Incorporated Business Association in Hungary, 1989—95

Type of association	1989	1992	1994	1995
Enterprise[a]	2,400	1,733	821	761
Private limited company	4,484	57,262	87,957	102,697
Joint stock company	307	1,712	2,896	3,186
Cooperatives[b]	7,076	7,694	8,252	8,321

Source: Central Statistical Office (1994d, p. 115) and (1996e, p. 120).

Notes: The data refer to December of the year given. a) The term enterprise covers the former socialist state-owned enterprises. These were gradually converted into companies during the transition. b) Cooperatives include agricultural cooperatives, housing, savings and credit cooperatives, consumer cooperatives, and miscellaneous cooperatives. In April 1995 about a quarter of the cooperatives were engaged in agriculture, a quarter on the real-estate and housing market, and over a third in manufacturing or construction.

derives from the grey and black economy (Árvay and Vértes, 1994; Lackó, 1995). Unfortunately, continuity also applies to willingness to pay taxes. Moral norms and behavioral rules instilled over decades alter at a snail's pace. Indeed, if taxpaying morality is altering at all, it seems to be changing in many cases for the worse. Those who infringe regulations had more to fear from the dictatorial state. Moreover, the sums at stake have become much greater; tax fraud and utilization of legal loopholes can earn their perpetrators much greater sums.

There is not just a handful of tax evaders at work, whom a strict fiscal authority can easily detect. There are not just organized criminals at work, whom the police have to catch. Almost the whole Hungarian population takes part, actively or tacitly. The "savings" from evading tax and other levies are shared between seller and buyer, employer and employee, and the customs-evading professional smuggler or "shopping tourist" and the consumer of the smuggled goods. The question of extending taxation to the grey economy is political, not just economic. It would be popular if the police or tax office could catch a few very rich people in the act of illegal tax fraud. But if they start applying more methodical controls—seeing whether traders and service providers give receipts, all employees are registered, or small and medium-scale entrepreneurs' declared incomes square with their life styles—they will arouse opposition. No government has attempted to do this except for one or two hesitant experiments.

Privatization and the genesis of new private enterprise led between them to half of total (recorded and unrecorded) GDP being derived from the private sector by 1992, and the proportion has risen further since then (see Table 18). By 1994, the share of the private sector in the recorded GDP amounted to 60 percent (Central Statistical Office, 1996f, p. 141). The private sector's share of employment is even greater.

I must mention how foreign capital is involved in the Hungarian private sector. Its share of recorded Hungarian GDP was 10.4 percent in 1994 (Central Statistical Office, 1996f, p. 141), but the effect of its appearance is disproportionally greater, making a big contribution to modernization of the economy. The volume of foreign direct investment in the 1990s has been far greater in Hungary than in the other post-socialist countries of Eastern Europe (see Table 19).[51] Statements by foreign investors suggest the attraction was mainly the consolidated state of Hungary's market economy.[52]

Table 18

Contributions of Ownership Sectors to Total GDP, 1980—92

Ownership sector	Contribution to total GDP (%)					
	1980	1985	1989	1990	1991	1992
Public ownership	83	79	74	70	63	50
Private ownership of which:	17	21	26	30	37	50
Domestic	17	21	26	29	34	42
Foreign	0	0	0	1	3	8
Total	100	100	100	100	100	100

Source: Árvay and Vértes (1994, p. 18).

Note: Total GDP is the sum of the contribution of the recorded and unrecorded economy.

Liberalization and Reform of the Legal Infrastructure

By liberalization I mean all changes that rescind earlier legal restrictions, administrative constraints, and bureaucratic regulations on economic activity. Without wholly coinciding with the categories of decentralization and deregulation, the concept largely overlaps with them.

Liberalization of many provinces of economic decision-making has taken place gradually, in many small stages, in Hungary since 1968. The process of price and export liberalization sped up markedly after 1990 and concluded in a relatively short time.[53] The government cannot be said to have applied a sudden, "shock-like" liberalization if for no other reason than because partial freeing of prices and imports had already occurred, and the bulk of import liberalization was accomplished in the four-year period of 1989–92.[54]

Central wage controls were abolished in 1992, quite soon after the change of political system. Nor was the special tax to

Table 19

Foreign Direct Investment in the Transition Countries, 1990—94

(Cash basis, cumulative total)

Country	Cumulative totals[a] (USD mn)			FDI per capita
	1990	1992	1994	1994 (USD)
Albania	—	20	116	36
Bulgaria	4	102	205	23
Croatia	—	16	104	22
Czech Republic	436	1,951	3,319	319
Hungary	526	3,456	6,941	670
Poland	94	495	1,602	42
Romania	—	120	501	22
Slovakia	28	210	434	102
Slovenia	7	183	374	185
FYR of Macedonia	—	—	5	3
Eastern Europe	**1,095**	**6,552**	**13,608**	**126**
Commonwealth of Independent States[b]	**—**	**1,761**	**4,622**	**22**
Baltic States	**—**	**111**	**811**	**102**
Total	**1,095**	**8,424**	**19,041**	**58**

Source: United Nations, Economic Commission for Europe (1995, p. 151).

Note: a) Cumulations of inward foreign investment from 1988. b) European countries only.

curb the running away of wages retained. However, there was steady development of a central "interest-arbitration" procedure between the government and the employers' and employees' organizations to influence wage trends. I will return to this later.

Investment projects before the reform of 1968 were carried out by central state decision and financed out of the central budget. Decentralization of this sphere of decision-making began decades ago as well (see Table 20). After the change of system, the transformation of property relations went on to institutionalize the distribution of decision-making rights customary in a market economy, whereby the central state authorities only decide on projects they finance themselves and have a say in decisions on projects they help to finance.

A measure of liberalization has occurred in foreign-exchange management as well, most of it since 1990. The Hungarian *forint* became partially convertible in 1992 (for the current payment transactions of banks and enterprises), but international capital transactions remained subject to official

Table 20

The Proportion of State-Controlled Investment, 1968—90

Year	Proportion of investment decided by the state in total investment spending (%)
1968	51
1975	44
1980	46
1985	42
1989	33
1990	29

Sources: 1968: Central Statistical Office (1974, p. 95); 1975: Central Statistical Office (1976, p. 80); 1980: Central Statistical Office (1981, p. 117); 1985, 1989 and 1990: Central Statistical Office (1991, p. 69).

Note: In the domain of state-controlled investment the decision was made at central state level and the funds came from the state budget. Remaining investment was decided at enterprise or cooperative level and funded partly from the enterprise or cooperative's own resources and partly from credit.

permit. Under the new exchange act, the convertibility of the *forint* was extended in 1996, although certain restrictions on conversion transactions by individuals and on capital transactions remain. The official exchange rate has hitherto been determined centrally, although free-market ("black") foreign-exchange trading has been tolerated. Periodic devaluations of the *forint* have been necessitated for years by inflation, but there was no rule of any kind to govern the timing or scale of devaluations before the stabilization program was announced in March 1995. Since then, as mentioned before, there has been continual devaluation according to a detailed schedule announced in advance.

Not for a moment has the principle of *laissez-faire* applied in a pure and extreme form in Hungary. Agencies of the bureaucratic command economy gradually turned into agencies of state supervision and partial regulation. In many instances, an earlier bureaucratic authority was abolished, and another, more "market-compatible" one eventually emerged, resembling more closely the supervisory and regulatory bodies of other market economies. For instance, the following agencies arose: the Economic Competition Office (an anti-trust agency), the Bank Inspectorate, Insurance Inspectorate, Securities Inspectorate, Ministry of Environmental Protection and Regional Development, and National Labor Centre. A Tax and Financial Office was created for the collection of personal income tax and value added tax, taxes that were patterned after the tax system in developed market economies.

The process of drafting legislation to conform with a market economy and repealing laws contrary to it began several years before the turning point of 1990. Although transformation of the "legal infrastructure" has again taken place gradually, in several steps, the earlier start and intensive work done have allowed Hungary in this respect to retain several advantages over the other countries in the region. The most important legislation for the operation of a market economy was in place by 1992–93. The courts and other law-enforcement and judicial organizations, along with the lawyers representing firms and individuals, began to obtain experience in ensuring the implementation of these acts.

I would not like to give the impression that an ideal combination of market and bureaucratic coordination had arisen in Hungary. It is doubtful, of course, whether such a combination exists anywhere. Certainly, both the market and the bureaucracy in Hungary today operate with a great deal of friction. Adequate supervision and legal regulation are lacking in areas where they are clearly needed.[55] However, there is still too much bureaucratic intervention in areas where it is superfluous, and in areas where bureaucracy is inevitable, it often works in a sluggish, unprofessional way.

Corporatist Formations

Trade unions under the socialist system had no great influence on the country's economic policy. They were confined to protecting employees' interests in job-related and enterprise matters. Trade-union leaders were appointed and supervised in their work by the communist party.

Political pluralism provided a chance for trade-union autonomy to develop. The legal successors of the "official" union movement of the old regime, eager to survive, sought to gain popularity by representing employees' interests as effectively as possible. New unions started alongside the old, and competition for members among the various alternative unions began. Relatively little attention was paid to unionism by the new parties in Parliament except for the Socialists, although its influence is substantial, especially in times of grave economic burdens on employees with declining real wages and rising unemployment. The successor to the old "official" union (MSZOSZ) became the strongest of the rival union movements.

National employers' federations were also founded. They, however, have so far had less say than the employees' union, perhaps because there is still not much intertwining between politics and business. The legal and semi-legal frames for business people to influence elections and political power relations by contributing money did not yet develop. The government at any time is more afraid of the employees' than of the employers' organizations.

A central framework for coordinating the views of the government and the employees' and employers' organizations on economic policy came into being in 1988;[56] it is known as the Interest Conciliation Council. Here the union movement has been demanding more and more vehemently that close attention be paid to its views, not only on wage policy, but in the preparation of every other major economic-policy decision. The scope of central coordination of interests is not fully institutionalized, but it is heading in that direction. This adds a major corporatist component to the Hungarian political and economic system. Intertwining of the state and unions was increased by the electoral alliance formed before the 1994 general elections by the Socialist Party and the MSZOSZ, several of whose senior officials were elected to Parliament, where they have joined the governing Socialist Party's faction.

Closely related to this trend are the changes in the way Hungary's social-insurance system is organized. The pension system and the health-insurance system were both branches of the central bureaucracy of the state, and the so-called social-insurance contribution was clearly a state tax. The expenditure of the pension and health-insurance systems was covered in practice out of the state budget.

Some separation of the finances of these two great "distribution systems" from the central government budget had begun before the political change. The profound change, essential from the political and sociological point of view, came with legislation embodying the principle of self-governance for the two social-insurance systems (to cover pensions and health insurance). The law stated that these two organizations were to be run jointly by representatives of the employers and the employees. For the employers, the employers' federations delegate the representatives, while the representatives of the employees are elected by those entitled to the provision. Under the special election procedures prescribed, the candidates are put up by the trade unions, not political parties. The first such elections brought a sweeping victory for the candidates of the MSZOSZ. Through this "personal union" the dominant trade-union movement exercises a controlling influence over the two vast apparatuses. This, of course, has further legitimized the movement's demand for a greater say in the country's affairs and has strengthened the corporatist strands in the fabric of social and economic relations.

As far as I know, the course of development in Hungary is unique in this respect. There are extremely strong formal and informal strands binding together the government, the Socialist Party with its majority in Parliament, the social-insurance system, and the strongest union federation. Perhaps only the social and economic structure of Israel has shown some similar features.[57]

The acquisition of corporatist traits is leaving its mark on Hungary's economic development. While the country continued on the well-trodden "Hungarian road," the mutual willingness to compromise shown by the government, unions, and employers fit in well, not least because they concluded no agreement likely to arouse widespread public protest.

It was not surprising that when the government announced its restrictive stabilization program, it broke the established corporatist conventions. There was no prior agreement with the unions and employers before the program was put forward. Negotiations had been going on in the previous months. The Interest Conciliation Council had met several times and the prospect of concluding a "social and economic compact" was raised repeatedly. But they could not agree. In the end, the government decided to present employees and employers alike with a *fait accompli.* Since then there has been some effort on the side of the government to negotiate with the trade unions and other associations representing various interest groups, leading to some partial agreements. Still, there is no general "Social Compact." The question is how long this state of "neither-agreement-nor-confrontation" can be sustained.

Concluding Remarks in Terms of Political Economy and Political Philosophy

Positive Political Economy[58]

This study approaches the history of the Hungarian economy's development and transformation from the angle of positive political economy.[59] The question I have tried to answer is not whether the Hungarian road of post-socialist political and economic transition is "good" or better or worse than the ones on which governments with other programs have taken their countries. I wanted to know *why* Hungary's transformation was on a different road. My answer is certainly not full and may contain mistakes, but I am sure it was justified and important to raise the question.

I have sometimes heard economists who agreed to act as advisers and then found their advice was not followed make statements like this: "My proposals were correct, but these selfish and stupid politicians have subordinated economic rationalism to their own criteria" or, "The proposal was correct from an economic point of view, but it was not politically feasible."

Though psychologically understandable, this reaction has nothing to do with a scientific approach.[60] The sphere of politics is not an external circumstance for the economy but one of the main endogenous actors in it. For positive political economy, this is the axiomatic point of departure for analysis. The quest is to know what makes a proposal politically feasible. What kinds of behavior are typical of the political sphere of the country concerned, and what are the typical solutions to dilemmas? Or to go a stage deeper, why have the particular typical political constraints and kinds of behavior evolved? Why are the dilemmas solved in this way, not in some other?

Economists brought up on welfare economics are inclined to take the "welfare function" for granted, expect every government to strive to maximize this function, and criticize a government that departs from the optimum.

This study suggests another approach, to some extent by analogy with the theory of revealed preferences. A specific historical process has occurred in which governments took active part. Can a degree of consistency in time be observed in the actions of the governments? If so, let us construct subsequently the objective function that the political leaders actually maximized or the preferences revealed in their actions.

By following this line of thought, the study has arrived at two conclusions: (i) There was a consistency in time in the economic policy of the successive, in many respects dissimilar, governments from the 1960s right up to the spring of 1995. (ii) They showed clearly discernible preferences. They wanted to avoid conflicts. They wanted as far as possible to ensure the uninterrupted survival of the economic elite and continual additions to it of people from the new political forces. They were not prepared to take radical, unpopular action. They aimed at short-term maximization of consumption, accepting as a trade-off the accumulation of social debt.

These revealed preferences go a long way to explaining the macroeconomic proportions that emerged, the constant redistributive concessions, and the gradualism typifying Hungarian development.

The preference system of Hungary's economic politicians was consistent inasmuch as it accepted, at least implicitly, the time-preference, that is, the point in the "now-or-later" trade-off attractive to them.

But I consider fairly inconsistent the position often taken by foreign observers, for instance several staff members of the International Monetary Fund and the World Bank, who were enthusiastic over a long period in praising the Hungarian reform, its gradualism, and the concomitant political consensus and calm, including the continuation of this policy after 1990. Hungary was the gradualist "success story." Nowadays, I have often heard the same economists say something like this: "We are disillusioned with Hungary. It used to be the model-country, but now its results are far worse than those of other, more successful post-socialist countries."

The disillusioned omit to consider the essential causal connection. Hungary now displays an unfavorable macroeconomic performance *precisely because* it previously stuck to the road of Hungarian reform and "gradualism Hungarian style" applied.

The revealed preferences of Hungarian policy can be deduced not from the programs announced in advance by politicians, but by what occurred. Rhetoric can say one thing and deeds another. It is not certain either that the politicians, individuals, and groups succeeding each other in positions of power really wanted to see what actually ensued. It may be, for instance, that they never fully thought through the "now-or-later" dilemma. They may have convinced themselves that they were only putting aside certain tasks temporarily until they were over some urgent problem. The approach in this study is not intended to interpret the politicians' psychology or to measure of their candor, deliberation, and foresight but the actual routines, conditioned reflexes, and decision-making regularities revealed in their deeds.

Further Remarks on Inter-Generational Time Preferences

Although it is not the main purpose of this study to assess development in the past, I cannot avoid in these final remarks addressing the question of whether the preferences of successive Hungarian governments deserve approval. The first aspect to clarify is *whose* approval is concerned. Can historians or research economists analyzing the period *ex post* seek to apply their own scale of values? They can, but if that is the case let it be stated, and let the value system concerned be declared. I have not aimed in this study to judge the past by my scale of values. What has concerned me more is to try to find the *internal* value judgement in the society examined.

Let us again take as an example the problem of "now or later" and compare in light of it the life stories of two Hungarian citizens, A and B.

A was born in 1920 and died in 1993.[61] He was starting out on his career when the first change of political regime began. By the time he was 70, A had lived under seven regimes.[62] The rule and collapse of most were accompanied by war, revolution, repression, bloodshed, imprisonment, and executions. As far as I know, Hungary set a world record by squeezing seven regimes, that is, six changes of system, into 47 years of modern history.[63] It was a benefit to have relative calm in the last thirty years, during the majority of A's adult life. If his material welfare matched the Hungarian average, it improved greatly to start with and deteriorated relatively little later. He did not live to see the time when a start had to be made to paying the bill for the earlier policy preference.

B's life differs from A's significantly. He was born in 1970 and started work in 1993. Two years later, in the spring of 1995, he began to pay the bill for the short-sighted policies of the previous regime and was likely to continue for a long time. As a working adult, however, he never felt that policy's relative benefits.

So what did Hungarian development in the last three decades, with its curious time-preference, mean in terms of material welfare, security, and calm? Let me repeat the question, now using the example: To whom?[64] For the older A it was favorable, more favorable than if he had lived in a communist country which had set little store by the population's standard of living and for that reason applied stronger repression. For the younger B, however, it was not favorable, because he inherited a bigger social debt than his contemporaries in countries where the political power had applied greater restriction.

Several general conclusions can be drawn from the line of thought so far. Consistent assessment of any past period must be based on normative postulates. Alternative postulates will yield different inter-generational distributive principles. In other words, divergent principles emerge for distributing the advantages and drawbacks, benefits and losses fairly between generations. At this point we touch upon the theoretically difficult issues of interpersonal comparisons of individual utilities and the possibilities and limits of creating a social welfare function.[65] There is a rich, well-expanded literature on the ethics and economic applications of ethical theory for distribution within the same generation, but to my knowledge, a dynamic generalization, that is, a normative theory of inter-generational distribution, is still comparatively immature. There are no well elaborated principles of economic ethics to say what "advance" the present generation can be allowed to draw at the expense of the next, which will have to pay it back. In other words, there are no rules to say what positive or negative legacy the present generation is obliged (or permitted) to bequeath to the future.

Economists, including the author, tend to take as "given," when considering long-term economic development, the social discount rate that should express the time-preference of society. Yet, we know what a decisive role this discount rate plays in every theoretical and quantitative model to determine the optimum savings and investment rate and the optimum path of growth.[66]

The problem is that the social discount rate is not "given" at all. The theory that it finds expression in the prevailing real market rate of interest is strongly disputed (Barro, 1974). The earlier example of the time-preferences of the two Hungarian citizens shows that behind the dilemma lies a deep ethical problem. It is not at all self-evident how one should "average" the time-preferences of people with different destinies.

If these difficulties obtain, who authorized us, as economists taking positions on matters of economic policy, to adjudicate on this dilemma? What right have we to decide what weight to give in the inter-generational welfare function—even if it is for the retrospective assessment of economic history—to the benefits enjoyed and losses incurred by the different generations? It is especially offensive that most of us, failing even to discern the ethical problem behind their historical judgements, brashly declare that Country X's policy was right and Country Y's was wrong.

Mention of "authorization" leads to the question of the legitimacy of choice. When examining legitimacy, the analysis should again begin with a *positive* scientific approach. It is understandable psychologically for generations that have suffered much to disregard the legacy they leave to later generations. It is understandable that A and his contemporaries, having gone through so much suffering, wanted to secure themselves a slightly better, more peaceful life.

Of course, most of those in society have lived through a stretch of both periods and start to pay off the bill in their lifetime. Relative weighting of present and future value takes place in the thinking of these people themselves, and the spread is certainly wide. If the time-preference differs from person to person, people under a democratic political structure have the right to express their preferences as a political choice. Many people try to do that in elections and by other political acts.

This leads to a fundamental question: To what extent can a government be expected to act always the way the citizens expect it to? I would like now to present this problem not just in relation to the "now-or-later" dilemma, but in more general terms, with special heed to the post-socialist transformation.

With or Against the Stream?

Communist ideology has a Messianic nature. Sincere believers in it are sure the system they want to apply is the only redeeming social system. This has to be accomplished even though people have not realized what their true interests dictate. Stalinist socialism put the vast majority of Eastern Europeans off Messianic doctrines for life. They want nothing more to do with systems that try to bestow happiness on them by force.

The Kádár regime marked a change in that it tried to confine such forced bestowal of happiness to narrower bounds. In Bolshevik terminology, this was "opportunism," a policy of "following in the wake of the masses." The Kádár regime was far from a political democracy, for which the underlying institutions were lacking. But Kádárite politicians resembled those of a parliamentary democracy in trying to form groups of supporters among certain sections of the population and represent their interests. This political endeavor reached fulfilment later, after 1990, when the success of every party and political movement, the seat of every member of Parliament, and the acquisition of governmental positions depends on the voters.

A Messianic politician feels authorized to impose his or her program by force. The more democratic politics become, the more a politician needs mass support to implement a program of any kind.

The Hungarian road of transition to a market economy, displaying the four characteristics described in this study, proved to be a policy that tended to receive mass support to a greater extent (or at least to be less likely to meet resistance) than ideas directed at a radical correction of macro tensions. This policy exacted a great price, however, with succeeding generations pushing before them an ever greater and more perilous quantity of social debt. But must happiness be bestowed on them against their wishes and will?

Here I would like to return to the stabilization program announced in March 1995, in which the government departed from the road taken so far, turning away from it in terms of all four characteristics. The program ended Hungary's relative political calm. It aroused passions. The government parties met with sharp resistance even from their supporters. Their political popularity dived.

Justification for the radical program of restriction can be made on several levels. The most obvious argument starts from the current position of the Hungarian economy. The grave macroeconomic tensions and the need to avert economic crisis speak in favor of drastic restriction, rightly in my view.

Another level of argument reaches its conclusions from the angle of the medium and long-term transformation of the Hungarian economy and society. The present package is only the first in a succession of measures to remove the barriers to long-term growth caused by the financial disruptions, improve the structures of production and foreign trade, and help to rearrange the role of the state, including a reform in the welfare sphere. I am convinced these, too, are correct arguments.

All these arguments, however, fail to resolve a deep political and ethical dilemma: Is it permissible to push through a reform despite opposition from most of the public?

The initial answer to the question comes easily. The government and the political parties and movements behind it should do much better at convincing the public so that communication between the government and the population improves. Preparation for the measures should be more circumspect. Greater consideration has to be given to the economic benefit and political "cost" of each measure, the destabilizing effect of the discontent it engenders. These are justified demands, but it can be questioned whether even the best professional preparation and persuasion can ever make popular a restrictive program that withdraws entitlements.[67] The dilemma cannot be side-stepped.

In my view, it is one thing to *understand*, in a sense affected by positive political-economic analysis but with a sympathetic heart, why there is resistance and another to *endorse* the resistance. More specifically, it is another matter for a responsible politician to bow to mass pressure and drift along the stream when this plainly runs great risks even in the short term and in the long term enhances the already grave accumulated debt and causes yet greater harm.

We have arrived at a fundamental dilemma in political thinking, which arises not only in Hungary, but in every country where a government and the parties behind it and the legislature face unpopular decisions. I will, therefore, put the questions in a general way, not one confined to a Hungarian context, and then try to answer them in line with my conscience.

If politicians defy resistance from the majority of the public, swimming against the tide, is this not a return to the Messianic approach of ideological dictators? Is this permissible in a democracy? Can a reform be applied without consensus, or to use a narrower criterion, without approval from the majority of the public at the time?[68]

I believe it is permissible, but only if several conditions are strictly met:

First condition. The government in all conscience has to be convinced there is no alternative. There is an inescapable need for the regulations being opposed by the majority of the public.

Second condition. The government has the obligation to remain within the bounds of the constitutional, democratic system of law. This is not self-evident, because the situation, the knowledge that there is a "state of emergency," may tempt a committed group of reformers to resort to unconstitutional, dictatorial methods.[69]

This ties in with the *third condition.* The governing group has to reach a sincere decision to subordinate itself unconditionally to the judgement of the public at the next elections. Furthermore, there have to be political power relations and institutional guarantees that leave no room for doubt about the freedom and cleanliness of the next elections. In that case, through the elections the public can express *retrospectively* whether it approves or rejects what the government and parliamentary majority have done without widespread support.

Political direction that is ready to go against the stream and commits itself to unpopular measures but subordinates itself to these conditions is acknowledged as "leadership" in American political jargon. Although I know this kind of "reform without consensus" departs from the usual "popularity-maximizing" behavior of many politicians in mature parliamentary democracies, I do not think it can be called anti-democratic in a normative sense, so long as the conditions mentioned are strictly met. Indeed, there are difficult situations that require this kind of determined political behavior, and the present Hungarian situation happens to be just such a situation.

Three Scenarios

At the time of writing, there is no way of predicting which way Hungary is bound. Several eventualities can be envisaged. I will confine myself here to outlining three clearly defined scenarios.

1. *Return to the policy of "muddling through."* After a time, the present government or a reshuffled version of it returns to the well-trodden road. Substantial concessions are made to mass pressure, the stabilization program is toned down, and the pace of implementation is slowed. Actions urgent from the economic point of view are further delayed. The reduction of state paternalism stalls at its present level. The government resigns itself to a slow rate of growth or even stagnation. With luck the policy does not end in catastrophe. (The bounds of this scenario are exceeded if it does.) It is not impossible to imagine that the policy of "muddling through" could be

continued for a good while after 1995, although it will lose the country its chance of achieving rapid and lasting growth.

There are many forces working to persuade those in power to abandon the course taken in the spring of 1995 and return to the old road. Apart from the ingrained Hungarian habits of decades, parliamentary democracy entices politicians to behave in this way.

It is worth recalling here the example of the United States. American democracy has proved incapable of coping with certain fundamental economic problems, such as the federal budget deficit or health-care reform, because politicians have been unwilling to perform unpopular tasks, especially swift and radical solutions to them. If this is the case in the most mature democracy of all, it is hardly surprising to find the same behavior in several half-mature Eastern European democracies. The experience of several countries shows that the more political scene fragments and the less the long-term rule of some political grouping becomes institutionalized, the less inclined is the prevailing government to take unpopular actions with a slow political return. Anticipation of political defeat in the foreseeable future is no incentive to embark on "altruistic" reforms with long-term prospects that entail thinking ahead over decades. Politicians are even more inclined than the general public to think in terms of the well-known Keynesian formula: "In the long run we are all dead."

2. *Perseverance and political downfall.* The present government perseveres with the strict principles of the stabilization program and is ready to carry it out consistently but fails to obtain the political support for doing so. The resistance steadily grows, manifesting itself, perhaps, in a wave of strikes that paralyses the economy or mass protest of other kinds. This further damages the economic situation, making even stricter measures necessary, so that society enters a self-destructive spiral of restriction and resistance. On reaching a

critical point, the process leads to the political downfall of the present government policy.

It is not worthwhile in this study to speculate on when and how this might happen. Would it come in 1998, at the next general elections? Or could it occur earlier, when the government parties' members desert them on a critical vote? I do not even include the possibility that the upheaval might bring down parliamentary democracy as well as the government, because I do not think there is a realistic danger of this happening in present-day Hungary.[70]

If the government, adhering to the stabilization program, succumbs politically, its successor is quite likely (though not sure) to take up a different policy. It may return to the old Hungarian road of "muddling through," for instance, or embark on a yet more perilous populist, adventurist policy, but this again points beyond the second scenario.

All who take an active part in the stabilization program, and all who support it in Hungary or abroad, must realize that the program's political downfall cannot be excluded.[71]

3. *Success after delay*. It is worth thinking over a variety of alternatives. One is that savage, unpopular stabilization reforms have succeeded in a number of autocratic countries (Collier, 1979; Evans, 1979; Haggard, 1990; Haggard and Kaufman, 1989; Waterbury, 1989). Protest was met with repression. Sooner or later, the economic results of the reforms arrived, and being no more protest, there was no more need for repression. The governments of such countries did not take on the inconveniences of democracy and freedom of speech and association until the reassuring economic results had been obtained. Often cited examples are South Korea, Taiwan, and Chile.

There is much debate among analysts of post-socialist transition about what was and what may be the best order in which to take political reform that leads to democracy and economic reform that leads to a market economy.[72] It certainly seems that if political reform is completed sooner or goes faster than economic reform, great political problems posed by the unpopular elements of economic transformation have to be faced.[73] The conclusion many draw from this is that it was unfortunate to rush the democracy. It would have been better to follow the Chinese strategy of entering a path of fast growth and rising living standards first.

I cannot agree. To my mind, democracy has intrinsic value, greater and more fundamental value than anything else. Despite the economic troubles and the inconveniences of democracy, I rate Hungary's firm parliamentary democracy as a great achievement. It means the road of suppressing protest by force is, luckily, closed. So let us confine ourselves to a "third scenario" in which the events occur in a democratic framework.

It is not unrealistic in the knowledge of Hungarian conditions to hope for a relatively favorable succession of events. The government may manage to explain better why and how the stabilization program serves the public's interests. The resistance may not be so vehement. The storm of initial protest may blow itself out and patience come to prevail. The not too distant future may bring favorable trends in the living standards of broad groups in the population so that the atmosphere improves.

The word "may" makes the uncertainty plain. Much depends on how the stabilization program's active participants behave, from government, Parliament, political parties, and interest groups to employers and employees.

I do not see it as my task to weigh the chances for the three scenarios and the various intermediate and mixed cases or to put subjective odds on the alternatives. I would like to hope the third scenario prevails, but I am ready to support the stabilization program even if the second scenario threatens. I am convinced that the good of present and future Hungarian generations requires us to find a new road that ensures lasting development.

Notes

[1] Yugoslavia set about dismantling the command economy before Hungary did, and in this sense the reform process has a longer history there. Slovenia is the only successor state of former Yugoslavia where the change of political system has been uninterrupted. Ruptures have occurred in all the others due to the conflicts and wars between successor states or ethnic groups.

[2] The study is not intended to cover all the essential themes of the Hungarian reform and transformation. Several very important issues are mentioned only in passing or not at all (like inflation or joining the European Union).

[3] There were tumultuous events in East Berlin in 1953, in Poland in 1956; the peaceful Prague Spring of 1968 was terminated by the tanks of the Warsaw pact. Yet, Hungary was the only country where an armed uprising took place and led to the collapse of the single-party political organization and to the formation of a multi-party coalition, even if only for a few days.

[4] Based on the verdicts of the courts, 123 death sentences were carried out in reprisals after the 1848–49 Revolution and War of Independence, 65 after the defeat of the communist regime of 1919, and 189 for fascist acts during the Second World War. See Szakolczai, 1994, p. 239.

[5] For the history of the taxi drivers' blockade, see Bozóki and Kovács, 1991; Kurtán, Sándor, and Vass, 1991; and Rockenbauer, 1991.

[6] The latter uses the expression "hidden deficit" on pp. 161–69.

[7] It is well known from the literature on the subject that the situation is different with state debt incurred to domestic creditors. At the time of repayment, the Hungarian creditors entitled to instalments and interest will receive money at the expense of Hungarian citizens paying tax at that time. Here there is a continual redistribution taking place within the Hungarian public, and it does not necessarily entail the dilemma of "consume now, pay later" for society as a whole.

[8] In periods when a populist government ruled in certain Latin American countries, a tendency for the exchange rate to appreciate was apparent in every case.

[9] Determining the desirable proportion of investment is one of the central issues in growth theory. Its size depends, among other factors, on the period in which consumption is to be maximized and

how steep the economy's growth path is to be.

A satisfactory conclusion has yet to be reached; there is still no theoretical consensus on the problem. Rather than becoming embroiled in a theoretical debate at this juncture, I have chosen a means of expression to which less exception may be taken. All I say is that "modest" growth would be absolutely necessary. This would seem to suffice for the line of argument in this study, since it gives an idea of the problem of "investment postponement."

[10] The fall in the proportion of investment would have been justified from an economic point of view if it had coincided with a rise in the efficiency of investment. Unfortunately, this was not the case. On the contrary, a great many costly investment projects of low efficiency were carried out.

[11] The average annual number of dwellings removed in the 1991–93 period fell to a quarter of the figure in the period 1976–80 (Central Statistical Office, 1994f, p. 25).

[12] To give a single example, the sum spent on research and development in 1993, at constant prices, was less than a third of the maximum level of such spending in 1987. As a proportion of GDP, the sum fell from 2.32 percent to 1.01 percent (Central Statistical Office, 1989, p. 13, and 1994e, p. 13).

[13] I will exemplify the vast scale of such postponed commitments with a single piece of data, the calculation made by the World Bank of the size of Hungary's "pension debt." This is the name given to the discounted present value of all pensions to be paid in the future under the laws and regulations that currently apply. It emerged that the pension debt is equivalent to 263 percent of the 1994 GDP. Similar calculations were made recently for seven OECD countries, of which Italy had the highest "pension debt." The Hungarian figure is close to the Italian one. See The World Bank 1995a, p. 36, and 1995b, p. 127. The idea that the state's "pension debt" is part of the hidden debt was first suggested by Martin Feldstein.

[14] The three items just discussed do not cover the *whole* social debt, which has other components as well. Examples include postponed environmental protection tasks or postponed repair of environmental damage.

[15] The well-known argument for a gradualist transformation over a long period is that if the steady development bears fruit soon enough, it will gain the reform supporters, who will back subsequent, less pleasant measures of reform as well (Roland, 1994a). This really applied initially; the "golden age" of 1966–75 provided the moral

capital for later reform. But in this sense Hungary's early start with reform becomes a drawback. Depletion of the initial moral capital began early as well, and it had largely run out by the time the change of political system arrived.

[16] One of the fundamental arguments of the "big bang" supporters is that if the "window of opportunity" opens, you have to reach in. See the account of the debate by Roland, 1994a.

[17] In a book I wrote in 1989, before the free elections (Kornai 1990), I recommended to the future Hungarian Parliament and government a radical surgery for stabilization and liberalization, similar in many ways to Poland's. This was to cover, among others, various unpopular measures, including a rise in tax revenues, an end to the budget deficit, and strict control on wages. With this part of my proposals I was left more or less isolated; most tone-setting economists in the democratic parties, which were still in opposition, rejected them. The search for popularity and fear of upheaval characteristic of the previous period was deeply imbedded in the economists' profession.

The new government's first finance minister, Ferenc Rabár, was prepared to draw up a radical package of stabilization and liberalization measures. This radicalism of his, with other conflicts, meant he soon had to resign.

[18] This also distinguishes the situation from Latin America's, where some countries undergo a cycle of events. Populism rules for a time and then falls but may well return to power later.

[19] For a comparison and statistical analysis of welfare spending in Hungary and in the OECD countries, see Tóth, 1994.

[20] I call the Hungarian welfare state premature because in my view, given the country's medium level of development, serious fiscal problems and extremely high level of taxation, it cannot allow itself to take on such a burden of state redistribution. Some economists and sociologists specialized on welfare issues take just the opposite view (for instance, Kowalik, 1992, and Ferge, 1994), arguing that because the problems caused by the transition are so grave, these post-socialist countries cannot afford not to make great social transfers.

[21] The statement does not apply in reverse. Not all developed countries have high proportions of welfare spending. It is notably low, for instance, in the United States and Japan. See Tóth, 1994.

[22] These trends do not apply to the development of the housing sector. There the steady rise in the proportion of private building

entailed a relative reduction in the role of bureaucratic-paternalist distribution.

[23] This connection is well known from the literature on the financial crises and stabilization attempts of the developing countries: the distributive demands push up the budget deficit, thereby contributing to inflation and other financial tensions. (See Haggard and Kaufman, 1992a, pp. 273–75.)

[24] This is not specific to the period of post-socialist transition. Governments everywhere use compensation designed to ease restrictive measures of stabilization as a means of dispelling protest. (See Nelson, 1988.)

[25] To quote Iván Szabó, the last finance minister of the 1990–94 coalition government, which described itself as moderately right-wing conservative: "It is strange, but it was a social democratic, rather than a conservative program that we carried out at the time" (Szabó, 1995, p. 15). On another occasion, Szabó remarked that "over-consumption occurred in the country by comparison with the level of income, of GDP attained. This was the sacrifice the government made for the sake of political stability in the country" (Szabó, 1994, p. 16).

[26] I have expressed my economic position in other works of mine. The study 1995b was written before the program was announced. I analysed the program itself in 1995c and 1995d and assessed the early results in 1996.

[27] Of the analyses of the Hungarian macroeconomic situation, I would emphasize Antal, 1994; Békesi, 1993, 1994, 1995; Csaba, 1995; Erdős, 1994; Köves, 1995a, 1995b; Lányi, 1994–1995; Oblath, 1995; and World Bank 1995b. For the view of those directing the stabilization program, see Bokros, 1995a, 1995b, 1996; and Surányi, 1995a, 1995b, 1996.

[28] As far as the program's macroeconomic results are concerned, they are undoubtedly remarkable. The main macroeconomic indicators are presented in Table 10. In 1995, as compared to 1994, the deficit of the current account and GFS budget deficit—in percentage of GDP—decreased by 4 and 3.4 percentage points respectively. What happened in Hungary was clearly an export-led adjustment: the decrease in final consumption was accompanied by a considerable expansion of exports allowing for some growth in aggregate demand. Thus, the external financial and debt crisis was avoided without a recession; in fact, GDP grew by 1.5 percent in 1995. However, the country had to pay a high price: inflation sped

up by about 10 percentage points, and real wages decreased by 12.2 percent. (See Kornai, 1996.)

[29] What made the March 12 stabilization program so urgent was the threat of great dangers to Hungary on the international financial market. Insofar as the program averted a credit crisis and its concomitant catastrophic effects, the present generation is already reaping its benefits, of course. Its consumption sacrifice averts the threat of a much deeper dive in consumption.

[30] On the political and sociological background of the 1994 elections, see Ágh, 1995; Gazsó and Stumpf, 1995; and Sükösd, 1995.

[31] Miklós Horthy was the Head of State during the right-wing, ultra-conservative regime in the period 1919–44.

[32] On the coalition formed in 1994, see Kis, 1994, and Körösényi, 1995.

[33] This took place much later in all other socialist countries but Yugoslavia.

[34] Like many other authors, I made a terminological distinction between the two phases in my earlier writings, most notably in my book (Kornai, 1992b). The first I called a "reform" (as it was directed at modifying the socialist system) and the second a "post-socialist transition." I have to concede, however, that in daily political language and professional parlance, the changes since 1990 are called a reform as well.

[35] The debate was initially confined almost exclusively to the normative plane: recommendation against recommendation. Later came the first theoretical models. A survey of the debate appears in Norbert Funke (1993). Among the participants in the debate at the beginning of the 1990s whose views he sums up are Dornbusch, Fischer, Gelb, Gray, Hinds, Lipton, McKinnon, Nuti, Roland, Sachs, and Sieberst. For a survey of political-economy arguments in the debate, see Roland, 1994a. A few examples of theoretical models are Aghion and Blanchard, 1993; Dewatripont and Roland, 1992; and Murrell and Wang, 1993.

[36] The study by Jozef M. van Brabant (1993) convincingly explains how far from apposite these established expressions are.

[37] One of the intellectual sources of the argument was conservative philosophy (for example, Burke [1790] 1982) and the other evolutionary theories in economics (see, for instance, Nelson and Winter, 1982).

[38] I myself would place in this category my first work on the subject of post-socialist transition (Kornai, [1989] 1990) in which I

recommended a rapid transformation for macro stabilization and liberalization and gradual transformation for privatization and other aspects of social transformation.

[39] See, for instance, Roland, 1994b.

[40] See, for example, van Brabant, 1993; Portes, 1994; and Rosati, 1994.

[41] Limitations of space prevent me from analysing developments in the property relations in the agricultural cooperatives, although they played an important part in the socialist system. They closely resembled the state-owned enterprises. For the same reason, I do not cover the privatization of state farms or of state (or local government) owned housing either.

[42] On the elite in Hungary, see also Kende, 1994; and Szalai, 1994. Nagy (1994a) analyses how the old party elite has developed into the new elite.

[43] I spoke out against the idea of free distribution in my book (Kornai, [1989]1990). Most Hungarian economists agreed, at least tacitly, and proposals for free distribution were only sporadic. (See, for instance, Siklaky, 1989.) Though espoused briefly, at first by one opposition party and later in the government as well, the idea never gained conviction.

Many Western economists, on the other hand, including notable figures like Milton Friedman and Harold Demsetz, recommended rapid, free distribution. The idea was taken up by many economists in several post-socialist countries, notably Poland, Czechoslovakia, and Russia.

[44] Two main exceptions need mentioning: (1) Those deprived of property under the previous regimes or persecuted for their political convictions, religious or ethnic affiliations, or class status have received compensation in the form of a special voucher entitling them to modest amounts of state property free of charge. Redemption of these “compensation vouchers” has been protracted and is far from over. (2) The law stipulates that specified state property shall be transferred free of charge to the social-insurance system. Partial implementation of this recently began. Ultimately, these exceptions have had little effect on how the property relations develop.

[45] On Czech privatization, see Dlouhý and Mládek, 1994; and Federal Ministry of Finance, 1992. On the Russian, see Boycko, Shleifer, and Vishny, 1995. These authors being advocates of free distribution. For more critical authors who were not active in

initiating or implementing the privatization campaign, see Brom and Orenstein, 1994; Hillion and Young, 1995; and Stark and Bruszt, 1995 in the case of Czech experience, and for analysis of the Russian situation, see Ash and Hare, 1994; Bornstein, 1994; Nelson and Kuzes, 1994; Rutland, 1994; and Slider, 1994.

[46] Of the literature on privatization in Hungary, I would single out Bossányi, 1995; Major and Mihályi, 1994; Mihályi, 1993, 1994; Mizsei, 1992; and Voszka, 1992, 1993, 1994.

[47] Official Czech reports suggest the proportion of the former state-owned enterprise sector "privatized" has risen to about two-thirds through coupon privatization. However, a majority of the shares have passed from the original coupon holders into the hands of a few investment funds, where the large state-owned banks wield great influence among the owners. (See Portes, 1994, pp. 1186–187, and Stark and Bruszt, 1995). Most privatized firms are heavily in debt to the state-owned banks. So if real bankruptcy proceedings were applied, most of their property would revert to the state. The question is whether genuine private ownership prevails where the primary distribution of property transfers a nominal title of ownership to private citizens, but the state's partial property rights remain in an indirect form. This is just one example to show how superficial it is to describe the state of privatization by a single aggregate percentage.

[48] To give an indication of its size, it exceeds Hungary's total investment in 1994.

[49] According to a survey in 1994, 50 percent of the adult population thought privatization should be sped up or continue at the same pace, but 50 percent thought it should be slowed or halted altogether (Lengyel, 1994, p. 98).

[50] The extremely rapid growth of self-employment is partly due to the much lighter tax burden levied on this sector compared to taxes levied on wages of paid employees.

[51] Reform socialist China deserves special note. The absolute quantity of foreign direct investment entering China is several times as great as Hungary's. However, using relative indices (for example, investment/GDP or investment/per capita GDP), investment in Hungary is still much greater than investment in China.

According to the data supplied by the Hungarian Privatization Agency, the cumulative total of foreign direct investment through 1994 was USD 7,956 mn, that is, significantly higher than the figure in Table 19, compiled by an international agency. In 1995 the total increased by the huge amount of USD 4,570 mn. (Communication of the National Bank of Hungary). The cumulative total in the period 1990–1995 went up 12,526 mn. USD.

[52] Another important factor is that Hungary has always been an utterly reliable, punctual debtor, never requesting a moratorium or rescheduling of its debts. This is reassuring to foreign investors.

[53] For a numerical presentation of the process of price and import liberalization, see my article (Kornai, 1995a, pp. 21, 23, 24).

[54] Several Hungarian economists criticized that the import liberalization was too fast, particularly in view of the failure to implement a drastic devaluation or to impose stronger tarriff protection at the same time. International experience with import liberalization does not contain an example of such an "own goal" policy in which unilateral, radical liberalization was applied without replacing the effect of the administrative restrictions with tariffs and/or a strong devaluation. See Gács, 1994; Köves, Lányi, and Oblath et al., 1993; Nagy, 1994b; and Oblath, 1991.

[55] Foreign tourists are surprised, for instance, by the "wild capitalism" practised by taxi drivers. Unlike most Western cities, Budapest has no clearly regulated system of taxi fares.

[56] On the emergence and problems of interest conciliation in Hungary, see Greskovits's (1995) instructive analysis.

[57] Some years ago an Israeli economist echoed the debate between Stalin and Trotsky in the ironic title of an article: "Can Socialism Be Built in Half a Country?" The reference is to the trade union control over half the economy. Though not in a fully developed form, a similar problem has arisen in Hungary. On the negative effects of the Israeli economy's corporatist features, see Murphy, 1993.

[58] A survey of the new Western trends in positive political economy is given by Alt and Shepsle, 1990.

[59] The trend known in Western literature for the last couple of decades as political economy, which examines the interaction of politics and economic policy, has few exponents in Hungary or the post-socialist region as a whole. (The old expression "pol-econ" denoted a different trend subscribing to Marxist-Leninist doctrine.) Pioneering work in applying political economy in the modern, Western sense to Hungary was done by Greskovits (1993a, 1993b, 1994). I would also like to mention the writings of Bruszt (1992, 1994a).

[60] "Economic blueprints that treat politics as nothing but an

extraneous nuisance are just bad economics," writes Adam Przeworski (1993, p. 134).

[61] According to demographic data, Hungarian men who were 50 in 1970 had a further life expectancy of 23 years (Central Statistical Office, 1994b, p. 37).

[62] (1) To 1944: Nationalist-conservative, semi-authoritarian Horthy system. (2) 1944: Occupation by Hitler's army; reign of terror under Hungarian Nazis. (3) 1945–1948: Expulsion of Hitler's army and Hungarian Nazis by Soviet army; beginning of Soviet occupation; formation of multi-party, democratic coalition. (4)1948–1956: Other parties ousted by communists; Stalinist dictatorship established. (5) October 23, 1956: Revolution; formation of multi-party revolutionary government. (6) November 4, 1956–1989: Revolution crushed by Soviet army; Kádár regime takes power, brutally repressive initially, but steadily "softening" and commencing reforms. (7) 1989–90: Collapse of communist system; formation of parties, free elections, formation of new Parliament and government.

[63] Americans, Britons, and Australians contemporary with A underwent no change of regime. These were not changes of the kind occurring in the United States when the Democrats replace the Republicans or Labour the Tories in Britain. Hungary underwent traumatic changes of regime six times, causing deep upheaval in society.

[64] I pose this question from the single angle of inter-generational choice, assuming that both individuals' living standard represented the national average. I left open the question of welfare distribution in the period concerned. There will clearly be relative winners and losers within the same age group as well.

[65] For a splendid survey of the debate on welfare judgements, social preferences, social choice, and public choice, see Sen, 1995.

[66] For examples in earlier or present, more up-to-date versions of the various "golden-rule" models, see, for instance, Blanchard and Fischer, 1989.

[67] Béla Greskovits (1993b, 1994) aptly describes this type of leader and expert staff as suffering from the "reformer's loneliness."

[68] "Reform without consensus" is what the study by Jeffrey Sachs (1994) calls the situation just described. I agree with the view expressed there, that the situation is acceptable temporarily, under certain conditions, for want of a better course.

[69] I urge the government to be forceful, decisive, and consistent, but nothing is further from my intentions than to recommend a

disregard for the democratic rule of law and constitutionalism. Anyone who reads this into my study or any earlier writing of mine misunderstands my position. Unfortunately, such a misunderstanding has already occurred (see, for instance, Elliott and Dowlah, 1993).

[70] However, I cannot exclude this eventuality under similar circumstances in some other post-socialist countries, where parliamentary democracy is less firmly founded than in Hungary.

[71] Many foreign observers take too little account in their calculations of this political risk. I consider this especially dangerous and maybe damaging in the case of those whose positions may give them influence over events in Hungary; for instance, those who participate in decisions relating to Hungary in foreign governments or international organizations. It depends on them as well whether the threat to Hungary described in the second scenario is averted. A breakdown of political stability would pull the rug out from under economic stabilization, not to mention the direct economic damage caused by radical forms of mass protest.

[72] See, for instance, Haggard and Kaufmann, 1992b, pp. 332–42.

[73] Here I select a few works from the rich body of writing that covers the chances and consequences of autocracy and democracy during the post-socialist transition: Bruszt, 1994a, 1994b; Greskovits, 1994; Bunce and Csanádi, 1992; Offe, 1991; and Przeworski, 1991.

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