Challenge

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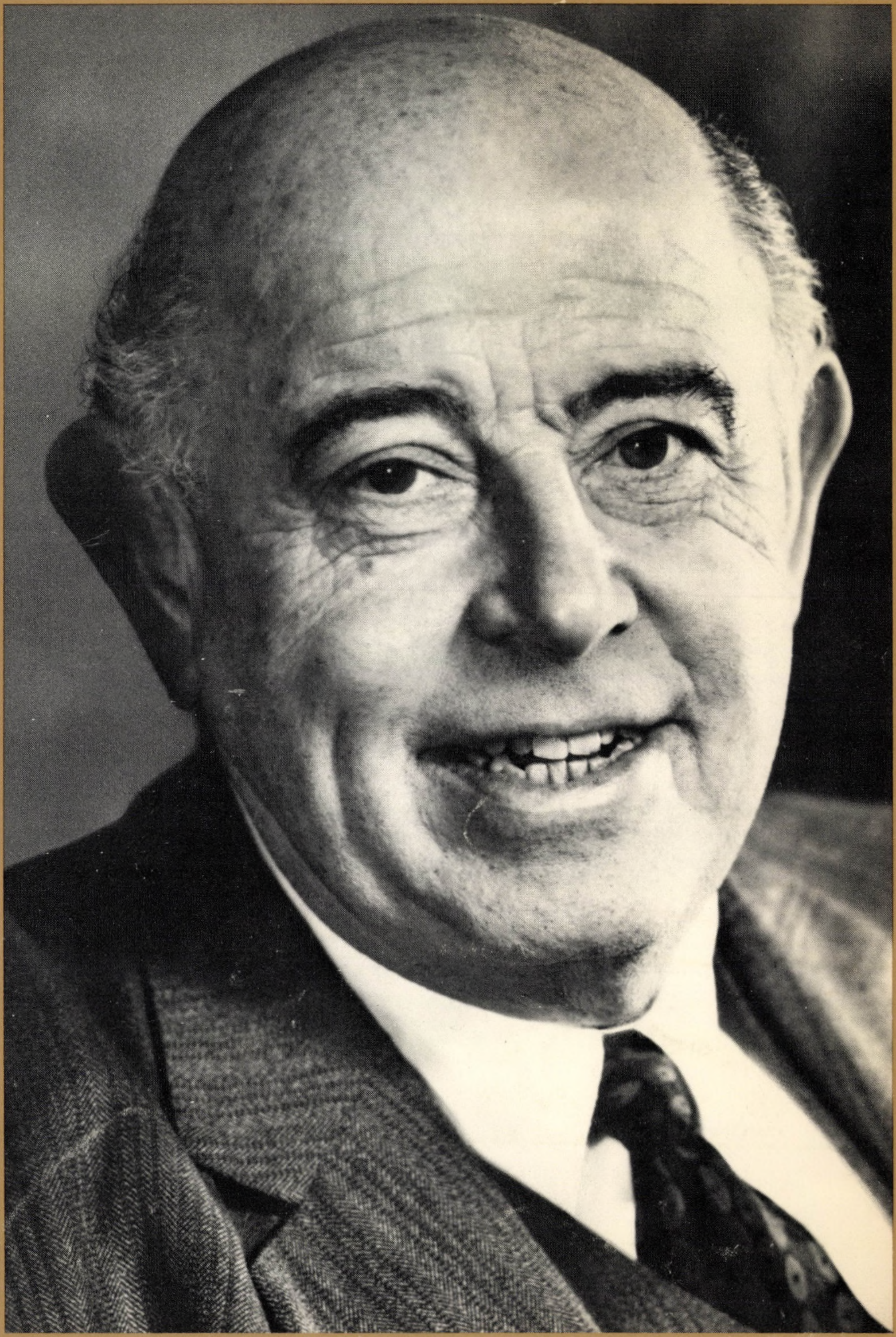

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INTERVIEW | JÁNOS KORNAI

Hungary's Reform: Halfway to the Market

Q. For more than a decade all of the advanced industrial countries have gone through tremendous economic upheavals, and we tend to forget that Eastern European countries have also experienced important economic change. What has been happening in Hungary, particularly since the radical reforms of 1968?

A. Hungary has no doubt introduced economic changes of historic importance, but the reform measures actually began well before 1968. The history of Hungarian reform goes back at least to 1957, when the state abolished the system of obligatory deliveries in agricultural products. In the twenty-eight years since then, the process of reform has gone forward, sometimes it has stagnated, and even reversed direction for a time. But you are right that 1968 was a very important date in the history of Hungarian reform, because in that year the administrative organization called the "command economy" was virtually abolished.

Q. Just what do you mean by "command economy"?

A. That is the characteristic organization of socialist countries in highly centralized economic systems administered by a hierarchical bureaucracy. The economic planners set mandatory output targets and input quotas for factories and farms; they had to fulfill those central plans and report back their results to the planners.

Q. And those targets and quotas were all quantitative?

A. Quantitative, yes, and very finely disaggregated. Under the command system, the planners set not only targets for large aggregates of total output. Even in the case of multiproduct firms, say with five different kinds of machinery, the planners set targets for machine number one, machine number two, machine number three, and so on. The quantity targets also implicitly established quality goals. Confronted by planners who emphasize quantities, firms are inclined to neglect quality in order to achieve higher output.

Q. But the planners must become immersed in the immense task of determining the millions of figures involved. Is that an efficient process, or even a viable one?

JÁNOS KORNAI is Frank W. Taussig Research Professor of Economics at Harvard University in 1984–85 and professor of economics at the Institute of Economics, Hungarian Academy of Sciences, Budapest. This interview was conducted on February 28, 1985 in Cambridge, Massachusetts by Richard D. Bartel, executive editor of *Challenge*.

A. It is highly questionable whether it is an efficient way of decision-making. But it is viable for sure, because it is organized in a whole pyramid with many layers. At the top there is the central administration, the major advisors to the government and the central planning office that prepares the economy-wide annual and five-year plans. Then that is broken down to individual ministries, each in charge of one particular branch of the economy—for instance, agriculture, heavy industry, light industry. These ministries break down again into agencies that plan for economic sectors, subsectors, and then ultimately for the firm. At the bottom of the bureaucratic pyramid you have a subsector agency which is in charge of, say, ten firms. These officials have a rather good overview of the activities of these ten firms, so they cannot be easily cheated by the firm managers. If they supervise a few tractor and a few car factories, they know the input-output ratios pretty well and can assign reasonable output targets and input quotas. There is, of course, quite a bit of bargaining between firms and their superior agencies when deciding on targets and quotas. That goes on also at the medium and the higher levels of the administration; within the vertical bureaucracy there is a continual process of negotiation and mutual adjustment between suppliers and buyers. In the command economy the most decisive and influential information did not flow horizontally, between seller and buyer, but vertically, between superior and subordinate levels of the hierarchy, down to the firms.

Q. And who decided on prices in the pre-reform system?

A. Price determination was also highly centralized.

Q. So the bureaucracy used to fix *both* the quantities exchanged *and* the prices?

A. Superior agencies determined essentially all terms of contract—both the quantity and the price, and in many cases also the specific seller to a specific buyer. That is called central allocation or central rationing. A firm would get something like a coupon from the ministry. It would specify that you are allowed to buy 10,000 bricks from firm A.

Q. That sounds very strange to me, for the authorities to try to fix both the quantities and prices. How could markets clear at the centrally fixed prices?

A. Yes, that's exactly the problem. But in a command system with central allocation, prices take on much less importance in the sphere of interfirm input-output flows. Planners and industrial firms are focused on quantities; they are not seeking profitability. The main thing is that you have to deliver 10,000 bricks at a certain point in time to a certain firm. Prices are not so terribly exciting, because if your firm is running a deficit, it will be covered by a state subsidy, or other adjustments will be made. The most important thing is to fulfill the input-output targets, and profitability is only a minor, secondary question. The reform of 1968 basically eliminated central bureaucratic allocation of goods through quantitative output targets and input quotas. State-owned firms and cooperatives have got the right to decide for themselves what to produce and how much. They have to purchase their own material inputs and machinery or parts. No longer do the central planners decide how many bricks a supplier must sell to a construction firm. The rationing of materials and labor, commonplace to the old command economy, came to an end in 1968. It was a substantive change of great importance. Hungary was the second socialist economy—only after Yugoslavia—to make this change. Now probably China is following. In sharp contrast, the prototype command system still prevails in the rest of the Eastern European countries and in the Soviet Union.

Q. I never imagined that central planners made so many tiny decisions at the microeconomic level. Firm managers must have felt insecure, suddenly to have to make their own decisions, to seek out buyers of their output and sellers of their needed inputs.

A. That was one of the problems after the reforms. I remember one group of visitors from a neighboring socialist country which maintained the command system. These were government officials and planners who came to see how the reforms affected a cooperative in a particular Hungarian village. Their guide explained how the cooperative must decide on its own how much tomato and how much paprika and how much cabbage to produce. This foreign delegation asked how on earth the cooperative would find out ratios between tomato production, paprika production, and cabbage production. Under the central allocation of the past, they simply got three numbers and they had to produce those quantities.

Q. Do firms enjoy the same autonomy when their output is delivered to a foreign buyer?

A. Not quite. The freedom of movement increased somewhat, particularly for some larger firms. Before reform, state-owned companies had complete monopolies in exporting and importing; Hungarian firms wanting to export to or import from foreign markets had to go to these state-owned foreign-trade companies. After the reform, at least some producers got the right to sell their own products directly to a foreign buyer or were allowed to buy certain goods directly from a foreign seller without intermediation by the state-owned trading companies. This relaxation notwithstanding, exports and imports are still rather tightly controlled, partly by formal and partly by informal interventions aimed at export promotion and import restrictions.

Q. We discussed what happened with quantities after the reform. What happened with prices? Are they now determined by market forces?

A. Yes and no. As I mentioned earlier, before the reform the whole price-setting system was highly centralized, with most prices being centrally fixed. Now there are different segments of the economy with different rules of price formation. There are many areas where buyers and sellers can negotiate prices when they arrange contracts. Several firms got a certain degree of autonomy in price-setting. But there are still areas where prices are centrally fixed. Again in other areas prices are not fixed, but there are very detailed instructions issued by the price office telling the firm how to calculate the price on a "cost plus" basis and constraining the seller and the buyer in deciding on the price in a free contract.

There are still many arbitrary, non-market-clearing prices. And since all prices are interdependent, the arbitrariness of some important prices has a spillover effect and leads to severe distortions in the whole price structure. Many Hungarian economists, including myself, feel that this is one of the weak sides of the reform process.

Q. How does investment fit into this picture?

A. Before the reform, investment decisions were highly centralized as well. Following the reform measures, firms are now allowed to retain part of their profits and use it for their own investments. It's like reinvesting their own savings. That increases the firms' autonomy and helps make the allocation of investment resources somewhat more flexible. Still, central planning remains very powerful, since the firms' retained profit is not enough to cover the total costs of medium or large projects. Therefore they have to apply for investment credits from the central bank or for investment subsidies from the financial authorities. This way the center has very effective leverage to make deep and very detailed interventions into the investment process. This is an area where the Hungarian system did not move away substantially from the earlier, highly centralized form.

Q. The reports on Hungary in the Western press often use the term "capitalistic reforms." What do you think about this characterization?

A. I find it wrong and rather confusing. By the way, the same term is used quite often concerning Chinese changes, and I think it is no less confusing when applied to China. There are two distinct dimensions of the reform process in socialist economies. The first dimension refers to issues we have discussed in our conversation until now, that is, "bureaucracy versus market." "Noncapitalistic," nonprivate economic organizations can be market-oriented. The other dimension refers to ownership. Even before reform the typical socialist country was not homogeneous concerning property rights. There were several sectors side by side based on different forms of ownership: state-owned firms, cooperatives, business based on private ownership, and in addition to that, individual activities pursued in an informal way outside any kind of formal organization. In the pre-reform system, the state-owned sector played an overwhelming role in producing total output. The cooperative sector, though not insignificant (especially in agriculture) was relatively weak and tightly controlled by the administration; it did not exhibit the attributes of a genuine cooperative as far as autonomy and decision-rights of the members are concerned. The private business sector was miniscule or nil. Informal activities were illegal or only half-tolerated.

Q. How has Hungarian reform changed the way that business is done?

A. Before describing the changes in more detail, let me emphasize in advance what remained unchanged. No state-owned firm in Hungary has been "re-privatized." The state-owned sector remained the dominant one, and it is growing if we look at the growth rates over a longer period. What actually happened was that the other sectors got more opportunities to grow and to play a more important role in total production. Cooperatives got more (but perhaps still not enough) autonomy, attention, and support.

Q. What about private ownership and individual activity?
A. That is perhaps the most visible change. There are many more self-employed people than before and also small-scale business units based on private property, with a few employees in each. The number of employees in private business is strictly limited. They make a significant contribution to the output in the service sectors, in retail trade, in construction; there are private taxi drivers, architects, computer consultants, and so on. Also many informal individual activities which were part of the gray or black economy before, became white—that is, they are now placed in a legalized framework.

Q. What about changes in the way farmers do their business? As you said earlier, that is where Hungarian reform began.
A. Before the reform, only a small part of the agricultural economy was operated by big state-owned farms. The larger part was run by very large cooperative farms. Each member of the cooperative had the right to keep a small household plot to carry on small-scale farming, but there were only limited possibilities to do what they wanted. The reform not only gave households much greater freedom to produce and sell what they wanted, but they got more material help to do that—fertilizer, seed, fuel, and the use of farm machinery. Consequently, the contribution of household farming to total agricultural output increased very much. At the same time state-owned farms and cooperatives also got more autonomy, as the reforms relaxed central controls. The state-owned farms and cooperatives and the small plots worked by the households became complementary to each other.

The agricultural reform has not meant that the land which was in the hands of the cooperatives is now being given back to the private farmer. The father or the son of the typical farm family is a member of the cooperative, but he also works his private plot along with other family members. On the private plot they work the land intensively, growing mainly vegetables and fruit and raising animals. Many of the large cooperatives produce mainly wheat and other cash crops on a large scale. Both economic units became more market- and profit-oriented, and that yielded a fantastic increase in agricultural productivity. Hungarian agriculture now really ranks at the top among socialist countries, as measured by growth rates, productivity, and efficiency. Obligatory procurement has been completely replaced by market-oriented reforms.

Q. After the agricultural reforms, did the state still set the price for farm products, with the peasant producing food on his private plot to sell at those prices in the open market?
A. No, it is not as simple as that. State-owned trading companies are commissioned to purchase some portion of total agricultural production, and they purchase at prices set by the central decision-makers. But they buy on a contract basis, and prices can be reasonably adjusted in negotiations with the farmers. Apart from these negotiated contracts, many agricultural products are simply sold at free-market prices without any intervention by central authorities. Meat, for example, is sold under contract prices, and there are no mandatory deliveries. Cooperatives find it advantageous to negotiate contracts with the big state-owned trading companies, because it brings some safety to their business. These contracts help to make agricultural prices more stable.

Take, for instance, a small farmer who has twenty pigs in his stable. He may sell them under contract with a trading company which would then sell them to the food industry or for export abroad. At the other extreme, there may be city people who have personal contacts with the farmer. For example, families who have relatives in villages may get at least part of their meat supplied directly from the farm.

Q. Now are the crops from the state-owned and cooperative farms mostly exported, or do you consume that in Hungary?
A. Both. As for total agriculture, Hungary is now a net exporter, and we are completely self-sufficient in food. One of the attractions of the reform is that now for a very long time we have not had a serious shortage of food supply.

Q. How do Hungarian economists appraise your country's reform?
A. If you would talk to a random sample of Hungarian economists today, you would find a wide range of views about the state of the reform—some satisfaction, some unhappiness.

Q. Where does the Hungarian economy now stand

between the extremes of the command system on the one hand and a complete market system on the other? How far have you moved from command to market?
A. That is one of the highly disputed issues in Hungary today. We have moved in the direction of the market, but the economy has not yet completely arrived there. One group of Hungarian economists would say that we have achieved just the right mixture of central administration or regulation of the economy and the free market. Another group would say we should move forward in the direction of more market and less bureaucratic regulation. I agree with the second opinion. In my judgment, we could advance still farther toward a shift in the combination of vertical interaction in the planning bureaucracy with horizontal coordination through the market system, in favor of the latter, to bring greater economic benefits, more efficiency, and better productivity.

Q. Exactly what would you like to see?
A. The vertical coordination through the various levels of bureaucracy that I described before should be focused on macroeconomic planning and policy and the instruments to carry it out.

Q. Are you referring to monetary and fiscal policy instruments?
A. Monetary and fiscal policy have to play a very important role. But in addition, I can imagine that planners have a clear idea of the ratios of investment and consumption to national output and how money, credit, and fiscal instruments could be applied to achieve the desired level of investment. It is not enough to rely on how the individual fragmented savings and investment decisions add up to some national aggregate. It is only reasonable to control total investment in a planned economy to achieve aggregate growth targets and the quality of that growth. In an economy like Hungary, based on public property, not on individual, private property, central political decisions are needed to influence the rates of saving and investment consistent with overall growth strategy. What I object to in our present situation is the microregulation of the economy and the vertical interventions of the bureaucracy into minor details of decision-making within the firm.

Q. So the bureaucracy still plays a critical role, even after the reform.
A. Of course. And there is not one central planning authority, but many sub-centers—one for prices, another for foreign trade, a third for banking, one for customs—and their decisions are often mutually inconsistent, and even contradictory. The bureaucratic bargaining that goes on now is not about physical targets and quantitative inputs; it is bargaining about subsidies, or tax exemptions, or the price to be set for administratively priced goods, or customs and tariffs. There are hundreds of specific import licenses or export promotions. There are hundreds of small affairs where you as a producer are more interested in getting support from the bureaucracy than from the buyer in the marketplace. This excessive vertical intervention diverts the attention of producers from the market.

Q. Despite the reforms, the producers still tend to look up to the bureaucracy rather than to define what the market wants, the qualities and quantities?
A. I'm not saying that producers ignore the market or that they like to seek favors from the bureaucracy. After all, it is neither costless nor pleasant to bargain with the bureaucracy for a subsidy or a concession. Nobody enjoys it. But ultimately, the producer always has the bureaucracy to fall back on when his market venture might not succeed. That surely weakens the incentives to be successful on the market. If you have two ways to look, one horizontally and one vertically, then you can manipulate these to achieve your success. Your whole success or failure doesn't depend only on the market, it depends on both the market and the bureaucracy.

Q. This reminds me very much of the American steel and automobile industries, which try to manipulate government agencies to support and protect their ventures rather than looking at how to make cheaper steel and better automobiles to compete with the Japanese and give American consumers what they want. It seeems to me that here you define an issue and a problem which is as relevant to our system as it is to the Hungarian system.
A. In part, yes. The difference is that you are mentioning two troubled industries that face strong competition from abroad and, at least in the case of steel, you have slack demand. In Hungary these problems are much more widespread. But I do agree that big and powerful firms have more access to the ears of those who are allocating funds than the less-important small

economic units. Powerful firms close to the center of power have more access to state support and public assistance, and they influence policy to their benefit.

Q. Do you see somewhere an optimal balance between the influence of the bureaucracy and the calculations of the market?

A. I am not confident we shall achieve optimality. I always have problems with the concept of optimality. Let's use a more modest term. I am confident that more influence of the market on economic decisions would improve the Hungarian economy even more. How far we have to go I can't say right now, but we are far from exhausting all the possibilities of what the well-functioning market could do. First of all, we need to expand the influence of market forces on the price system, as I have already indicated. Second, Hungarian firms need to face stronger financial discipline and need to be more accountable. A firm's profitability should really mean something serious.

Q. It doesn't mean something serious for the firm even now?

A. Perhaps moderately so. By my yardstick it should be a matter of life and death. If something is terminally important then it is serious. A firm can incur losses for years and years, instead of profits, and still survive because of the intervention of the bureaucracy. State assistance may be unpleasant, but not tragic. It is as if you are worried about illnesses which can be cured, but you are less worried than with a terminal disease.

Q. Bankruptcy is an impossible outcome?

A. There are occasional liquidations in the Hungarian state-owned sector; also, one firm may merge with another, but all these events are not by natural selection. You didn't die because you couldn't survive competition. There is always an administrative decision. Your survival depends on the goverment agencies and not on the market process.

Statistical data show that typically highly profitable firms are very severely taxed: their high profits are skimmed away to cover the deep losses of other firms. This is a strange egalitarian policy of equalizing profits across firms. Instead, profits should be a highly differentiated indicator of efficiency. Those firms earning more profits should be allowed to prosper, and those sustaining losses should sooner or later go out of business. That would be a natural selection process, and that is largely missing in Hungary today. The two issues—a distorted price system and the weakness of profit incentives—are, of course, interrelated.

Q. And that's tied up with your concept of the "soft budget constraint," isn't it?

A. Yes, I use the term soft budget contraint to mean a budget that does not really bind decision-makers. Managers can incur a flow of expenditures that exceeds the flow of revenues over long periods, because the persistent deficit caused by such an excess will be covered by the state. The budget constraint is expandable, and its expansion will depend on the willingness or generosity of the state to provide additional funds. This naturally leads managers to be less concerned with costs and prices. They are not absolutely careless with costs, but they tend to feel that a cost overrun can somehow be recovered. This reminds me of the famous story about the French-British project to build the Concorde and their repeated cost overruns in creating and running that airplane project. Many of our investment projects are Concorde-like in the sense that they start with a certain projection of costs and then in the process turn out to cost more and more and more, far in excess of the original budget. Eventually, the excess costs are recovered. If managers expect this from the outset, then their responses to relative costs and prices grow weaker.

Q. So your soft budget constraint is linked to your concern about the low degree of responsiveness of firms to price changes.

A. That's crucial, after all. A manager should take the relationship between proceeds and expenditures as a terribly serious matter, because ultimately the survival and growth of the firm depend on that. His personal career as a manager also depends on whether he is leading his firm into deeper debt or to a flourishing financial position. The successful manager should be very much concerned with his selling price and the prices of inputs and should respond sensitively to changes in those prices, always searching for better combinations of resources. But the soft budget constraint syndrome undermines these cost and price calculations that are essential to efficient management.

We see here a vicious circle. Prices are distorted. Therefore profitability measured at the incorrect prices is not a true reflection of efficient performance. Not even in a stochastic sense do profits measured this way accurately reflect the degree of efficiency statistically, in most of the cases. Profitability does not have much prestige under such circumstances. A firm lobbying for subsidies may argue that the loss occurred not because of poor performance but because of incorrect prices. All right, it receives a subsidy, and others also get them, each of them bargaining for better treatment in the complicated network of fiscal redistribution. As a consequence, we arrive at dozens or hundreds of taxes and tax extemptions, highly differentiated, sometimes almost tailor-made tax and subsidy rules. And that inevitably leads to price distortions. The soft budget constraint is both a cause and a consequence of the price distortions.

Once the manager knows that profitability is really a matter of vertical bargaining, then he is less interested in price changes to be achieved in horizontal bargaining with his trading partners. Thus, the soft budget constraint contributes to weak price-responsiveness among firm managers, which in turn reinforces a distorted structure of relative prices. These phenomena reinforce each other; market forces grow less important while negotiations with superiors in the bureaucracy become more important. Firms grow more tightly linked to the bureaucracy and much less dependent on, and responsive to, the market.

Q. You have described how the intervention of the bureaucracy tends to tax away the profits of the more profitable firms in order to subsidize the weak firms. Doesn't this also dampen the entrepreneurial spirit of the economic system?
A. Entrepreneurial spirit, I think, is a necessary condition of every efficient economic system. It brings forth innovation—whether a new product, a new technology, a new organization, or the penetration of a new market. But that involves risks, and managers will take risks only if success promises to bring them large gains. That implies that those who do not succeed will lose. But intervention by the bureaucracy in post-reform Hungary means that the economic leaders cannot lose very much. They cannot gain a lot, either. There is no scope for great rewards, for any great leap forward. The firm with unusually high profits will sooner or later be taxed. So what we have here is a leveling of income that discourages the entrepreneurial spirit. The tendency to income-leveling also tends to level managerial performance.

Q. You have written that achieving full employment is one of the successes of socialist economies, in comparison with capitalist systems. Yet your *Economics of Shortage* notes that over-full employment has harmful side effects in an overcentralized, bureaucratic system. How do you reconcile the benefits of full employment with problems of chronic labor shortage?
A. Before answering your question concerning labor shortage, we must talk about shortage in more general terms. Labor shortage is but one partial form of a broader phenomenon, which might be called the shortage economy. The system—and here I am talking not about Hungary, but about the highly centralized socialist economy in general—the system is plagued by unsatisfied demands in an ongoing and general way. You experience it almost every day in the goods markets, the markets for services, and in the labor markets. Most Western observers of socialist economies concentrate only on the shortages which households suffer—unsatisfactory supplies of food, clothing, housing, and other consumer goods. But just as important are the chronic shortages we face in the market for producers' goods and on the labor market. Firm managers, government bureaucracies, and consumers alike have all adjusted to this chronic shortage, so that it has become a way of life. One way of adjusting to it is what I call forced substitution. You look for a certain good but you can't find it, so you buy something else, almost anything as a substitute.

Q. But how is that substitution different from what happens in a Western market economy?
A. Substitution in a capitalist market economy typically follows the signals of changing prices. In the economy of chronic shortage you make substitutions because of the lack of availability. That can lead to costly increases in production processes and also to inferior quality. Both consumers and producers will simply settle for substitute goods, even if they are more expensive or they are of inferior quality. Put quite simply, a chronic shortage economy is a form of widespread sellers' market. If you use a Walrasian concept of the market, the market function has a symmetric arrangement with both trading partners gaining through exchange. In a Walrasian equilibrium situation, suppliers and demanders have equal strength, and they compensate one another with a mutually agreeable price. In a chronic shortage economy, by contrast, traders are unequal partners. The seller's position is relatively much stronger than the buyer's. The seller can dictate

to the buyer. The buyer has little possibility for selection; he must buy what is available. That leads to very important consequences in trying to enforce quality standards. If you have a housing shortage, for example, and you finally have housing allotted to you, you will be happy to move in and you could not care less whether it is of shabby quality or the kitchen equipment is wretched. You accept it because you don't have a choice. In this arrangement, the buyer's threat of rejection cannot work to improve the quality of the product for sale. There are other important consequences, too—there is no sufficient stimulus for technical innovation. A seller facing other competitive producers will try to improve his product, or create new products. In a chronic shortage economy, the seller doesn't have to worry about new and improved products to attract buyers.

Q. Do you see progress in Hungary in eliminating shortages?
A. Chronic general shortage is typical of a command economy, and reforms mean that Hungary is moving away from that characteristic. Since the Hungarian economy has moved only halfway from a command system, chronic shortages have been eliminated in some segments of the economy but are still prevailing in others. Hungary has been very successful in the food sector, where buyers' markets seem prevalent. Most of the time, most food products are available and the consumer has a variety of choices of varying quality. But if you look, for example, at private construction activity or at spare parts for cars or household appliances, you still face problems of shortages. Today one thing is not available, tomorrow it's something else.

Q. How do the dynamics of chronic shortage work in the labor markets?
A. There are a few factors at work in explaining overfull employment. If an economy begins from a state of relative underdevelopment, it may take quite a long time—even two or three decades—to absorb all your slack labor, the so-called disguised unemployment and underemployment. But now Hungary and almost all of Eastern Europe are beyond this stage, and we are now experiencing a chronic labor shortage. We have gone from an excess supply of labor to an excess demand. A mature shortage economy, characterized by frequent and intensive shortages in the goods markets, sooner or later develops shortages in the labor market. I am searching for a unified theory to explain chronic shortages by the same factors, or common roots, in the consumer-goods, producer-goods, and labor markets. Other economists have used segmented theories to explain separately shortages of housing, foreign exchange, or labor.

Let me mention various alternative theories. One regards the chronic shortage to be a mismatch of specific supplies and specific demands—essentially a "frictional shortage." I don't deny that frictional shortages do exist, but I don't think that this is the primary explanation of the general chronic shortage. Other economists would look to a severe distortion of relative prices and wages as the major cause.

Q. Wouldn't the right prices, changes in prices, induce the right adjustment between the demand and supply?
A. What we would really need is not only the *right* relative prices; even more, we need *responsiveness* to relative prices and price changes. You can have the best of relative prices, but if buyers and sellers don't respond to them you can't expect adjustments in the market.

I put the main emphasis on "runaway demand." Don't mistake this to be simply an excess demand, say, 20 percent higher than your supply. It is not that demand is finite, only too large, but that some components of total national demand have a tendency to run away, to be virtually limitless.

Q. Can you give me an example?
A. Let's look at investment again. I've just talked about how the intervention of the bureaucracy prevents a firm manager from being penalized when he makes a wrong investment decision. Since there is no risk of penalty by financial failure, why not invest? The result is what we call "investment hunger." There is an almost insatiable demand for investment resources. You see that's exactly the symmetrical opposite of the Keynesian problem of insufficient demand for investment. In the command economy you have an ever-insatiable, never-satiable investment demand.

Q. What are the underlying causes?
A. There are essentially two. First, a positively motivating factor, and second, the lack of any restraint. A manager wants to see his firm grow and to make technical improvement. That motivation is linked up to typical bureaucratic behavior and to how he enhances his self-esteem. The director of a hospital wants better

equipment and more hospital beds, the president of a university wants new equipment and new buildings, the general needs more arms. Expanding your budget means expanding your scope of power. The larger and more technically equipped you become, the more power, the more prestige, and perhaps the more salary you acquire. Now when you aggregate this behavior and combine it with the soft budget constraint, then you have a society with what I call investment hunger.

Of course not only firms exhibit investment hunger; that is a common attitude of officials in charge at all levels of the bureaucracy. Even the minister is ''fighting'' for more investment resources for the sector under his supervision at cabinet meetings.

Many analysts believe that the expansion drive originates from the growth obsession of general economic policy: to run ahead as fast as possible. There are overambitious growth targets and, with the aid of different transmission mechanisms, for example, material and moral incentives are conveyed to the lower levels of the bureaucracy down to the firms. Maybe. In any case, firms happily join the expansion drive and even push for more investment as long as it can be done without too much risk.

Q. That sounds to me like the runaway U.S. defense budget.
A. Yes. Bureaucrats can gain but they cannot lose. That's why I stress a more far-reaching decentralization of investment allocation together with a hardening of the budget constraint for firms and forcing managers to take full responsibility for their decisions. Poor decisions must lead to market penalties.

Q. You see investment as the most important component of runaway demand?
A. But investment links up to an insatiable demand for imports, particularly for imported investment goods. And because you have to pay for imports with revenues from exports, the import hunger leads to an export drive. Most exports from socialist countries are arranged by government trading companies, and they create a ready demand for tradeable goods that is virtually insensitive to domestic costs and prices. This export drive is the second component of runaway demand in a chronic shortage economy; a third, somewhat less important, is hoarding.

Q. And labor can be hoarded, as well as other inputs.
A. If a firm is afraid of future labor shortages, it will keep the worker even if he is not really needed today. More generally speaking, you buy inputs whenever you find something to buy, according to availability, not according to what you actually need the next day. As a result of runaway demand for investment goods and exportables and because of hoarding, the derived demand for labor leads to labor shortages. If wage controls are relaxed, this may lead to nominal wage inflation. Since the government tends to hold down consumer prices, this tends to lead to repressed inflation in consumer-goods markets.

Q. But don't the firms face chronic cost inflation?
A. There is that tendency. If firms have increasing costs and their output prices are not keeping abreast of wages, their managers apply for help from the bureaucracy—remember the old soft budget constraint. Typically, the net outcome of this situation is not inflation, but chronic shortage or a combination of both.

Q. Let's return to look more closely at how Hungary's economic performance responded to the reforms of 1968.
A. The reforms did bring tangible and favorable benefits. In the ten years after 1968, production grew strongly and steadily at about a 5 to 6 percent annual rate. Not only has full employment been achieved, but the economy increasingly encountered labor shortages. Since labor reserves were almost entirely absorbed, the growth in output reflected mainly rising labor productivity. As a result, real wages grew steadily and the supply of goods to consumers improved significantly—in quantity, in variety and quality. Those favorable results of reform were particularly remarkable at a time in the 1970s when many other countries suffered from severe recession, unemployment, and accelerating inflation.

Q. But wasn't there some deterioration in the Hungarian economy by the end of the 1970s? What caused this?
A. True, Hungary is economically no better off now than it was, say, eight years ago. Since Hungary is now still only a half-reformed economy, I am among those economists who think that the economy derailed because we did not move far enough in our reforms. Certainly, there are other Hungarian economists who claim our troubles started because we became ''overreformed.'' Let's go back to 1973 and the Hungarian

response to the first oil shock. Relatively fast growth continued up to 1978, but the planners only succeeded in postponing our adjustment to the worldwide oil shock. In my view, shared by other Hungarian economists, government policy overprotected Hungarian firms, cushioning them from the impact of the traumatic changes in the outside world. Hungary is an energy importer and our national terms of trade—that is, the price of our basket of imported goods in terms of our basket of export goods—deteriorated quickly. Now a more decentralized economy would have distributed these losses widely among the producers. Even a genuinely decentralized economy would experience some trauma from the external shock. But those firms suffering from the deteriorating terms of trade would have adjusted, some might even turn the adverse shock into a positive improvement. They would economize on costlier inputs linked to energy prices, they would find more efficient production techniques, change the composition of imported and exported goods. They would be forced to do something to adjust. But instead, what happened in Hungary is that, because of the soft budget constraint, the bureaucracy cushioned firms from the external shocks; firms were not forced to adjust. The government took advantage of easy credit terms offered by the West, and that helped to keep Hungary's economy moving in high gear at least a bit longer. When our foreign debt reached a certain critical amount, conditions became riskier, liquidity became a problem, and then suddenly the government pressed down the brake. After many years of 5 to 6 percent annual growth, economic expansion halted and the economy came close to stagnation for years.

Q. What brakes did the bureaucracy apply? What policy instruments?
A. The government cut imports and decreased investment in the first place. Then the rise of real wages came to a halt and later even declined some in absolute terms. These are the well-known, bitter consequences of macroeconomic adjustment programs. What happened was not a spontaneous response of decentralized decision-makers to frightening changes in the external world. The drastic adjustments followed central decisions. I mentioned earlier that a thousand means of microeconomic regulation make it possible to intervene deeply into the economic process. One could even say that the need for macroeconomic adjustments almost encourages the reliance on centralistic microeconomic intervention and the use of administrative means.

In any case, I personally see the main cause of our slowdown not in too much but in too little decentralization—that is, in too little confidence in and reliance on the market. We didn't adjust quickly enough to the changing world situation. I think many of the market economies responded better to the changing world-trade situation than Hungary did, with its half-market, half-bureaucratic control. Adjustment was delayed too long.

Q. In response to the quickly changing conditions in the world economy, then, you would have recommended that the budget constraint be made harder?
A. That was and still is my advice, but of course not my only suggestion. I don't regard this hard budget constraint as a panacea. It is one of the necessary conditions for efficient adjustment, but not a sufficient condition to solve the problem. We need a package of measures and a package of further changes, and that is one of the necessary ones.

Q. If you advise taking the tough route of market adjustment coupled with the hard budget constraint, what about the human hardships that invariably result?
A. That is an inner conflict, a dilemma, that every policymaker must face, whether in a capitalist or socialist society. One would like to imagine, in theory at least, a system in which contradictions between the values of economic efficiency and the ethical values of social and economic justice do not emerge. Remember, the great Polish economist Oscar Lange described in the Thirties a decentralized market economy along Walrasian lines, which functions efficiently and at the same time fits without difficulty into a system built on socialist ethical principles of justice. But in light of our experience in the real world, there are conflicts when we have to make choices. Here we have talked about applying a hard budget constraint, the need for market incentives, rewards linked to profits, and the market discipline that may lead to the exit of some firms. It is not easy to reconcile the earnings of managers and workers linked to the firm's profits with the socialist wage-setting principle that each should be paid according to his work and equal work should receive equal pay. We have to find ways to help each member of society feel economically secure, even though jobs and firms may be threatened by fluctuations of the internal and external markets. Our job as social scientists is to search for at least acceptable compromises.