From Totalitarian Central Planning to a Market Economy: Decentralization and Privatization in Hungary

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Antecedents to privatization

During the last decade of the twentieth century a change that could be characterized as truly revolutionary has occurred in numerous countries of the former ASoviet bloc.@ In Hungary, scarcely ten years have passed since the election of the first post-communist government, but the ensuing changes have been many and far reaching: they have led to the emergence of a market economy in which private ownership is now dominant and in which market forces have supplanted the state bureaucracy as the economy=s primary coordinating mechanism. Although prior to the post World War II communist take-over, Hungary already had a developing market economy, between 1945 and 1990, to use Kornai=s term (1990, 54), the long historical process of the country=s *embourgeoisment* suffered a dramatic interruption.

There were many attempts to correct the many inefficiencies, wastes, and internal contradictions of the highly centralized, Soviet-type planning mechanism that had been imposed on Hungary by the Muscovite communists in power; the best-known of these attempts was the New Economic Mechanism (NEM) that sought to achieve a sustained and balanced growth of national income by linking plan and market, using indirect economic regulators (interest rates, management bonuses, etc.) to regulate state enterprises. The NEM also faltered, however, despite many attempts to rationalize it. The efficient operation of economic regulators would have required significant economic competition which did not exist within the Council for Mutual Economic Assistance (CMEA), a fundamental rationalization of the price and incentive systems, and truly market-oriented managerial activities. As shown by Kornai (1990, 1992) and many others, in an economy characterized by high industrial concentration, the direct dependence of state enterprises on the state apparatus, and the bureaucratic mentality of managers, centripetal tendencies will tend to overwhelm the rudimentary market mechanisms. Through bureaucratic action, exceptions were always available to the financial regulatorsCKornai=s now famous Asoft budget constraint@Cand thus many of the negative features, normally associated with the more traditional planning system, survived. But attempts to rationalize the system also prompted the beginning of *de facto* privatization.

The process of privatization

APrivatization@ may mean the acquisition of state-owned property by private individuals, but also the ascendancy of private over state property in general. During the two decades prior to the systemic change in 1990, with the tacit approval of the communist authorities, a large segment of the population made a continuous effort to expand the use of property in private hands. The numerous problems that had plagued the state sector, along with the government=s pragmatic approach to economic policy, facilitated the burgeoning of the Asecond economy,@ a quasi-legal economy that was guided by calculation and rational responses to the existing environment of shortages.

During the 1980s, the National Assembly passed numerous pieces of legislation enlarging the potential scope of private activity; as a result, *de facto* privatizationCoften referred to as supplementary economic activityCgrew and created a new, young, business-oriented stratum of society. The prestige of private enterprise also increased, and, according to surveys, was influenced by an individual=s gender, education, and financial situation (Mizsei 1992). According to official estimates, by 1990 approximately 10% of the labor force consisted of individuals who had engaged in some sort of Asupplementary economic activity,@ often in addition to their primary employment in the state sector (Központi Statisztikai Hivatal, 1991). In recognition of the importance accorded to private property by the population and probably also due to the change in regional political pressures, eventually the National Assembly passed an amendment to the country=s constitution declaring the right to property, the freedom of enterprise, and equal protection of the law for various forms of property (Csaki and Macher, 1998).

Already prior to the 1990s all elements of market socialism were subjected to careful scrutiny and fundamental criticism in Hungary. Numerous surveys revealed not only people=s awareness of the petty annoyances and corruption of Hungarian socialism, but also their perception of economic stagnation and the Party=s inability to achieve even its own objectives. The ensuing Acrisis of legitimacy@ of the Party (Swain, 1992, pp. 7-32) eventually resulted in free multi-party elections and a truly democratic government after over four decades of totalitarian rule. When the new, noncommunist government took office in May, 1990, it announced certain political, social, and economic objectives and principles: political freedom, economic transformation into a socially-constrained market economy, and a return to the European heritage. Privatization was one important element of the government=s program.

As indicated by Aslund (1992, pp. 18-19), privatization had been viewed as the solution to a large number of problems that market socialism was unable to effectively address: interenterprise competition, rational criteria for the allocation of capital, success criteria for enterprises and managers, technological progress, product quality, and the stagnation of living standards. The task of gradually creating a competitive market economy (but with a welfare safety net) was the clear goal of the four-year economic program of the Hungarian government. The program was based upon a three-year agreement with the International Monetary Fund (IMF), concluded in 1990 and made public in March, 1991. It envisaged the privatization of state enterprises such that by the end of 1994 private ventures with a commercial orientation shaped by the market would become dominant in the economy. The document stressed the importance of foreign capital (both foreign direct and portfolio investment) in the privatization process, the necessary international convertibility of the forint, as well as the modernization of the economic and legal framework such that the existing competitive forces would be strengthened (Kocsis, 1992, pp. 76-77).

There appears to be general agreement that privatization is an essential element in establishing a market economy; other elements include macroeconomic stabilization, general liberalization, domestic price reform, and currency convertibility. Despite this consensus, there is still disagreement about the speed of the required change and the methods to accomplish the objective. The choices made in Hungary included a *gradualist approach* (as opposed to rapid Ashock therapy@) and the *sale of government assets* to domestic and foreign private investors (as opposed to the free distribution of ownership claims represented by vouchers). The justification for the gradualist approach was the notion that the development of market institutions is a gradual process, necessitating the creation of an infrastructure to support the market economy before that economy actually emerges. An attempt to rush the process might become counterproductive and lead to other crises due to the economic dislocations and social pain caused in the process.

The specific methods utilized involved the creation of two organizations: the State Property Agency (1990) and the State Holding Company (1992). The function of the former was to direct the privatization process on behalf of the state (to supervise, coordinate, and keep records); the main function of the latter was to efficiently operate those firms that were to remain in state ownership. In 1995 these two organizations were merged into the State Holding and Privatization Company, whose task is to manage the property remaining permanently in state ownership and to sell the rest as quickly and efficiently as possible (Csaki and Macher, 1998).

The lack of realistic asset valuations and thus the impracticality of direct auctions for state-owned property were recognized early. Unlike privatization within a market economy that typically involves a single firm whose financial performance can be evaluated by independent auditors, the transition from communism to a market economy involves the simultaneous privatization of hundreds of firms for which even rudimentary balance sheet information is usually unavailable. Although shares of Hungarian enterprises could be sold on the newly reopened Budapest Stock Exchange, asset valuation was typically not performed by the market mechanism. Instead, the State Property Agency (SPA) had chosen to ask for proposals from (usually foreign) consulting firms and investment banks, asking them to value company assets, find one or more foreign buyers, receive and evaluate bids, arrange credit, etc. (Stark, 1992, 42). The consultants established the firm=s approximate market value, disseminated the information to potential foreign investors, and acted as an intermediary between the foreign buyers and the Hungarian firm.

Throughout the privatization process the Hungarian authorities emphasized the role of *foreign investors*. Although the importance of cultivating domestic owner-entrepreneurs was stressed--and various credit schemes were established to encourage the broadening of property ownership among local citizens--local entrepreneurs were considered poor, lacking the necessary capital to become major participants. Furthermore, the role of foreign capital in transferring state-of-the-art technologies and entrepreneurial attitudes as well as improved access to world markets was clearly recognized. As a result, between 80% and 90% of the privatization proceeds have come form foreign investors, including such giants as IBM, GE, Suzuki, Audi, among others. From 1989 through 1997, Hungary attracted $18 billion in foreign investment; it received almost one-third of all Foreign Direct Investment (FDI) invested in Central and Eastern Europe during this period.

The inflow of foreign investment and the repatriation of earnings have been facilitated and quickened by the introduction of currency convertibility and the lack of any performance requirements. The Hungarian forint (HUF) became convertible in 1991 for essentially all business transactions within Hungary and complies with IMF Article VIII and OECD convertibility requirements. The exchange rate is managed via a crawling peg to a basket composed of the German mark (70%) and the dollar (30%). Hungary also does not impose performance requirements as a condition for establishing, maintaining, or expanding investment. There are no government imposed conditions on permission to invest, local content or ownership, export requirements or targets, employment of host country nationals, or technology transfer (Country Team, 1999).

The privatization process has not been free of controversy. According to a survey conducted in April, 1992, and published in *Népszabadság* (May 20, 1992) there was at the beginning a great deal of ambivalence among certain groups. Of those surveyed, one-third approved of the privatization of large-scale enterprises, one-third opposed it, and one-third had no opinion. Those who approved privatization were typically the younger, more educated urban citizens; those who opposed it were the older and less educated and those who were unemployed. For several reasons privatization has turned out to be more difficult than had been expected: there were no similar examples to follow, since the reprivatization processes that took place elsewhere (e.g. France, U.K., Chile) had all occurred in a market economy; the Soviet-style development strategy had left the economy not so much underdeveloped as Amisdeveloped,@ with obsolete and noncompetitive industrial capacity that previously produced for the CMEA market and had to undergo severe contraction; due to conflicts between the two privatization agencies, the pace of the process came to a virtual standstill until the two were merged into the current State Holding and Privatization Company; special interests were able to capture the process temporarily; and the compensation issue. The last two reasons created unusual dilemmas.

Vigorous debates took place in the Hungarian press during the early 1990s about the merits and equity of what became known as Aspontaneous privatization.@ Legislation in 1988 and 1989 authorized private investors to participate as shareholders in the ownership of enterprises, allowed for the creation of limited liability and joint stock companies, specified the precise manner in which state enterprises could transform themselves into joint stock companies (or corporations), and permitted extensive foreign ownership of Hungarian corporations. These changes meant that enterprise councils and general assemblies of workers, together with senior management, were given the *de facto* right to transform the state enterprise into a corporation and to negotiate the terms of any acquisition or investment by foreign firms. Members of the communist managerial elite in power were thus in the position to bargain with foreign investors and exchange their enterprise-specific know-how and general familiarity with Hungarian business conditions for significant financial benefits, including future income and job security, in the newly privatized firm; foreign investors also gained in being able to hire the best available local talent for managing the firms.

With respect to the compensation issue, by all accounts the communists had inflicted great injustices on the Hungarian population. Aside from political terror which reached its peak under the Stalinists in the early fifties, a great many families suffered economic deprivation due to the confiscation of their property both immediately after Aliberation@ and in another wave again after 1948. During the beginning of privatization, surveys indicated that even those who seemingly benefitted from the regime thought that Soviet-type socialism had been Aunfair,@ but there was little agreement as to who was entitled to compensationBand to what extentBfor what types of injuries (Csepeli and Orkeny, 1992, pp. 71-72). One political party within the government coalition pressed for restitution; others considered restitution to be impractical. Instead of actual restitution, the solution offered was *compensation* in the form of transferable, interest bearing compensation coupons. The extent of proportionate compensation varied inversely with the losses suffered, with a statutory maximum irrespective of the amount of loss suffered. The coupons could be used to purchase apartments, land at special land auctions, shares of industrial firms, or a life annuity.

Some social and economic costs

As indicated previously, the system of central planning and Soviet-style development strategy left the country with obsolete and noncompetitive industrial capacity. That system also provided a certain economic safety net, however, including both job and retirement security. At the time of the systemic change, most economists had predicted that in the process of the Arationalization of production@ the previously centrally-planned economies would experience a decline in output and consumption following the start of the market-oriented reforms. The *magnitude* of the deterioration of living standards suffered by broad segments of the population, however, was generally underestimated.

In Hungary, according to Kocsis (1999, 69), *officially-reported* real output fell by almost 20% between 1990 and 1993, and according to official statistics published in *Népszabadság* (December 20, 1999), real GDP did not reach the 1989 level until the end of 1999. The numerous Acosts@ incurred *as a result of privatization* are difficult to estimate, however, as some of these costs might have occurred even under the old regime, some would have occurred under a rationalized form of the old regime, some result from measurement inadequacies, and some are undoubtedly due to the systemic change itself.

One important cost of privatization has been an apparent shrinkage in employment. Although published Hungarian unemployment rates approximate the Western European average, they do not reflect the fact that by 1998, as shown by the U.N. Economic Commission for Europe (1999, p. 131), the *decline* in total reported employment in Hungary from the 1989 level was approximately 30%, the largest in all of the transition economies. The systemic change involved massive permanent layoffs and early Aretirements.@ Job losses during the first half of the 1990s were especially extensive and were concentrated among older workers (over 55) many of whom became unemployed as a result of the severe contraction of industries that had previously produced for the CMEA market. Unemployment and nonemployment continue to be extremely high among the Gypsy population, whose official unemployment rate, according to Ehrlich and Revesz (2000, p. 20) in some parts of the country reaches 50%. According to the Hungarian daily *Népszabadság* (January 22, 2000), homelessness among the Gypsy minority is also very high. What makes the official figures suspect and the nonemployment and unemployment picture rather opaque, however, is that due to the radical restructuring of the economy and because of high marginal tax rates, there has been an expansion in the informal (and unreported) Asecond@ economy, which, according to some of the estimates reported by Kocsis (1999, p. 65) now produces up to one-third of Hungary=s GDP. As to what portion of the intraplant underemployment that had existed in the previous planned economy is now being redistributed between nonemployment, unemployment, and employment in the informal sector cannot be ascertained with any degree of accuracy. For many in the region, however, joblessness has been a new experience and a severe blow not only in terms of income but also in social status and morale.

Although inflation rates during the 1990s in Hungary were relatively modest compared to the other transition economies (only the Czech Republic and Slovakia had generally lower rates), workers= real wages and labor=s reported share of Gross Domestic Product (GDP) both fell. As shown by the U.N. Economic Commission for Europe (1999, p. 92), compared to 1989, labor=s share of GDP in Hungary in 1995 was only 65.7%, which reflects the composite effects of *both* lower real wages *and* lower reported employment. What is unclear, however, is the degree of decline in *real incomes*, due to the expansion of the informal sector. Nevertheless, there is little doubt that income inequalities have widened and that a peculiar feature of the transition has been a marked polarization of society: the hardships being experienced by the majority are accompanied by the enrichment of a small minority.

Various demographic and social changes have also taken place, some of which show a society under stress since the reemergence of the market economy. As indicated by Matolcsi (1996), as a result of the introduction of the market system, the economy was subjected to an *unintended* shock therapy due to bankruptcies, higher inflation, and unemployment. Although life expectancy at birth for men did not decline in Hungary (as it did in the Russian Federation), there have been other indicators of social stress. Although the population is essentially stationary, marriages are down and divorces, out of wedlock births, and crime are up.

Some infractions have grown at an especially rapid rate during the 1990s. According to data provided by Hungary=s Central Statistical Office, customs violations, human trafficking, drug-related offenses, and theft by deception have increased especially rapidly. And the appearance of beggars at Budapest=s subway stops and in pedestrian underpasses is an entirely new phenomenon. Generalizing not only for Hungary but also for the whole group of transition economies, the U.N. Economic Commission for Europe (1999, p. 92) somewhat pessimistically notes: AThe transition countries, which had been characterized by relative equity, are now facing a split society.... A new...economic elite is emerging, while the former middle classes are sinking into poverty@ with all the attendant social problems that are to be expected.

Conclusions

By all reasonable measures, the Hungarian privatization process has been successful. The political transformation has been followed by an economic transformation; the private sector now (in 2001) produces over 80% of the country=s GDP. For the most part, the private sector operates the wholesale and retail sector, commercial banking, insurance, most manufacturing and construction, food processing and catering, printing and publishing, and tourism. Most public utilities have been privatized as well, including the national telecommunications company, the oil and gas industry, and the major part of power generating.

Privatization has been accomplished to a great extent by means of foreign participation. That foreign participation, in addition to causing domestic firms to be more globally oriented, is likely to have other major economic benefits in providing more domestic competition and entrepreneurial role models to Hungarian top managers many of whom were educated by and whose values were formed under the previous communist system. Both inflation and unemployment have been reduced from the early 1990s levels (although long-term, structural unemployment remains a problem), the government has repaid its debt to the IMF, and the currency is fully convertible for all business transactions within Hungary.

Considering the immensity of the tasks and the economic conditions faced by the country due to the collapse of the CMEA market, Hungary made a truly remarkable progress during the past decade. Since its political transformation that began in 1989, the country has become a pluralistic democracy and a market economy. It has successfully attained political stability; its third free, democratic election took place during May, 1998.

Hungary is a member of both the OECD and the North Atlantic Treaty Organization (NATO) and is a prospective member of the European Union (EU). Preparation for full EU membership is now at the heart of its external economic policy. It is thus expected to continue to encourage major inflows of Foreign Direct Investment also in the future. Domestic inflation has been reduced from the annual rate of 35% prevailing during the early 1990s; a single digit inflation rate was the government=s goal for the year 2000. The political and economic transformation of the country has been nothing less than profound. That transformation has been accompanied by certain social costs, however, and the future success of the market economy will undoubtedly depend upon its ability to keep these costs within politically acceptable bounds.

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