THE HUNGARIAN ENTERPRISE: ISSUES OF SIZE AND OWNERSHIP

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The main goal of the Hungarian economic reform at its outset in 1968 was to abolish the central allocation of materials and products, and to introduce market forces into the economy. As a result, Hungarian enterprises now formulate their own plans in the context of the national plan, and inform the central authorities of their goals. In addition, profit, instead of output, has officially become the main success indicator in Hungarian firms.

In place of direct central planning, the economy is run according to a set of indirect planning instruments. These instruments of "economic regulators" include prices, wagesetting rules, interest rates, bank credits, exchange rates, taxes, subsidies and tariffs. Over the past two decades these economic regulators have been modified constantly in response to changes in world economic conditions and domestic economic problems. The result is a complicated, often confusing set of rules, with which the government attempts to introduce certain aspects of a market economy – in other words, to imitate a market mechanism. Significant market orientation has been achieved through the introduction of several forms of private economic activity, ranging from autonomous agricultural co-operatives to small private companies. Yet the majority of Hungary's industrial production is still carried out by large, centralized, monopolistic firms.

The Hungarian economy operates on two distinct levels; state-owned enterprises have one set of rules and constraints, and the non-state sector, which includes private and co-operative firms, has another. This paper describes the rules and constraints facing each type of enterprise, the policies of state authorities towards the various types of firms, and the responses of managers to the constantly changing economic environment.

In our examination of Hungary's dual economy, we will see that in spite of attempts to introduce market forces, much of Hungary's economic system still operates on the principles of a traditional centrally-planned economy. This legacy is most obvious in the structure and behaviour of large state-owned enterprises, but can also be seen in constraints and rules influencing private firms and co-operatives.

The paper is organized as follows: Parts I and II describe the various forms of state and non-state enterprises and the rules of the game for each. Part III covers the objectives and constraints of enterprise managers in each type of firm. Competition between

the state, cooperative and private sectors on Hungary's capital, labor and commodity markets are examined in Part IV. Finally, Part V describes some of the reforms recently undertaken to address Hungary's internal and external economic problems, and some solutions offered by Hungarian economists

I. The state-owned sector

Hungary's state-owned industrial sector is one of the most concentrated in the world. The large enterprises were the result of several waves of mergers which took place in the late 1940's, 1950's, and early 1960's. These mergers were intended to improve the central direction and control of the large enterprises. However, the centralized, monopolistic structure which emerged was, and remains extremely ill-suited to the needs of a market-reformed economy.[1] Large state firms occupy monopolistic positions in the domestic economy, and often rely on the government's financial support to stay afloat.

The relationship between the government and large enterprises is based on several obligations which firms are required to fulfill, in addition to the officially stressed goal of maximizing profit. Large firms must provide contractual deliveries to the CMEA markets, meet the government's convertible currency export goals, and supply the domestic market with inexpensive consumer goods. In addition, they must employ the less productive portions of Hungary's labor force. These tasks limit a large enterprise's flexibility and responsiveness to changing market conditions.

Large Hungarian enterprises are typically over-diversifed, due to insufficient supply to the domestic market. Many workers are employed in side industries in order to fill their factory's supply gaps. In-house of direct and indirect inputs draw many workers away from the firm's main manufacturing activity.[2] Persistent shortage conditions make suppliers unresponsive to buyers' demands, an example of the "soft budget constraint".* Although new private and semi-private work groups fill some supply gaps, Hungary still has insufficient specialized subcontractors and small firms to provide the large firms with necessary inputs. The undependable delivery and quality of CMEA machinery imports has greatly contributed to supply problems. Because of lower CMEA costs and due to Hungary's hard currency constraint, however, large firms still prefer CMEA imports to those from the West.

Taxation and subsidization have become important instruments of indirect central control in the Hungarian economy. The constantly modified tax and subsidy laws directly influence enterprise incentives and long-temps plans. About 90 percent of a firm's gross profit is taxed away, when all enterprise taxes are combined.[3] In a survey conducted by Tardos between 1981 and 1985, of the 44 percent of *net* enterprise profits which was taxed away, 24 percent was redistributed in the form of subsidies. The gov-

* This refers to János Kornai's theory of cost pass-through of raw materials costs and capital costs in socialist economies. See also p. 4.

ernment's policy of equalizing revenues has amounted to taxing profits away from efficient enterprises and subsidizing less efficient firms.[4]

The problem lies in the tradition of informal bargaining between enterprise managers and government officials over taxes and subsidies, and the ambiguity of constantly changing financial regulations. According to Tardos, one-fourth of taxes and subsidies are allocated on the basis of bargaining between the government and the respective enterprises. Because the system is based on privileges, a firm's incentive to increase profits is considerably reduced. The confusing, changing rules also make it difficult for firms to adjust to long-term changes in demand.[5]

Hungary has a highly centralized monetary system. The allocation of investment funds and credit is largely under the control of central authorities. Large enterprises, because of their close bargaining relationships with government financial officials, enjoy preferential access to investment allocations. Based on the government's goals of increasing large enterprises' hard currency exports, maintaining certain levels of employment, and fulfilling CMEA export goals, large firms obtain credits and loans over small, private enterprises. The lack of market-determined criteria (i.e. profitability) in the government's allocation of investment and credits is one of the sources of what Kornai calls the "soft budget constraint". According to Kornai, "although there is a budget constraint that forces some financial discipline on the firm, it is not strictly binding, but can be 'stretched' at the will of the higher authorities."[6]

Another form of indirect regulation is the pricing system. Although in 1980 producer prices were directly linked to world market prices, there is still limited flexibility in both consumer and producer pricing.[7] Prices continue to be heavily subsidized and taxed, distorting suply and demand conditions. On one hand, the government is gradually giving firms more freedom to determine prices on the basis of supply and demand; on the other, it limits this freedom in order to prevent large firms from taking advantage of their monopoly power on the domestic market.[8]

Wage regulation is another method used by central authorities to influence enterprises in the state sector. Since the abolishment of absolute ceilings on the total wage bill in 1968, wage regulations have changed frequently. Until recently, state enterprises were progressively taxed according to average wages, wage costs, or wage increases. The result was a highly restrictive wage system in which wage increases were not tied to increases in profitability. In spite of some liberalization in wage policy, there remain strong central pressures on firms to follow the wage policy guidelines.[9] To get around the restrictions, firms compensate workers with non-monetary benefits, or they hire private or semi-private groups (described below) at a higher wage to carry out needed tasks.

An important factor in determining both price and wage levels has been Hungary's hard currency debt status. Faced with the necessity to reduce this debt throughout the 1980's, the government's austerity measures resulted in the stagnation or decline of wage levels in state enterprises, which in turn has affected productivity and incentives.[10]

II. Non-state sector

Hungary's non-state sector consists of several different forms of economic activity, some legalized and others still operating outside of the official sphere. The legal or official non-state sphere includes co-operatives, small privately-owned operations, and groups of mixed ownership, which usually involve the use or leasing of state facilities. Table 1 shows the contribution to national income of the state versus non-state sector:

Table I[11]
Contribution to National Income

	1975	*1980*	*1984*
1. State sector	73.3	69.8	65.2
2. Non-state sector, consisting of:	26.7	30.2	34.8
A. Co-operatives	17.8	19.8	206
B. Private activities*	8.9	10.4	14.2

* Includes household farming, contract work associations, and the formal private sector.

As shown by the table, the non-state sector's contribution to Hungary's national income has grown steadily since the advent of reform. The legal or "formal" sphere of private activity includes small cooperatives, specialized industrial and service cooperative groups, and contract work associations.

A. Co-operatives

Non-state co-operatives are responsible for about one-half of Hungary's agricultural output. Since the agricultural reforms of the early 60's, these co-operatives have not only become much more attuned to market forces than the traditional Soviet-type co-operative farm, but they have diversified into non-agricultural activities such as food processing, the production of parts for state-owned industry, production of light industrial goods, construction, trade, and restaurants. Production from private household plots has also been quite successful in Hungary. A unique division of tasks has evolved between co-operatives and private household farming in which the co-operatives concentrate on efficient large-scale production of grain and fodder, while the private household farms carry out small-scale, more labor- intensive agricultural activities.[12]

In addition to their significant role in Hungary's agricultural sector, non-state, non-agricultural co-operatives have contributed substantially to the manufacturing, construction, commerce and service sectors.[13] Co-operatives are restricted in size to 15 to 100 members. By keeping membership under 30, however, co-operatives can avoid many of the bureaucratic restrictions imposed on large co-operatives, such as the election of a supervisory committee. Small co-operatives elect a chairman to manage the operation, but the general assembly decides major issues such as approval of a change of statutes,

preliminary consent to major contracts, or the dismissal of members.[14] Most importantly, small co-operatives are financially autonomous. They assume the same financial risks as do small private firms, that is, if they incur losses, the government will not bail them out. The inavailability of government subsidies, credits and loans to small co-operatives creates a "hard budget constraint". This accounts for the stronger profit motive and increased price-responsiveness among small co-operatives.[15]

According to Kornai, co-operative members prefer to work in this sector because "it combines the efficiency of a medium size firm with a certain degree of participation in managerial decision. The linkage between individual and collective performance and individual earning is more direct than in the state-owned firm."[16]

B. The Formal Private Sector and Contract Work Associations

Private activities have filled many of the gaps created by shortages in the consumer sector in Hungary, as demonstrated in the private agricultural and construction industries. In the absence of adequate public housing services, Hungary's private sector has virtually taken over the construction sector. In 1980 71.4% of the total housing was privately-owned, and 85.7% of all housing built in 1984 was privately-owned.[17] Because of its stabilizing effect on the economy, especially in the area of social services, private economic activity continues to be supported by the government. Official encouragement of private enterprise is demonstrated by the new law which raises the limit on the number of employees in a private firm from 30 to 500.[18]

Some of the most significant new forms of private activity are the contract work associations (CWA's), legalized in 1982. These groups manufacture for the provide other services to enterprises, cooperatives, or the population at large. One type, the independent CWA, is not affiliated with a specific enterprise and is essentially privately-owned. Members invest their own capital or lease capital and facilities from the state sector, and work for market wages. Since their legalization in 1982, the number of ICWA's has grown rapidly, due to the easing of government licensing restrictions.[19]

A related form of private activity is the enterprise contract work association (ECWA). In 1982, after one year of legal status, there were 2,775 ECWA's; by the end of 1984 this number had grown to 17,337.[20] These groups contract with an enterprise to carry out tasks which cannot be done by the enterprise due to a shortage of labor, ECWA's can also carry out some tasks more cheaply than the state sector. They work after hours or on weekends, using the enterprise's tools and facilities. Highly productive workers prefer to work in ICWA's or ECWA's instead of working regular overtime in their factory, because they can earn two three times the regular factory wage.[21] The purpose of creating these new forms is to give a legal framework for previously illegal activities, and yet to allow the employing firm some control over these groups. ECWA's are supported by many state enterprise managers because in this way they can get around the central wage regulation and still improve the operation of their firm. ECWA activity is carried out in the framework of a state-owned firm, so it provides

ambitious workers with an opportunity to earn a higher wage while avoiding the risk of working independently, as in the ICWA's. The ECWA is often commissioned by a state firm, or gets its from outside the firm with the consent of the firm manager.[22]

Other forms of mixed ownership include leasing arrangements, in which a private individual leases fixed capital from the state, pays taxes, but keeps the profit or covers the deficit at his own risk. This form is very common in the foreign trade and restaurant sectors.[23]In addition, there are now 111 joint ventures in Hungary, and the government has recently legalized wholly-owned foreign firms.[24] Although foreign firms and joint ventures compose a relatively small sector of the Hungarian economy, recent liberalization of taxes and regulations has made Hungary more attractive to foreign investors. However, the limited convertibility of the forint remains an impediment in attracting foreign investors to Hungary.

Unlike the state-owned enterprises, the private sector rarely receives credit from state-owned banks, and therefore must rely on funds from private sources. This situation has been somewhat alleviated recently by the creation of several small new financial institutions (non-banks) which provide capital for new ventures is the form of credit and/or equity. These small institutions actively compete with each other in the market for financing small firms.[25]

III. Large enterprise management

In Hungary's case, the transformation of the centrally-planned economy did not make state-owned firms autonomous. In spite of the abolishment of mandatory planning, these firms remained dependent on the center. In pre-reform Hungary, planning was not exclusively based on directives and central distribution, but was largely influenced by bargaining and negotiation between the central authorities and enterprise managers. Economic decision-making was made by government and party-appointed managers.

In spite of efforts to make firms more autonomous, the links between managers of large firms and Party and government officials have remained strong throughout the reform. Party organs directly or indirectly influence managers by persuasion, or discriminative practice of budget subsidization, tax relief, or credit-granting. According to Tardos' 1981–1985 survey, the primary interest of large enterprises managers is to establish good relationships with party and government financial officials.[26]

This trend was especially evident in the state-owned foreign trade sector, where enterprise managers insisted that as long as the government remained socialist, their primary goal was not to maximize profit but to fulfill the authorities' expectations in meeting CMEA contractual goals, increasing exports and reducing imports. These managers perceived it their duty to pursue the interests of the "socialist national economy". They viewed the market essentially as an instrument to harmonize the details of supply and demand, but not to determine the survival or failure of their enterprise.[27]

State enterprise managers are faced with a set of conflicting and confusing goals. They are expected to generate profits, satisfy the demand of the domestic market,

produce for exports, keep prices down, save on costs, and solve conflicts over wages and working conditions. In addition to this, they are expected to introduce technological innovation. The contradictions are clear: pursuing efficient, profitable management and technological innovation will necessitate lay-offs. Yet according to Tardos, most managers avoid the conflict brought about by the threat of lay-offs, and instead of insisting on profit and efficiency, choose to retain superfluous labor. All enterprise managers claimed that if they had the right to fire workers (which they do in theory), they could manage to continue operating (and to pay better) with one-half to-thirds of their current work force.[28]

In Hungary, as in most industrialized countries, managers of large firms have often held high-ranking positions in the Party and/or government, and vice versa. The fluidity of movement in political and economic circles reinforces managers' internalization of the goals and attitudes of the central authorities. According to Ádám Angyal, manager of the Hungarian Ship and Crane Factory (a large state enterprise), "politically trusted and active individuals frequently move between positions in high [political] offices...and enterprise management..."[29] It should be stressed, however, that large enterprise managers maintain close ties with the authorities because of the underlying economic rewards inherent in these relationships.

In 1985 a new system of electing state enterprise managers was instigated. Now the top managers in most state-owned firms are no longer appointed by higher authority, but rather are elected by the employees of the firm.[30] This is the first step in loosening the links between party and government officials and large enterprise managers.

IV. Private and co-operative management

In contrast to the negotiable or "soft" constraints faced by large enterprise managers, private and co-operative firms face economic constraints enforced by the market, and legal constraints enforced by the government, i.e. they are both "hard". If the enterprise is not profitable, it goes bankrupt. These operations are more market oriented and price responsive than those carried out by state-owned firms. However, co-operatives and private enterpreneurs are limited in the size of their operations, type of activity, and level of profits. The lack of a capital market for these enterprises also contributes to the small size and scale of these activities. Constantly changing tax laws create an uncertain environment. For example, austerity measures introduced in January, 1988 included a progressive personal income tax and a value added tax (VAT) of 25%. Both the VAT and the income tax drain off capital which otherwise would go into much-needed private investment, and are therefore a disincentive to potential enterpreneurs.[31]

The new law allowing up to 500 employees in private companies could create more competition between private and state firms, but only if it is accompained by changes in Hungary's capital market. Private and cooperative firms must have the opportunity to compete equally with state firms for loans and credits, and to be axed at compar-

able levels. Anothermeasure to be introduced is 1989 in the so-called "association law", which will allow privately held share companies.[32] This law should facilitate private firm's access to capital; however, the real issue remains the large enterprises' unfair advantages over small, private ventures and co-operatives in obtaining financing.

Private entrepreneurs have traditionally been afraid to invest too much in long-term fixed assets because of progressive taxes and uncertainty about future political and economic conditions. They fear the possibility of their assets being nationalized; without government assurance that their assets are secure, they are unwilling to take long-term risks.[33] Partly because of the experience of confiscation in the late 1940's, most people still have little confidence in the permanence of private enterprise in Hungary. The attitudes about entrepreneurship and risk-taking so common in free market economies will take longer to establish in Hungary, and will require stability of the laws effecting these enterprises.

V. Competition between state and non-state sectors

Competition between the state and non-state sectors in Hungary occurs mainly in the labor and capital markets. Large enterprises' wage systems are rigid and do not allow adequate compensation of worker initiative; as a result, ambitious workers turn to the private sector (ECWA's, ICWA's), while often keeping their state-sector job. The abundant opportunities in the private and co-operative sectors mean that many Hungarians sacrifice their leisure time to supplement their incomes. According to Kornai, one-third of the labor force's total work time is spent in the private sector.[34] Meanwhile, the state-owned sector sustains underemployment of its labor force.[35] Inflation, combined with the depressed level of state sector wages forces many Hungarians to take on second jobs; this results in conditions of stress and overwork. The situation is increasing the pressure for a freer wage system in state enterprises.

Whereas private and co-operative firms enjoy advantages over state firms in the labor market, the opposite is true in the market for capital in Hungary. Large state enterprises' strong ties to the central bureaucracy give them a definite advantage over small private firms and co-operatives in obtaining loans and credits. State firms have maintained ties with specific banks, and there are no hard and fast rules on refinancing limits, interest rates charged on refinancing credits, or reserve requirements.[36] The system of informal bargaining generates inefficient allocation of capital, and has even been shown to cause negative rates of return in some of Hungary's high priority industries.[37]

Recent reforms have produced important changes in Hungary's financial system: Limited markets for stocks and bonds were set up, and new methods of inter-enterprise financing, which involve bills of exchange and inter-firm commercial credits, are allowed. In 1987 the monopoly of the central bank was officially curtailed and five new commercial banks were established. However, major financial decisions are still cen-

trally determined by negotiation between large state enterprises and the authorities rather than being based on uniform and binding laws.[38]

VI. Summary and conclusions

The majority of state enterprises continue to depend mainly on the government authorities, and only to a lesser degree on market discipline. The lack of enterprise autonomy in Hungary's state sphere is a direct consequence of these firms' inability to adapt to market conditions. Under existing circumstances, bankruptcy is not a plausible threat for large state firms. These firms continue to occupy monopolistic positions, both on the commodity and capital markets. The situation is perpetuated by the privileged positions of managers in the government and Party hierarchy.[39]

In Hungary there is an open and lively debate over the country's economic problems. A somewhat radical group of reformers has proposed the following measures to address the situation of large and small enterprises. This group proposes that control over allocation of financial regulators (taxes, subsidies) should be shifted from the branch ministries to the Central Bank. The intent of this change would be to base financial decisions on market performance of firms, rather than on negotiation, bargaining, and privileges. In addition, they propose that tax revenues no longer be used to subsidize inefficient enterprises, and taxation not be used as the primary means for controlling wages and allocating investment. State and private enterprises which produce the same commodities should have uniform tax rates.[40] This would reduce the unfair competition between state and private enterprises on the labor and capital markets.

Finally, new forms of ownership should be introduced. State-owned assets should be allowed to be collectively-owned, in the form of transferable property shares. State firms could also be converted into joint-stock companies, with their assets owned by individuals and institutions which would have a real interest in the value of the shares, and would buy and sell shares in their best interests.[41]

The probability that these measures would have political support in the near future is subject to question. In the eyes of the leadership, Hungary's immediate need is to reduce its convertible currency debt. The large state firms are perceived as the only ones who can carry out this task. Western observers and many Hungarian economists see reliance on state firms as the source of the problem, not the solution. So far, the market-oriented solutions proposed by Hungary's reformers appear to be outside the bounds of the leadership's views on economic policy.

Hungary has managed to actively pursue "market-oriented" reforms for the past 20 years, and will certainly continue to introduce new measures aimed at increasing economic efficiency and performance. The question remains, however, to what extent fundamental institutional change will occur, especially in regard to the status of the large firms. As long as these firms hold monopolies in the majority of manufacturing and production, real market competition is impossible. The success or failure of market re-

form in Hungary depends on the government's ability to adjust to the economic environment, while continuing to experiment with new forms of ownership and management.

Notes

1. Catherine M. Sokil, "Markets and 'Market-type' Instruments in a Reforming Centrally Planned Economy: The Case of Hungary". Paper presented at SSRC Summer Workshop on Soviet and East European Economics. July 10–21, 1988. p. 3.
2. Leyla Woods: "Enterprise Size, Behavior and Performance in the Reformed Hungarian Economy", in Josef C. Brada and Istvan Dobozi (eds.) *The Hungarian Economy in the 1980's: Reforming the System and Adjusting to External Shocks.* (Greenwich, CT and London: JAI Press, 1988)
3. Enterprise taxes include: property tax, wage tax, special enterprise tax, urban and communal contribution turnover tax, general income tax, corporate tax, income tax on employees, profit moderation tax, tax on earnings, and social security contribution. György Varga, "Tax Reform in Hungary", Paper presented at 11th Annual Hungarian-American Roundtable, Bloomington, Indiana, Oct. 27–Nov. 3, 1987.

   The survey, conducted between 1981–1985, covered manufacturing, agriculture, construction, transportation and foreign and domestic trading firms. Márton Tardos, "The Behavior of Hungarian Firms Since the Abolishment of Mandatory Planning", 1987, p. 14.
5. *Ibid.*
6. János Kornai, "The Hungarian Reform Process: Visions, Hopes, and Reality", *Journal of Economic Literature,* vol. 24, Dec. 1986., p. 1697.
7. Paul Marer, "Economic Reform in Hungary: From Central Planning to Regulated Market", U.S. Congress, Joint Economic Committee, *East European Economies: Slow Growth in the 1980's.* vol. 3 – Country Studies, 99th Cong., 2nd Sess., 28 March 1986, p. 261
8. *Ibid.,* p. 260
9. Kornai, p. 1696.
10. Marer, p. 261.
11. Hungary, Central Statistical Office. Cited in Kornai, p. 1692.
12. Kornai, p. 1702.
13. *Ibid,* p. 1703.
14. György Varga, "The Role of Small Ventures in the Hungarian Economy", in Brada and Dobozi, pp. 70–71.
15. Kornai, p. 1704.
16. *Ibid.*
17. *Ibid.,* p. 1708.
18. *New York Times,* 6 October 1988, p. 41.
19. Marer, p. 252.
20. Kornai, p.
21. Marer, p. 251
22. Kornai, p. 1709.
23. *Ibid.*
24. *New York Times,* 12 October, 1988.
25. Sokil, p. 13.
26. Tardos, pp. 6–7.
27. *Ibid.,* pp. 7–8.
28. *Ibid.,* pp. 10–11.
29. Ádám Angyal, "A nagyvállalat szindróma", *Közgazdasági Szemle,* 1984, no. 5.
30. Kornai, p. 1694.
31. *Business East Europe,* 22 August, 1988, p. 266.

32. *Ibid.,*
33. Tardos, p. 23.
34. Kornai, p. 1707.
35. Sokil, p. 9.
36. *Ibid., p. 12.*
37. Mark Reiman, ''Generalized Restricted Cost Functions for Hungarian Heavy Industry; a Translog Test of the Soft Budget Constraint Hypothesis'', PhD Dissertation, University of Washington, 1988.
38. Tardos, pp. 17–18.
39. László Antal, et al., ''Fordulat és reform'', *Közgazdasági Szemle,* 1987, no. 6.
40. *Ibid.*
41. Tardos, pp. 23–24.

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