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The Hungarian model: markets and planning in a socialist economy

XAVIER RICHET

Translated by J.C. Whitehouse

THE HUNGARIAN MODEL: MARKETS AND PLANNING IN A SOCIALIST ECONOMY

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Preface

My aim in this book is to examine the economic reforms introduced in Hungary over the last twenty years or so. More specifically, I wish to investigate decentralization procedures and the effects of decentralization on the Hungarian economy and the behaviour of agents. The mainly institutional approach adopted represents an attempt to describe the main features of the system which came into being as a result of the successive changes and modifications following the 1968 reform, and to reflect on the feasibility of a market socialism combining micro-economic efficiency, indirect regulation and socialist ethical principles. The situation-related and structural problems which the country is experiencing and the latest reforms, introduced during the first half of 1988, mean that the questions examined here are quite important.

For some years the Hungarian leaders have seemed to be embarked on a cycle of reforms to their system. Each successive one has led them to widen the area of decentralization and extend it to hitherto relatively unaffected fields, and we have seen such developments as a virtual capital market, a fiscal system now including income tax and value added tax, and a consideration of the possibility, however problematic it may be, of reforming political institutions as well as increasing the role played by indirect regulation in the form of a credit policy and a wider sphere of free prices and the like. Such reforms have been carried out in a fairly unfavourable economic environment reflected in the poor performance of the Hungarian economy. These latter questions have not been taken into account here, and little attention has been paid to foreign trade or agriculture. The mechanisms studied here, however, apply to both those sectors.

In my research, I have enjoyed the support of the CNRS (the French National Centre for Scientific Research) and the Hungarian Academy of Sciences, and have been able to spend several study periods in

Hungary as a guest of the Institute of Economic Sciences in Budapest. I have also had the opportunity of visiting many institutions, research centres and ministries, including the Finance Ministry, the National Planning Office, the Hungarian National Bank, and several enterprises. During my investigations, I have always had considerable help from my Hungarian colleagues and informants. My particular thanks are due to Professor J. Kornai and the Messrs M. Tardos, J. M. Kovács and T. Bauer, who regularly provided information. The constant help and friendship of J. Koltay, A. Soós and L. Halpern must also be mentioned. In addition, I should like to thank Professor M. Lavigne and my colleagues A. Deszényi-Gueullette, P. Hare, M. Marrese and H. Radice, who all in various ways had a beneficial effect on my research.

Paris, April 1988 XAVIER RICHET

Foreword

Hungary is an exciting country to study, and this book could hardly have come forward (at least in its English version) at a better time. For Hungary's leader since 1957, János Kádár, was finally pushed aside (to the largely honorary position of Party president) at a special party conference held in May 1988. Many of the more conservative elements of the old leadership not only failed to retain their positions on the Political Committee, but they were not even re-elected to the Central Committee which changed over a third of its membership. Thus the new First Secretary of the Party, Károly Grosz, has many fresh faces to work with on the leading bodies of the Party and within the country there is now considerable optimism that reforms – both economic and in the country's social and political institutional structure – will be resumed with added vigour and commitment. This would contrast strongly with the closing years of the Kádár era, when the country seemed to drift from crisis to crisis, introducing partial and half-hearted reforms, but lacking clear direction.

Considered alongside the recent developments, Richet's book provides an exceptionally thorough treatment of the Hungarian economy and its important experience of economic reforms, leading up to a discussion on the limits on and limitations of the present Hungarian economic model. For students of Soviet-type economies (STEs), this is essential reading; some of the ideas might even be of benefit to Hungary's new leadership!

Alone among the European STEs, Hungary not only embarked on a programme of radical reforms in 1968 (known initially as the New Economic Mechanism), but unlike other radical reformers such as Czechoslovakia, never returned to the traditional, highly centralised model of an STE. There were, however, some twists and turns in the country's reform experience, including substantial recentralization in the early to mid-1970s and a renewal of reform momentum, from the late 1970s onwards. By now, it is evident that the major reforms undertaken so far have been insufficient to overcome the country's problems: in recent years, living standards have begun to fall, output has increased only very sluggishly, and hard currency trade and payments have been a major difficulty. Politically, the continuing difficulties have provided ammunition for those opposed to reforms, while the reformers have argued forcefully that reforms must go much further to be really effective.

At this point, it must be conceded that much early work on reforming STEs (including some of my own) was marked by what now appears as a striking degree of naivety. Reforms tended to focus on enterprise-level incentives, pricing and, in the Hungarian case, dismantling the apparatus of current planning. The latter, especially, sounded sufficiently radical to change the manner of the economy's functioning, not least because it was buttressed by exhortations to enterprises to study their markets and respond to market signals. To many observers, this was market socialism in the making.

How wrong we were! And one of the great strengths of Richet's book is that it explains what went wrong, and why. While traditional forms of planning were changed or abandoned and the market was permitted greater influence, the central institutions were not markedly reformed, and retained (*de facto*, at least) their formal and informal powers over the economy. As Richet puts it, 'the third type of mechanism – a particular method of allocating resources called social expectations. In STEs it is inseparable from planning, and it forms the natural complement to systems of injunction. It is all the more important because the other mechanisms – the plan and the market – have partially failed . . . and although it is typical of the administrative planning phase it has survived efforts to decentralize and introduce indirect regulation' (p.185).

Social expectations, the mainly informal 'guidance' that permeates the Hungarian economy and affects every enterprise, have continued to dominate the course of development partly because of the interpenetration of party and government that characterizes communist countries, ensuring that the political and economic spheres should not be separated; and partly because of Hungary's astonishingly high concentration of production, it is hard to see how markets and competition could have functioned within the limits of the domestic market alone. For the market to work well, Hungary must be a highly open economy whereas, ironically, its very failure to advance in that direction reinforces the conditions – low efficiency, poor innovative performance, over-protection of large domestic firms – that make such an advance so difficult to achieve.

In this respect, Hungary's development experience contrasts interestingly with that of the newly industrializing countries, the so-called NICs. Several of them (e.g. Taiwan, South Korea, Hong Kong, Singapore) have developed highly competitive, sophisticated industries on the basis of an extremely strong orientation of their economies towards participation in world markets.

In many of their speeches and articles, one can see this orientation proposed by Hungarian leaders; but it is one thing to say it, and another thing altogether to do it, especially in view of the persistence of the 'social expectations' approach to economic management noted above. In practice, Hungarian firms have been slow to modernize, and when they have done so it has often been with regard to the domestic or CMEA market requirements, rather than to the more demanding conditions of the Western world market. At the same time, import restrictions have sometimes inhibited the import of Western technology, and the prevailing protection of major enterprises by the State in any case makes change seem unnecessary. In this environment, it is not surprising to find that the most significant changes and the most dynamic developments are occurring in parts of the economy least under state influence, such as agriculture, small-scale private and co-operative businesses and much of the personal and business services sector.

Somehow, the same dynamism must be extended to the rest of the economy; and while Richet's book is not exactly a detailed blueprint for fundamental reform, it does at least set out a clear and full agenda for anyone with serious intentions to revive Hungary's lack-lustre economic performance.

PROFESSOR PAUL HARE

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June 1988

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1 A model of market socialism?

In many respects the planning system that has grown up in Hungary and is regularly modified by the government is unlike the classical model encountered in most Soviet-type economies. There is no apparent clash between planning and market forces, the economy is increasingly open to foreign trade (with market economies) and new forms of co-operation between enterprises are emerging. Individual initiative is encouraged, agricultural productivity is rising, and enterprises in the socialist sector are increasingly free to make their own decisions. At the same time, the function of macro-economic planning is merely to set guidelines, and a new decentralized financial system will, in principle, replace the old system of financing activities by means of the State budget.

It is of course true that the international economic climate is currently not very favourable and that adjusting the internal mechanisms of Comecon might, in the medium term, threaten the smooth running of a decentralized economy. Nevertheless, Hungary's economic performance after the stringent policy of adjustment adopted during the critical period of the 1980s has exceeded that of certain of its Comecon partners, despite a very considerable increase in productivity. Currently, it has one of the highest growth rates in Eastern Europe, along with a relatively high level of debt.

Despite problems and partial achievements of this kind, the Hungarian leadership is determined to pursue reforms and also plans to introduce new measures to increase decentralization. What is being attempted in Hungary is helping to give a more precise shape to the new model of market socialism to be described in this book. My task will be to present the striking features of that model, to analyse how it proved possible to introduce it into what had hitherto been a highly centralized economy, and to show clearly the constraints it is currently encountering.

The new features of Hungarian economic reforms

There are three immediately striking aspects of the reforms. In the face of periodic attempts to return to a centralized policy, they have been extensive, continual and progressive.

During the 1950s and 1960s, every Eastern European economy underwent more or less considerable reforms (Kaser, *et al.*, 1986). The aim was to smooth the passage from 'extensive' to 'intensive' growth, which meant using more sophisticated planning instruments whilst still retaining the principles of both micro- and macro-administrative planning. In other words, the introduction of market elements such as prices and profits was intended to help to bring about a more rational version of the centralized model rather than to replace it, which in general terms explains the secondary role allotted to the market. The age of reforms in Eastern Europe persisted for a few years before the centralized model once more became dominant. The only countries to reform their planning system were those (like Poland) which had no choice. The others preferred to return to the delights of 'perfecting the existing mechanism' (Richet, 1986a), thus avoiding the need for reform or limiting it to particular areas. The Hungarians alone continued to plough their furrow, extending the scope of their reforms from planning mechanisms to the institutional field.

Any thorough-going reform of planning takes a great deal of time, both to adapt mechanisms and to modify institutions and the behaviour of agents. In a highly centralized economy with a flourishing and ubiquitous bureaucracy, Schumpeter-type entrepreneurs do not emerge overnight. Moreover – and we can see in this another quality of the Hungarian reformers – there were a good number of economic and political constraints (external problems, recession, the leadership of the Communist party) affecting society that might on several occasions have cooled a vague desire to extend decentralization. Apart from one or two moves towards recentralization in the 1970s and early 1980s, however, the reforming spirit and determination remained paramount.

1. The scope of the reforms

In the typology of the models of various kinds of socialism, the two poles of the centralized and the decentralized (or market) models are generally taken as points of reference. Although the former, which is, roughly speaking, in operation in most socialist countries, is not hard to define, describing the latter is a more delicate task, given the degree of decentralization, the distribution of power, the organization of enterprises, the kind of tools used for control, and the roles allocated to planning and the market respectively. As we shall see later, the Hungarian reformers tried to introduce instruments compatible with the principles governing the way the socialist economy worked.

The aim of the reforms introduced in 1968, under the title of the New Economic Mechanism (NEM), was to adapt the Hungarian economy to the conditions of the international division of labour by attempting to guide investment towards those sectors offering sure economic advantages. This would mean opening it up and consequently giving it easier access to Western technology and the chance to modernize its productive apparatus and hence to pay for the acquisition of capital goods by means of exports bringing in convertible currencies.

An overall reform of the management system was initiated in order to achieve this. Indirect instruments of control – known as regulators – were introduced with regard to prices, taxation and incentives in the field of foreign trade. At the same time, the practice of a highly compartmentalized plan and the transmission of orders from the centre to enterprises was abolished,and as a consequence of market relationships the latter achieved a greater freedom to arrange their own supplies and organize their markets, importing raw materials and plant and fixing production levels freely. What happened in fact was that these indirect mechanisms were additional to the already existing direct ones. A number of the prerogatives of the plan were maintained, and a not inconsiderable proportion of investment was still determined centrally and financed by means of the State budget. The system of prices and taxation, as well as profits, were also highly controlled. The old bargaining practices, which had more to do with fixing rates of taxation or prices than levels of output or the provision of finance, were implicitly retained. Bargaining about planning objectives was replaced by bargaining about regulators (Antal, 1986). Until recently, foreign exchange regulators continued to reflect a preference for a protectionist system rather than an opening up and a dynamic approach oriented towards increased exports.

One of the factors partly accounting for the limited nature of the first wave of reforms is that it was restricted to the purely economic field. Indeed, there was no change in the institutional structure of planning (central power, a great deal of Party intervention in economic life, and so on) or the highly concentrated structure of industry. Two further factors also served to act as a brake on the effects of the reforms: Hungary's membership of and high level of trade with Comecon, and the end of the period of reform in most other Eastern-bloc countries.

Within the country itself, both the administrative apparatus and the trades unions also helped to slow down the process and led to an almost total recentralization in the early 1970s.

2. *Ongoing cumulative reform and short-term recentralization*

In the 1970s, both Hungary and the other socialist countries of Europe experienced a slow deterioration (and in the case of Poland a real collapse in growth) in their economic performance, a rising level of debt and the emergence of both internal and external imbalances. Recentralization seemed to offer the easiest immediate solution, particularly since the Hungarian leadership, like that of the other socialist countries, was slow to realize the seriousness of the crisis affecting growth in market economies and the reasons why its own was flagging. Reactions were tardy, particularly where putting defensive policies into operation was concerned.

Coupled with the brakes on reform, this delay in seeing problems and reacting to them accounts for several of the imbalances severely affecting growth, particularly with regard to foreign trade with Western markets and the Comecon zone. There was a very marked decline in the terms of trade, and both inflation and foreign-currency debts soared. There are a number of reasons for this decline.

On the one hand, there is a relative scarcity of energy and mineral resources. Hungary imports 45% of its energy, including 80% of the crude oil it consumes. Furthermore, since energy costs little domestically and modernization of the productive apparatus, which consumes more energy, has taken place, consumption has become highly elastic in relation to growth. On the other, given the structure of its foreign trade and changes in world prices, the country has experienced a decline of 20% in its terms of trade, which corresponds to a fall of 10% in national income. In the face of a high level of domestic demand and given the structural factors mentioned above, the government has been powerless to contain this trend.

In 1978, the new economic policy established two priorities that were to help slow the cycle down. These were that external balance should take precedence over growth and that maintaining the standard of living should be seen as more important than investment.

Achieving a moderate (3% on average) growth rate without increasing imports was deemed possible, and the considerable reduction in accumulated national income was expected to put the latter objective within reach. The expected results did not materialize. Not only did it take time to reorient growth, but maintaining the general standard of living also demanded a larger share of national income at the expense of investment.

Controlling and reducing domestic demand, stabilizing debt and getting back to external balance were achieved in the early 1980s by the introduction of a policy of depressing the economy, leading without doubt to balance, but at the cost of a long period of stagnant growth.

Given the background of stagnation, the effects of the second oil crisis increased the difficulties the Hungarian economy was facing. For a time, the fall in demand from abroad, and more particularly from countries with convertible currencies, made it harder to increase exports, and because of its many structural problems Comecon was no longer an enormous potential market capable of absorbing Hungarian surpluses. A lasting and vigorous policy of adjustment was therefore needed if the Hungarian leadership was to reduce imbalances and restore the relative position of their country's economy (Richet, 1985a). However, after implementing such policies and engaging in recentralization for brief periods (1974–9 and 1982–4) they came to the conclusion that administrative measures such as subsidies, reintroducing quotas, controlling investment and the like were not a suitable long-term answer and that only further reforms could provide the solution to Hungary's economic problems.

The second wave of reforms (1979–82) intensified decentralization and also came to grips with a hitherto exempt area, that of planning institutions. Two series of measures were introduced.

(a) Adjusting the instruments of control The major reform concerned the price system. Prices, which had previously been more or less hybrid in the sense that they were half freely and half administratively determined, did not offer a satisfactory reflection of the relative scarcity of goods, particularly at a time when the prices of raw materials were increasing. The gap between producer and consumer prices was therefore reduced by lowering the level of subsidies. They were fixed by a competitive price system established to ensure that Hungarian enterprises exporting more than 5% of their production had to calculate domestic prices on the basis of the level of profitability achieved on exports. Enterprises were thus encouraged to make more rational use of their factors of production. The price of energy