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Transition Issues: A Case Study of Hungary

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Abstract

The collapse of Eastern markets has increased the depth and duration of the recession in Central and Eastern Europe, making the implementation of reforms more difficult than expected. Drawing on the Hungarian experience, the paper reviews some of these difficulties in the areas of fiscal and monetary policy, and privatization. In the fiscal field, the factors which have contributed to diverging trends in revenue and expenditure and the resulting issue of growing deficits are discussed. In the area of monetary policy, the issue of uncertainty is emphasized. Finally, the paper examines the factors that hinder privatization.

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Summary

This paper argues that the sharp fall in output in the transition countries of Central and Eastern Europe should be regarded as an "exogenous" reform supply shock. This was caused as much by the conditions that led to the reforms as by the reforms themselves and the necessary tightening of financial policies to harden budget constraints and to promote liberalization and restructuring. Drawing on the experience of Hungary, the paper examines some of the difficulties encountered by the reforms in the areas of fiscal and monetary policy and privatization.

In the fiscal area, the paper reviews the factors that have contributed to a decline in the tax/GDP ratio and those that are preventing a similar scaling back of expenditure, among which is the costly social benefit system inherited from the socialist past. It is not inconsistent with the reforms that, in the early stages of transition, the negative macroeconomic consequences of larger fiscal deficits may be offset by an increase in the willingness of households to save. However, if the diverging trends in revenue and expenditure are not reversed by a downsizing of the budget redistribution, they will pose a serious threat to stability and the resumption of growth.

The formulation and implementation of monetary policy in transition economies is complicated by the unpredictability of expectations. Having learned not to trust government policies under the communist regime and remembering the stop-go reform policies of the past, people remain skeptical about the durability of current policies. A further complication is the uncertainty about developments in the real economy, since the official statistics do not yet capture the growing private "gray" economy.

Finally, the paper reviews some of the conditions that hinder privatization. Most importantly, (i) the valuation of enterprises has been hampered by the lack of an active industrial assets and real estate market and the fact that the past track record of a firm is not a good indication of its future performance because of the fundamental structural changes in market prospects; (ii) with government finances coming under heavy strains, the pressure to obtain the highest possible price for the privatized enterprise has increased just as the market prospects have weakened; (iii) the emergence of conflicts of interest between those responsible for privatization--for example, between managers and the government or between central and local government authorities--have slowed the privatization; and (iv) frequent shifts in priorities set by the government--for example, between employment maintenance, minimum national participation, and the best possible price--have delayed the conclusion of many deals.

I. Introduction

When Central and Eastern Europe embarked upon the transition two years ago, it was often said that they were entering uncharted waters: that the attempt to move from a centrally planned economy to a market economy was unprecedented and that the transition would be a process of learning by doing. After two years of experience, it is clear that these statements were not the mere expression of commonplaces but recognition that, while the starting point and the final destination were known, there were great uncertainties about the obstacles and difficulties that would be encountered on the road to a market economy. The transition has already presented some surprises, events that may have been anticipated--and were in fact anticipated by many--but whose magnitude and impact were greatly underestimated.

This paper focuses on a few of these events and the problems that they have created for the process of transformation. Drawing on the experience of Hungary, the paper attempts to highlight those issues which seem to be of particular importance for the success of reforms. Although the discussion is based on the Hungarian experience, the issues are common to all reform economies.

II. The Collapse of Output: The Reform Supply Shock

There was general consensus among economists and policymakers at the start of the reforms that there will be a temporary decline in output as the liberalization of imports, the reduction or elimination of producer subsidies, and the general hardening of budget constraints facing enterprises will affect the production of those companies which could not compete in the new, more open and competitive environment. Furthermore, it was recognized that the transition countries will face inflationary and balance of payments pressures. As regards inflation, the transformation process involved an initial upward pressure on prices due to the elimination of subsidies; the freeing of prices coupled with the existence of a liquidity overhang and monopolistic structures; and the opening up of the economy to international competition and the consequent "importation" of international prices. On the external side, in addition to the contraction of Eastern markets, there was a need to build up reserves to levels commensurate with the higher degree of openness of the economy and the switch to convertible currency settlement in trade with former CMEA partners. The move to world prices in trade among former CMEA members entailed a terms of trade loss for the non-Soviet members which, although varying among countries, was significant for all of them. All these called for tight financial policies which were also expected to have a negative impact on domestic demand and output.

While these factors were foreseen, the extent and duration of the fall in output were more serious than anticipated. In each of the Eastern European countries, real GDP declined in both 1990 and 1991 for a cumulative decline of about 32 percent in Bulgaria, 19 percent in Romania, 18 percent

in Poland, 16 percent in the Czech and Slovak Republic and 14 percent in Hungary. In most countries, the prospect is for a further, albeit smaller decline in 1992. It is clear now that the extent of the contraction in Eastern trade has been greatly underestimated, particularly the collapse of solvent import demand in the states of the former Soviet Union (FSU), which has had a ripple effect on output and demand in the whole region. Although a reduction in Eastern European exports to the former FSU states had been projected, the collapse of the Soviet market as a result of the break-up of the Soviet Union was not fully anticipated two years ago. In Hungary, for example, the fall in GDP was revised downward several times in the course of 1991, largely because of a continuous downward revision in exports to the former FSU states as it became clear with each passing month that the fall in Soviet demand would be much sharper than had been expected earlier. A similar process of revision of exports to the FSU states took place in several of the other countries as well. At the same time, it seems that it has not been fully recognized that the negative forces on domestic demand and output associated with the reforms will work simultaneously in the whole region, exacerbating each country's output fall through the shrinkage of trade among former CMEA countries, which previously formed an integrated and largely closed trading area.

There may have been other factors whose impact on production has been underestimated, such as the importance of the reduction in hoarding, a typical phenomenon in a shortage economy. It can also be argued that in some of the countries there may have been a more than intended tightening of credit, as for instance in Poland, due to an overshooting of inflation following a large initial devaluation. It is also true that the actual declines in production are likely to have been smaller than shown in the official GDP statistics because the latter do not yet fully capture the newly emerging private sector. None of this, however, changes the fact that the magnitude of the reduction in Eastern trade has not been anticipated, compounding each country's fall in domestic output associated with the implementation of reforms. 1/

An interesting question to ask with hindsight is whether something could have been done to prevent the sudden collapse of trade. The answer is probably no. First, there is little that could have been done to prevent the sharp fall in solvent import demand in the states of the FSU. The collapse in output and import demand in the FSU states has been the result of political events which, although not directly linked to economic reforms, are not independent from the social-political developments that have permitted reforms in Central and Eastern Europe to take place in the first place. Second, trade among Central and Eastern European countries fell largely because, with trade liberalization, goods produced in the East could

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1/ Calculations in Rodrik (1992) indicate that the Soviet trade shock (including both the market loss and the terms of trade loss effect) explain a substantial part of the GDP loss in 1990-91 in Hungary, the Czech and Slovak Republic and Poland.

not compete with those produced in the West, not always necessarily in terms of price and quality, but often also because of the general appeal of western goods. 1/ Under such circumstances, trade could have been maintained only with a slower speed of trade liberalization. However, there was little public support in these countries for a slow trade liberalization, since the latter was regarded as an integral part of the policy to end the decades-long isolation from the West. Whatever the merits of a more gradual liberalization may have been, it ran against the aspirations of the people at that time. While pressure is mounting to tighten protection, it would be a mistake to reverse course as it would undermine credibility in the reforms.

Taking these factors into consideration, it can be argued that the sharp fall in output in the transition countries should be regarded as an "exogenous" reform supply shock, in the sense that it has been as much a consequence of the conditions which have led to the reforms, i.e., the break-up of the former U.S.S.R., 2/ as it has been the result of the reforms themselves and the necessary tightening of financial policies to harden budget constraints and to promote liberalization and restructuring. This said, the much deeper and more prolonged-than-expected fall in output has rendered the task of implementing the reforms more complex and difficult. In the following sections, some of these difficulties are reviewed in the areas of fiscal and monetary policy, and privatization.

III. Fiscal Policy: Shrinking Tax Base and Sustainability

The fall in output and the implementation of reforms have led to a shrinkage of the tax base which complicates the task of maintaining macroeconomic stability and restructuring government expenditure. Revenue in real terms has been declining from all the major sources: the enterprise profit tax, consumption taxes, and the personal income tax (as employment has been reduced). In addition, with a growing number of enterprises facing bankruptcies, the need for banks to provision for bad debt has risen, reducing also the taxable profits of financial institutions. Furthermore, as domestic demand has fallen, the structure of production has shifted toward exports. While this shift is a desirable development from a long-term point of view, in the short run it has the effect of reducing the revenue from the value added tax since exports are not subject to this tax.

1/ The greater availability of export credits in western countries has, to a certain degree, also contributed to a crowding out of eastern trade.

2/ The drop in Soviet output resulting from the break-up of the former U.S.S.R. can be considered as a supply shock in the states of the FSU which has translated into a drop in foreign demand for the other members of the former COMECON.

Privatization is also having a negative impact on revenue in the short term, as the sudden multiplication of firms has caught the tax administration unprepared for enforcing tax collection. It will take several years to build up an administration which is capable of collecting taxes from smaller and a much larger number of companies than before. The change in the amortization rules is also going to affect future revenue developments in Hungary. Until 1992, the amortization rates in Hungary were below internationally accepted standards and the replacement values were not adjusted for inflation. As a result, when inflation started to accelerate in the 1980s, the resources set aside for amortization fell far short of the cost of replacement. Chart 1 shows that amortization as a ratio of GDP declined from about 13 percent in 1980 to 7 percent in 1991. The insufficient provisioning for amortization artificially boosted the resources of the enterprises, part of which was distributed in the form of wages and benefits and part of which was transferred to the budget in the form of taxes. 1/ It is estimated that in 1990, about one third of the true replacement value was distributed by the enterprises and one third was taxed away. 2/ Since capital expenditures financed through the government budget also declined sharply as a ratio of GDP during this period (Chart 2), it cannot be argued that the replacement value which was taxed away helped to increase investment through the budget; it simply served to boost the general resources of the budget.

Starting with 1992, the amortization rates for new investment have been raised to conform with international standards. This was a necessary change from the point of view of promoting investment, but it will affect revenue from the enterprise sector as new firms are being set up and old ones get modernized through privatization. Consequently, revenue from the enterprise sector is likely to grow more slowly than output for the next several years, underscoring the need to expand the revenue base elsewhere, especially by widening the basis of the VAT and eliminating tax exemptions.

Revenue and expenditure as a ratio of GDP are still significantly higher in Hungary than in the developed market economies or in countries with a similar level of per capita income. A further downsizing of the government is needed to increase the efficiency of resource allocation and prepare the way for Hungary's integration into the European Community. While the factors affecting revenue discussed above are resulting in a decline in the revenue/GDP ratio, 3/ a similar scaling back of expenditure

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1/ The initial ideology behind the taxing of amortization was that enterprise amortization should cover only investment necessary to maintain the current rate of output growth. Investment needed to increase the growth of output should be decided on and financed by the central government budget.

2/ See Matolcsy (1991).

3/ A similar reform-induced decline in government revenue has been observed in China since the start of market-oriented economic reforms in 1978. See Blejer and Szapary (1990).

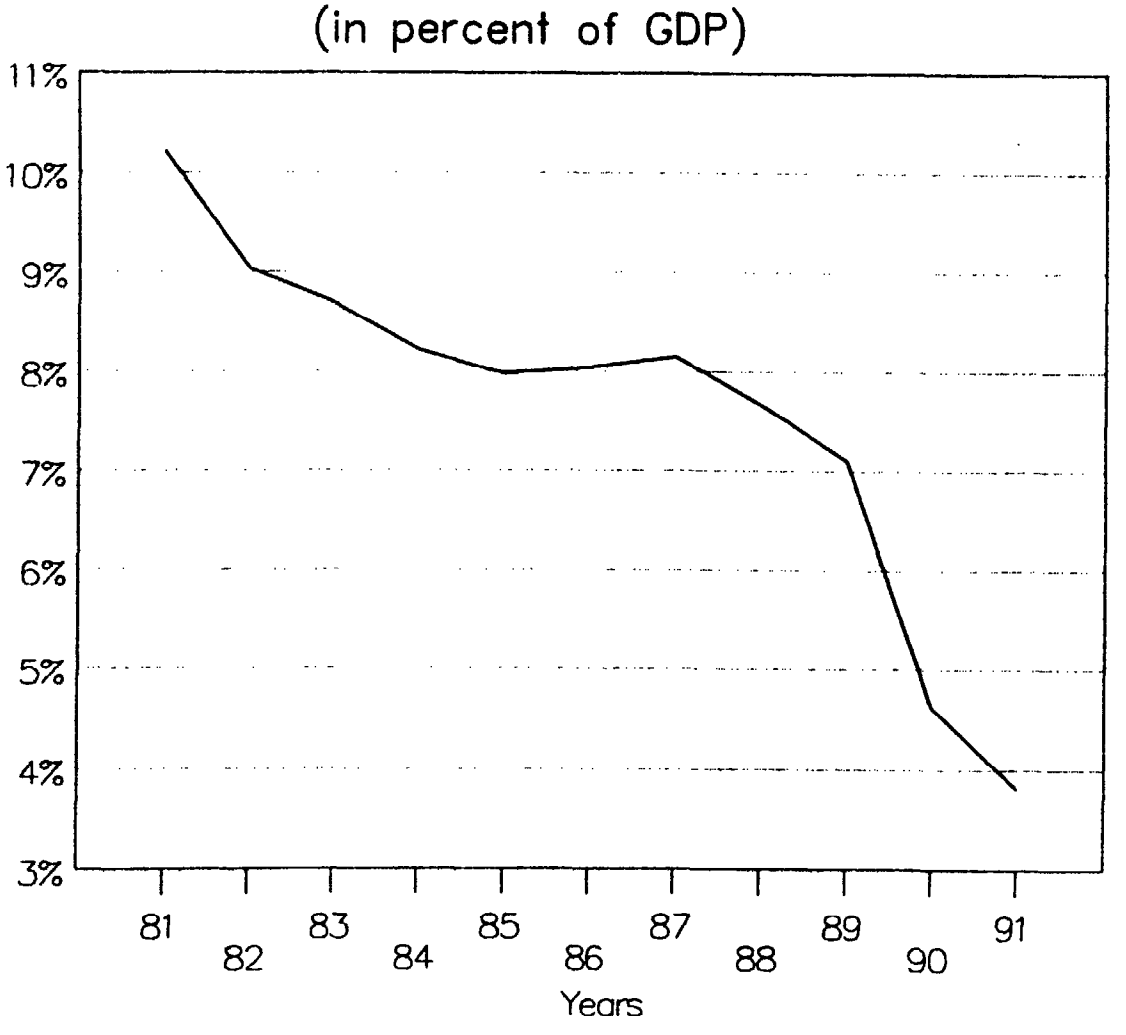
Chart 1

Hungary: Enterprise Amortization, 1975–91

Source: Data provided by the Hungarian authorities

Chart 2

Hungary: Government Capital Expenditure, 1981–91



Source: Data provided by the Hungarian authorities

is proving difficult--despite the substantial cut-backs in subsidies--when output is shrinking and new reform-driven needs are emerging. 1/ On the one hand, it is necessary to channel resources toward social expenditures to support a growing number of unemployed and those segments of the population that are the hardest hit by inflation and the elimination of subsidies, such as those to low-income pensioners. On the other hand, a bigger portion of the shrinking pie has to be channelled toward investment to ensure that the pie is going to grow. This should be carried out in the form of both increasing government expenditure on infrastructure development and allowing the tax burden on enterprises to diminish. The latter is in part taking place through the introduction of higher amortization rates and also the application of more realistic provisions for losses. However, enterprises in Hungary have to pay social security and unemployment taxes totalling 49 percent of wages. Such high burden encourages tax evasion and inhibits investors, particularly small entrepreneurs, from expanding their businesses or starting new ones. The tax wedge, i.e., the difference between the net take-home pay of a worker and the wage cost to the enterprise is about 100 percent in Hungary, substantially higher than in the industrialized countries. This is a reflection of the large income redistribution system inherited from the socialist past, which involves low wages and relatively high social benefits. It would be more desirable to pay higher salaries and reduce redistribution through the budget, since not everybody needs the same services to the same extent and some services are provided more efficiently by the private sector.

One of the main difficulties facing the reform economies is that the socialist redistribution system was not meant to meet the requirements of a market economy. In market economies, the role of social benefits is to mitigate income inequalities: the differentiating factor is the income and the equalizing factor is the redistribution system. In the socialist systems, it was the other way around: official incomes were fairly undifferentiated, but the benefits, such as the possibility of getting good housing, medical care, or vacationing were quite differentiated. Even pensions were more differentiated than salaries. 2/ This situation has changed over time in Hungary under the impact of reforms, but it has remained dominant in countries such as the states of the FSU where a complex system of benefits and privileges has prevailed which has dwarfed the inequalities in wages and salaries.

1/ General government revenue as a ratio of GDP declined in Hungary from 58.9 percent in 1989 to 55.7 percent in 1991, while government expenditure remained at about 60 percent. The EC weighted average is 43.6 percent for revenue and 46.5 percent for expenditure (1989 data, excluding Greece and Luxembourg). Since the GDP data in Hungary do not capture the important and growing "gray" private economy, the revenue and expenditure ratios are exaggerated to some extent in Hungary.

2/ Illés (1992).

What makes the reform of the redistribution system in former socialist countries particularly difficult is that--unlike in market economies where safety nets were built up, so to say, from scratch--in the transition economies the existing safety mechanisms have to be transformed into a system which is targeted to the most needy, at a time when living standards are falling, the revenue to be redistributed through the budget is shrinking, and every segment of society tries to preserve the benefits it already has. In western countries the social benefit systems have been expanded and improved gradually over time in line with the increased production capacity of the economies. In Eastern Europe, the governments have inherited a social benefit system which absorbs an excessive proportion of the resources given the requirements for investment and the restructuring of the economy. The aim should be to reduce the overall size of the redistribution system while making it better targeted. One problem that the introduction of a need-based policy must face is the relatively large proportion of hidden incomes not captured by the current tax information system which makes it difficult to determine who are the truly needy.

The success of reforms requires the maintenance of macroeconomic stability. An issue which is often debated in Hungary is the level of fiscal balance that is compatible with such stability. It is not inconsistent with the reforms that, in the early stages of the transition, the negative macroeconomic consequences of fiscal deficits may be offset by an increase in the willingness of households to save. In Hungary, for example, the net financial savings of households increased from an average of less than 1 percent of GDP in the 1980s to about 11 percent in 1991, 1/ which was reflected in a rise in the demand for money, allowing the Government to collect seignorage and finance a higher deficit without placing additional pressure on domestic demand. Several factors have contributed to the increase in household savings. First, the reforms have created new uncertainties, such as the risk of unemployment and the possible erosion of social benefits, which have encouraged people to be more thrifty. Second, following the liberalization of interest rates, the return on financial savings has improved, and savings instruments have become more diversified. Third, income differentiation has widened with the emergence of a rich class with a high propensity to save. Fourth, investment opportunities have increased, including the possibility of buying the apartments which people

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1/ To the extent that the GDP statistics do not capture the informal economy, the savings ratio is overestimated.

have been renting from the state. Finally, the greater availability of imported durable consumer goods, together with the dearth and high cost of consumer credit have provided additional incentives to save. 1/

Although there are factors which will continue to promote savings as the reforms proceed, such as a further differentiation of incomes and greater reliance on private pensions, the higher level of saving observed in the early years of the reform may not represent the desired level in the medium term. For instance, once people have purchased their rented apartments, have adjusted to the uncertainties, and consumer credit becomes more available, the willingness to save may diminish. At the same time, privatization and the development of the capital markets are likely to induce a portfolio shift away from bank deposit instruments toward shares. Both of these developments may lead to a reduction in the demand for money and the possibility for seignorage revenue. In addition, the reduction of inflation will also result in a loss of seignorage revenue in all transition economies. 2/ Taking these factors into consideration, great caution is needed in order to avoid setting expenditures in the early stages of reform at a level which may not be sustainable in later years. 3/

IV. Monetary Policy: The Uncertainty Trap

A major factor complicating the formulation and implementation of monetary policy in transition economies is the unpredictability of expectations. Having learned not to trust government policies under the communist regime and remembering the stop-go reform policies of the past, people remain skeptical about the durability of the reforms now being implemented. Given such historical background, it will take time to gain people's confidence in government policies, even if these policies strive to be consistent and predictable. For example, although inflation has been declining continuously since June 1991 in Hungary, inflation expectations are slow to change and many people even question the veracity of the data

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1/ A large part of the growth in household bank deposits occurred in foreign currency deposits which were legalized in September 1989. To some extent, therefore, the growth in household deposits may reflect the repatriation of savings held abroad or the recording in the statistics of savings previously held in the form of foreign currency notes. In addition, household deposits include the working capital deposits of small private enterprises. In part, therefore, the growth in household deposits may reflect an increase in the transactions demand for money of enterprises.

2/ In Hungary, for example, it has been estimated that reducing inflation from 35 percent in 1991 to 10 percent in 1993 will result in a loss of seignorage revenue equivalent to 2 percent of GDP. See Dervis and Condon (1992).

3/ There is an interesting and detailed discussion in Kornai (1992) of the factors which tend to slow down the downsizing of the Government.

published. 1/ There is a lag in the adjustment of expectations in every economy, but the longer the period characterized by the lack of confidence has been, the longer the initial lag of adjustment is likely to be. The slowness of inflationary expectations to adjust downward in line with the decline in the rate of inflation has made it more difficult to bring down real interest rates in Hungary, which is hindering investment and could delay the resumption of growth.

Another area where the "confidence gap" has implications for policy is in regard of the introduction of currency convertibility for households. Many people in Hungary believe that if such convertibility is introduced, individuals will convert their local currency balances into foreign currency, simply because they do not trust the government, even though domestic interest rates measured against the exchange risk are attractive. The fear of sparking a capital flight weighs heavily on the mind of the Hungarian authorities when considering the timing of the introduction of convertibility for households. This example goes to show that the lack of confidence is a practical problem which policymakers have to face in transition economies. The issue is to find the optimal policies which will minimize the costs arising from the confidence gap.

The implementation of monetary policy is also hampered by the uncertainty about developments in the real economy. With the emergence of a growing private "gray" economy which is not yet captured in the information system, the official statistics do not reflect accurately the developments in output, making it hard to predict the demand for money and thus complicating the task of judging the appropriateness of the stance of monetary policy. The difficulty of predicting developments in the demand for money is increased when the economy and the institutions are undergoing fundamental transformation. As discussed above, the households' demand for money has increased considerably over the past two years, but there are factors which could reverse the trend in the later stages of reforms. There is uncertainty also about the demand for money of enterprises. There has been an increase in such demand in Hungary as a result of the break-up of large state-owned enterprises into smaller private firms and in response to the gradual hardening of budget constraints, including tighter conditions for credit. While this process is likely to continue, it is less clear how the demand for money of an enterprise facing the prospect of bankruptcy will behave; it may well be that such an enterprise will use up its bank deposit balances to avoid that they be confiscated. If this were the case, the demand for money of the enterprise sector could decline, given the large number of enterprises that are facing bankruptcies.

1/ It should be noted that the official price statistics do not fully reflect the actual situation to the extent that they do not capture price developments in the growing informal economy. This is particularly true for the service sector in such areas as house repairs, rents, car service, etc.

A further complicating factor is the uncertainty about the functioning of the transmission mechanism of monetary policy in an economy where the banking system is undergoing a fundamental reform. After the establishment of a two-tier banking system with an independent central bank and commercial banks in 1987, the portfolio of Hungarian state enterprises has been distributed among the large state-owned banks. The distribution had a heavy sectoral concentration: for example, the bulk of the mining sector portfolio was given to one bank and a large part of the agricultural sector portfolio to another. Such initial sectoral concentration has thwarted competition among banks and has made it difficult for them to diversify their portfolios. Furthermore, because of the concentration of production in the hands of a few firms, a bank's decision to cut off credit from an enterprise may have wide-ranging social and economic consequences. Such heavy, largely inherited responsibility intimidates banks to take the tough decisions. 1/ All this makes it difficult to ensure that when credit is tight, it is cut off to those for which the return is lowest. 2/ As a result, when monetary policy needs to be restrictive to control inflation, the cost in terms of output loss may be larger. The inadequacies of the financial intermediation by the banking system are exacerbated by the underdevelopment of the capital markets. Firms that are "crowded out" from bank credit cannot turn to the capital market, thereby further increasing the bias against output of a restrictive monetary policy.

Finally, there is the need to tackle the issue of the bad debts accumulated by banks. Part of the bad debt portfolio of the banks in Hungary has been inherited from the time of the monobank system prior to 1987, but there has been a very substantial growth in the bad debt portfolio over the past two years as a result of the collapse of markets and output. A "cleaning" of the books might appear to be an attractive approach to delink the fortunes of bad enterprises from the fortunes of banks. 3/ However, such an approach raises two issues. One is the issue of moral hazard: cleaning of the books always carries the risk that after the cleaning operation banks would continue to take unwise risks in the expectation that the Government will bail them out once again. The probability of this happening is less if hard budget constraints already prevail in the whole economy, but if the banks and the bulk of enterprises are still state-owned, budget constraints are likely to remain soft and the danger of the books being "dirtied" again is considerable. The second issue concerns the task of restructuring or liquidating the enterprises which cannot service their debts. In the case of a book cleaning operation, the banks would be relieved from this responsibility and the task would have to be given to a separate institution. It is doubtful that the restructuring of hundreds of

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1/ It seems that banks are risk-averse toward the emerging private sector, but risk takers toward the big state firms.

2/ There is a discussion of the various aspects of financial sector reform in transition economies in Stiglitz (1991).

3/ See Calvo and Frenkel (1991).

enterprises could be efficiently carried out by a new central institution which will first have to acquire the information and expertise which already exist at the commercial banks. A more pragmatic solution would be to require the banks to provision for the bad loans (allowing them to do so gradually over a number of years if necessary) and provide them with incentives to play an active role in the restructuring-cum-privatization of enterprises. Such incentive could take the form of loan guaranties by the Government or the swap of government bonds for the doubtful loan portfolio. However, such incentives should be given on a case-by-case basis and conditioned on the restructuring program for the enterprise.

V. Privatization: Too Many Moving Targets

Privatization has encountered a wide range of largely unanticipated factors that tend to slow its process. Hungary, which had started with privatization a few years ahead of the others, has used several approaches: a centralized privatization program under which major state enterprises are offered for sale by the State Property Agency (SPA); "spontaneous" privatization when the enterprises themselves initiate the privatization under SPA supervision; and a decentralized program where buyers approach the SPA with proposals and the SPA may also force enterprises into privatization. The Czech and Slovak Federal Republic has recently initiated a mass privatization program through the distribution of vouchers to citizens and financial institutions. The main idea behind this scheme is that financial institutions, such as banks, insurance companies, pension funds and newly established mutual funds would end up with enough shares in their hands--either through direct distribution or through acquisitions from citizens--to be able to exercise supervision over the management of firms. Since it is too early to judge the success of the voucher system, only the case-by-case approach adopted by the Hungarian Government is discussed here. Whatever the success of the mass privatization programs, the case-by-case approach will remain one of the main avenues of privatization and the lessons of the Hungarian experience are thus not irrelevant for the other countries.

One factor which has slowed privatization has been the time-consuming process of valuation of enterprise assets, due in part to the lack of adequate accounting. The difficulties have been compounded by the unfamiliarity of the foreign advisory firms selected to carry out the privatization with the socialist system of accounting. More importantly, however, valuation has been rendered difficult--and subject to more challenge--by the lack of an active industrial assets and real estate market and the fact that the past track record of an enterprise is not a good indicator of its future performance because of the fundamental structural changes in the economy and the markets. For instance, the privatization hopes of many Hungarian companies have been dashed with the collapse of the U.S.S.R. economy: investor interest in companies producing mostly for the

Soviet markets has simply vanished in the face of the changed market prospects. The prospects of companies producing primarily for the Hungarian market have also changed with the sharp decline in domestic demand.

Paradoxically, just as the market prospects have weakened, the political pressure to obtain the highest possible price for the privatized enterprises has increased. Since the government budget has come under heavy strains in the face of a shrinking tax base and new needs such as in the areas of infrastructural development, restructuring of enterprises, environmental clean-up, and the setting-up of new institutions, the desire to use privatization as a means to raise additional resources for the budget or for different special funds has increased. This has led at times to protracted negotiations over the price--and a long search for the investor who can afford it--in order to get the "best deal" for the Government. There has always been a trade-off between the best-deal and the speed of privatization, but as the pressure on the public finances grows and the value of enterprises is eroding, the calls against a "sell-out" are getting louder and the "best-deal" attitude gains importance. 1/

As time passes, privatization gets entangled in politics. People are afraid that if the Government leads the privatization, only those loyal to the Government will get management positions. Confronted with this fear, many managers are either attempting to privatize quickly in the hope that they can thus preserve their position, or are simply adopting a wait-and-see attitude while living off the firm's assets. Such "internal looting" is similar to the attitude adopted by private companies before the nationalization. In these circumstances, it becomes increasingly difficult for the Government to resist the political pressure for appointing its own candidates as managers, with the mandate to prevent a "sell-out" or stop the dilapidation of the firm's capital. The change in management tends to slow down the privatization as the new managers have to acquaint themselves with the firms. The temptation to put the enterprise "back on its feet" and make it "ready" for privatization also increases with the change in management. While restructuring the firm before putting it up for sale can be the right course of action in certain cases, it also carries the danger of preventing the phasing-out of unviable activities and of maintaining the pressure for subsidies, tax preferences, preferential credit, government guarantees--in short, the soft budget constraint.

There are often conflicts of interest among those responsible for the privatization. Many private investors are interested in majority shareholding while managers who feel secure in their new government-appointed jobs may be reluctant to give up government majority out of fear of loosing

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1/ This observation does not apply to the privatization of small shops and restaurants under the so-called preprivatization program in Hungary, where there has been a move toward lowering the sales prices in the interests of speeding up the privatization.

their position. Local authorities eager to look good to their constituents are often pushing for a higher sales price than the central government; quite a number of privatization deals have been held up because of the lack of agreement over the price and the distribution of the sales proceeds between the central and the local governments. Also, local authorities seem to be less interested than the central government in full privatization because they are more eager to share in the profits.

All these have led to frequent shifts in priorities. At times within the same project, the emphasis has shifted, for example, between employment maintenance, minimum Hungarian participation and the best possible price. One complaint often voiced by investors is that there have been too many moving targets which have become an obstacle to speedy privatization. Delays in the privatization represent a serious problem because during the "waiting-for-privatization" period, enterprises are in a state of limbo when practically all strategic activity, such as investment, search for new markets, conclusion of long-term contracts, etc., come to a halt.

Last but not least, privatization is seriously hampered by the lack of domestic capital. It would be unrealistic to expect that foreign investors will buy more than a limited portion of the state assets to be sold. As of April 1992, foreign investment accounted for 75 percent of the accumulative privatization receipts in Hungary, but this share has declined from 83 percent in 1990 to 68 percent in the first four months of 1992 and is expected to decline further as the best ventures are being sold off. Despite the relatively large share of foreign capital in the privatization receipts so far, foreign ownership through privatization represented only about 3 percent of total state enterprise assets as of the end of 1991. 1/ Although this share is going to rise, foreign investors are often more interested in launching green field projects than in buying existing companies with outmoded equipment. Therefore, a large portion of the state-owned companies will have to be sold to domestic investors. However, apart from a few individual success stories, there has not yet been enough accumulation of capital in the hands of domestic investors. At the same time, potential domestic investors have difficulties in obtaining bank credit because of the lack of adequate collateral and a long enough track record. The high level of real interest rates is another discouraging factor. An approach which could help to overcome these difficulties would be to offer to potential investors the possibility of leasing the companies with the option to buy.

1/ See Giday (1992). Note that the total capital over which foreign investors exercise management control is larger than their ownership share, since in many ventures the foreign partner has only a 51 percent controlling interest. There are also cases where even a smaller share gives control over management to the foreign investor through ad hoc arrangements, such as "golden" shares.

While it is too early yet to judge the relative merits of the various approaches to privatization in the region, it is becoming increasingly evident that privatization will be a slow process. It must also be recognized that politically it is impossible to close down all uneconomic enterprises at once. This raises the issue of what role the government should play in managing the restructuring and phasing out those enterprises which are not yet or cannot be privatized. It seems that governments will unavoidably have to play a more active role lest there will be a greater destruction of wealth and employment than necessary. This would call for the formulation of a national industrial policy to determine which are the "good" industries to be reorganized and the "bad" ones to be phased out. Unfortunately the record is not very encouraging in this area, since experience has shown that governments have not been particularly successful in picking the winners and losers. Restructuring is also costly and in view of the tight budgetary situation, it becomes increasingly difficult to find funding for the restructuring. It is probable, therefore, that privatization and restructuring will proceed by trial and error and that the results will be less satisfactory than they would be if optimal solutions could be applied.

VI. Concluding Remarks

The transformation of centrally planned state-owned economies to market economies in which the private sector becomes the dominant force is a longer and more difficult task than many had expected in Eastern Europe. The establishment of new institutions, the preparation and enactment of new legislation, the reordering of ownership structures, and the reorganization of production along the lines of new comparative advantages dictated by opening up to the world economy require time, determination, and innovation. The transformation is a process of learning by doing for which there is no cookbook to follow. It has to be recognized that it is often not possible to apply first best solutions and that one has to settle for less. In conclusion, let me list the three principal factors which are making the transformation particularly complex and difficult:

- First, the break-up of the former U.S.S.R. coupled with the opening of the economies of Eastern and Central Europe resulted in a collapse of trade among former CMEA countries which has increased the depth and duration of the recession, complicating the implementation of reforms in virtually all areas. The collapse of Eastern markets dictates a much more drastic restructuring of production and trade than was thought necessary at the outset of the reforms. This underscores the necessity of coordinating the policies with respect to privatization, enterprise restructuring, and the banks' bad debt portfolio into an integrated industrial strategy.

- Second, the costly and elaborate social safety net built up under the socialist system is proving to be difficult to transform into a system which meets the requirements of a market economy. The old system places a

heavy burden on the budget, which slows the downsizing of the government and poses a continuous threat to the maintenance of fiscal balance, especially at a time when revenue is affected by the recession and the reforms. While the increase in household savings induced by the reforms provide some breathing space, care is needed not to crowd out the private sector by excessive government spending; the large investment needs necessary to ensure sustained growth requires a strict limitation on the government's claims on resources. At the same time, the tax base needs to be broadened and the tax enforcement improved to ensure that government revenue grows in line with the expansion of economic activity.

- Finally, privatization is being hindered by the emergence of a series of factors not foreseen at the start of the reforms. To keep the process moving, it will take not only determination on the part of the governments to push ahead with privatization, but also imagination in designing new approaches to overcome the emerging obstacles. Governments should keep the privatization out of politics as much as possible.

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