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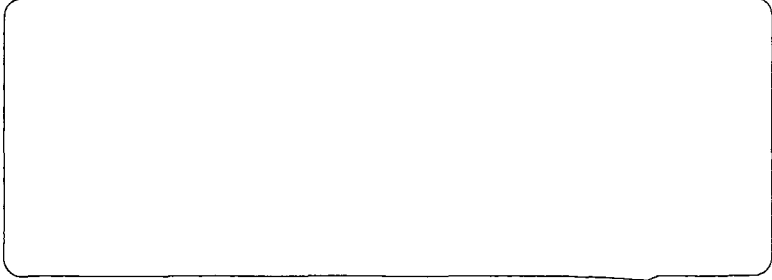
Reforming the New Economic Mechanism in Hungary

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Bela Balassa

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Reforming the New Economic Mechanism in Hungary

Abstract

The paper evaluates the reform measures taken in 1980 and 1981 that aim at the further development of the Hungarian New Economic Mechanism, introduced on January 1, 1968. The reform measures concern price setting, the exchange rate and protection, wage determination and personal incomes, investment decisions, and the organizational structure. It is concluded that the measures taken represent important steps towards improving the efficiency of the Hungarian economy but would need to be complemented by further steps in future years.

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Summary

On January 1, 1968, Hungary introduced the New Economic Mechanism (NEM), in order to respond to the needs of an increasingly sophisticated economy characterized by considerable reliance on foreign trade. The NEM aimed at replacing plan directives by market relations among firms; limiting the scope of central price determination; linking the domestic prices of exports and imports to world market prices; and decentralizing a major part of investment decisions.

Steps towards recentralization were, however, taken in the wake of the Party resolution of November 1972 and in response to external shocks, in the form of the inflationary 1972-73 world boom, the 1974-75 world recession, and the deterioration of Hungary's terms of trade after 1973. The newly-introduced measures, involving lesser reliance on the operation of market mechanisms and increased central directives and interventions, had adverse repercussions on the Hungarian balance of payments and on the efficiency of resource use. As these effects came to be recognized, the October 1977 and December 1978 Party resolutions called for re-establishing the original directions of the NEM. This was subsequently done in the framework of the 1980 and 1981 reforms.

The lynchpin of the 1980-81 reforms was the introduction of competitive prices in the industrial sector, entailing increased alignment with world market price relations. It is further envisaged to eliminate compensation payments to high-cost exporters over a period of five years. This, in turn, would necessitate adjusting the exchange rate in order to maintain balance-of-

payments equilibrium, when the occasion of the exchange rate adjustment may be utilized to lower rates of import protection.

The reform measures also established a stronger link between wages and labor productivity, although further steps would need to be taken in this direction. At the same time, firms were given increased freedom to make their investment decisions and bank lending is to be based on the profitability of investment by the firm. Nevertheless, firms would need increased financial resources of their own to carry out new investments.

Industry in Hungary is highly concentrated by the standards of capitalist, as well as socialist, countries. The extent of concentration was reduced in 1980 and 1981, when 137 new firms were created by breaking up trusts and large firms. Also, regulations introduced on January 1st, 1982, provide for the creation of new, and the expansion of existing, small- and medium-size firms. Apart from the establishment of subsidiaries by state-owned firms, the new regulations allow for new, flexible forms of co-operatives and small-scale private producers, including partnership and leasing.

Parallel with the 1980-81 measures that provided greater freedom of decision-making to the firm, the consolidation of the industrial ministries into a single unit reduced the possibilities for central interventions in the firm's operation. This purpose would further be served by separating the functions of the state as the source of regulations and the owner of the means of production. A possible solution is to establish independent boards for individual firms, consisting of representatives from the government, the banks, the Chamber of Commerce, the firm's management and its workers, as well as independent experts.

The Board would have responsibility for hiring (and firing) managers, overall supervision of the operation of the firm, decisions on major changes in the scope of its activities, and, if necessary, closing down the firm. Firms may be closed down as budget support in case of continuing losses is scheduled to end over a five year period. At the same time, the possibility of bankruptcy would provide inducements to firms to rationalize their operations.

The measures applied in 1980 and 1981 represent important steps towards improving the efficiency in the Hungarian economy. The pursuit of this objective would, however, require further steps to complement the measures so far taken. This may be done over a period of time, so as to minimize economic disruptions.

REFORMING THE NEW ECONOMIC MECHANISM IN HUNGARY 1/

Bela Balassa

Introduction

On January 1, 1968, Hungary introduced the New Economic Mechanism (NEM), in order to respond to the needs of an increasingly sophisticated economy characterized by considerable reliance on foreign trade. The NEM aimed at replacing plan directives by market relations among firms; limiting the scope of central price determination; linking the domestic prices of exports and imports to world market prices; and decentralizing a major part of investment decisions.

At the time of the NEM's introduction, a variety of 'brakes' were applied, in part to smooth the transition from the old to the new mechanism and in part as a compromise between the supporters of the two. While several of these brakes were eased in the next few years, steps towards recentralization were subsequently taken in the wake of the Party resolution of November 1972. Furthermore, policy responses to external shocks, in the form of the inflationary 1972-73 world boom, the 1974-75 world recession, and the deterioration of Hungary's terms of trade after 1973, led to reduced use of market mechanisms and to increased central directions and interventions.

The measures employed weakened the link between domestic and world market prices, reduced the scope of application of the profit motive, and increased the role of governmental preferences in investment decisions. They aggravated

1/ The author provided an early appraisal of the NEM (Balassa, 1970); examined its operation during the first decade (Balassa, 1978); and reviewed its practical implementation (Balassa, 1982) -- Unless otherwise noted, the data cited originate from the Statistical Yearbook and the Foreign Trade Statistical Yearbook, both published by the Hungarian Statistical Office. The former is available in Hungarian and in English; the latter only in Hungarian.

the problems resulting from the predominance of large firms, the maintenance of the supervisory organizations established during the period of central planning, and the fact that the firm had little to fear from bankruptcy and could have recourse to the state in the event of financial difficulties (Kornai, 1979 and 1980).

This situation could not fail to have adverse effects on the balance of payments and on the efficiency of resource use in Hungary. As these adverse effects came to be recognized, the October 1977 and the December 1978 Party resolutions called for re-establishing the original directions of the NEM. The newly-adopted guidelines envisaged the transformation of the price structure to correspond to world market price relationships, the acceptance of profits reflecting performance at these prices as the sole success criterion for the firm, and reductions in the scope of government interventions in the firm's operations and in its investment decisions.

This paper sets out to evaluate the reform measures taken in 1980 and in 1981 ^{1/} and to examine possible future changes. It will examine price setting (Section I), the exchange rate and protection (Section II), wage determination and personal incomes (Section III), investment decisions (Section IV), and the organizational structure (Section V).

I. The Price Reform

The lynchpin of the 1980-81 reforms was the introduction of 'competitive' prices in much of the industrial sector. This involved equating the domestic prices of raw materials, fuels, and basic intermediate products to the tariff-inclusive import price in convertible currency trade; providing exporters with

^{1/} A detailed description of the reforms is provided by Csikós-Nagy (1980) and Horváth (1980).

the fob export price, supplemented by tax rebates; and setting prices for the domestic sales of the bulk of industrial products on the basis of profit margins reflecting the domestic cost of earning foreign exchange in exports.

Equating the domestic prices of raw materials, fuels, and basic intermediate products to import prices paid in convertible currency trade represents the application of the marginal cost principle, with differences vis-á-vis the prices of imports from socialist countries being compensated by taxes and subsidies. On January 1, 1980, the average prices of raw materials and basic intermediate products were raised by 30 percent while energy prices were increased by 57 percent (Rácz, 1980, p. 133). Following these adjustments, the domestic prices of raw materials and basic intermediates are free to vary with changes in prices paid in convertible currencies and in the exchange rate, while energy prices are fixed centrally and modified intermittently in response to changes in world market prices.

Industrial exporters receive the price obtained in convertible currencies, times the exchange rate, plus a rebate for imputed indirect taxes that is set at 10 percent of export value, except for light industrial products (originally 16 percent, but subsequently reduced to 13 percent) and for iron and steel (nil, but subsequently set at 5 percent). Exceptions have been made, however, in cases when the domestic cost of earning foreign exchange exceeds the sum of the exchange rate and the tax rebate. In such instances, compensation continues to be provided for a period of five years on a decreasing scale. Also, production taxes for individual firms have been

abolished and while firms may continue to receive budget support, this is done on a temporary basis.^{1/}

As of January 1, 1980, firms that exported more than 5 percent of their output in convertible currency trade were required to set the prices of their domestic products by calculating with a profit margin based on the domestic cost of earning foreign exchange in exports. Firms where this ratio equalled the exchange rate, adjusted by the 10 percent tax rebate, could apply a profit margin of 6 percent on the sum of their fixed capital and the wage bill; the profit margin rose to 12 percent for firms that had a domestic cost ratio one-fourth lower than the exchange rate; and it declined to nil in the case of firms that earned foreign exchange through exports at a cost one-third higher than the exchange rate.^{2/} Also, firms may not subsequently raise their average domestic prices to an extent greater than the increase in their average export prices, and they are obligated to reduce domestic prices if export prices decline, with changes in the profitability of exports providing a further constraint to price setting. At the same time, firms are not supposed to charge domestic prices higher than the tariff-inclusive import price. Finally, firms that export less than 5 percent of their output but manufacture products similar to those produced by firms having an export share in excess of 5 percent are to follow the price setting procedures applied by the latter.

^{1/} Still, in 1981, the various subsidies will amount to 42 percent of the profits of industrial firms, compared to 58 percent in 1977 (Gadó, 1981, p. 9).

^{2/} At the same time, the payment of a charge on fixed assets was abolished and social security contributions were reduced from 35 percent to 24 percent of wages; the rate will be 27 percent starting on January 1, 1982.

The rules for competitive pricing have found application in about two-thirds of Hungarian industry, with the share varying between 75-80 percent in machine building, 50 percent in the chemical industry, and 15-20 percent in food processing. In turn, firms in the so-called noncompeting sphere were allowed to calculate with a profit margin of 6 percent in setting their domestic prices as of January 1, 1980, with subsequent changes in prices determined by changes in costs.

The regulations introduced on January 1, 1980 provided incentives to firms to raise their export prices, since they could increase their domestic prices accordingly. However, the regulations discouraged the expansion of export volume in cases when this would have involved lower than average export prices and/or export profitability. Moreover, inducements were provided to reduce the volume of exports when this permitted raising domestic prices.

In fact, the current price value of manufactured exports (excluding processed food) in convertible currency trade increased by only 1 percent in 1980 in terms of forints, representing a decline of 2 percent in volume terms, (Garamvölgyi, 1981). This followed increases of 29 percent in value terms and 17 percent in volume terms in 1979. It contrasts with trends in processed food exports, which are not subject to the same regulations and experienced an export increase of 13 percent in value and 9 percent in volume in 1980, nearly matching the results for 1979.

Within the manufacturing sector, the exports of steel, transport equipment, and clothing declined in current price terms as well, while machinery exports fell in volume terms and, among major product groups, only chemicals experienced an increase in export volume in 1980. These results cannot be explained by reference to the pressure of domestic demand since the domestic sales of industrial products declined by 1.5 percent in 1980. Nor do

unfavorable business conditions in Western Europe provide an adequate explanation, the principal exception being steel. In fact, the volume of manufactured exports from developing countries to the OECD increased by approximately 10 percent in 1980, following a rise of 15 percent in 1979.

A survey of 38 firms, representing 80 percent of manufactured exports in convertible currency trade (Fazekasné, 1981), and an investigation of the structure of machinery exports (Csobay, 1981), show that the expansion of exports was positively correlated with profits made in exporting. And while this involved in part reducing exports that were not socially profitable, both authors report that socially profitable exports, too, were foregone. Such is also the conclusion of a paper provocatively entitled: "The Firm's Export Dilemma: Only the Best -- or the Good as Well" (Garamvölgyi, 1981).

The observed adverse consequences led to changes in the regulations in 1981. As the changes did not have the desired effects, further modifications were made as of January 1982. If a firm is able to earn foreign exchange in convertible currency trade at less than the official exchange rate, while raising its exports by a predetermined percentage,^{1/} it does not have to lower domestic prices even if its average export prices or export profitability declined. Also, firms have to report increases in their domestic prices to the Material and Price Bureau in cases when their exports declined in terms of forints.

^{1/} The value of exports in terms of forints has to rise by 8 percent for firms that export 5 to 12 percent of their production in convertible currency trade; the required export expansion is 6 percent for firms with an export share of 12 to 25 percent; and it is 4 percent for firms exporting more than one-fourth of their output. The required increases are 14 percent, 12 percent, and 10 percent, respectively, in the case of firms that earn foreign exchange in convertible currency trade at less than the official exchange rate, adjusted for the tax rebate.

Changes in the regulations can only alleviate, but not eliminate, the adverse effects of incentives on export volume. Fluctuations in export prices and in the profitability of exports due to events outside the firm's control also tend to discourage exports and may induce firms to reduce their exports below the 5 percent limit that triggers the application of competitive pricing rules. In general, firms may be inclined to play it safe, avoiding risky exports and the introduction of new export products or entry into new markets, where initial costs are high and/or price concessions need to be made to obtain a foothold. ^{1/}

Apart from variations in prices expressed in terms of foreign currency, fluctuations in export prices may result from changes in exchange rates among convertible currencies, exemplified by the gyrations of the dollar-mark relationship in recent years. Fluctuations in the foreign currency prices of industrial materials also led to variations in the profitability of exports. While firms may establish reserves in the event of variations in export and import prices, this is likely to be insufficient to cope with the actual magnitude of price fluctuations (Kováts, 1981).

The above considerations have led some observers to suggest replacing export-oriented pricing by import-oriented pricing, with domestic prices equated to the tariff-inclusive import price. This price presently represents a ceiling for domestically sold products, but a survey has shown that firms

^{1/} Firms may also attempt to adjust their records to suit their interests, in particular in understating the cost of exports. This possibility was recognized by the authorities in deciding against the direct application of profit margins obtained in exporting in the formation of domestic prices (Csikós-Nagy 1980, p. 171). In fact, profits in the manufacturing sector exceeded calculated magnitudes by one-fourth, with a difference of over 100 percent shown for 180-200 industrial firms within a total of about 700 (Gálik, 1980).

often do not know the relevant import price (Réti, 1981). And while import prices are easily ascertainable in the case of raw materials, fuels, and basic intermediate products, which are standardized commodities, price comparisons encounter considerable difficulties in the case of differentiated products, owing to differences in product specifications and quality. Quality differences are of particular importance since the products Hungary does not export tend to be lower in quality. In the absence of import competition, then, import-oriented pricing would not have the desired effects.^{1/}

The question remains as to how existing regulations may be modified in order to provide incentives for efficient export expansion in the present situation when the conditions of import competition have not been established. As far as new export products and export markets are concerned, this could be done by excluding them from the calculations for an initial period of, say, two years. For the remaining products, two-year averages may be used in the place of annual data, or, alternatively, firms may be allowed to establish a reserve to even out fluctuations in profits.^{2/}

It would further be desirable to adopt a single criterion of price setting for domestic sales in the place of the double criterion based on changes in the prices and in the profitability of exports. The price

^{1/} It has been noted, for example, that, due to the higher quality of consumer goods imported in small quantities, the price of imports in no way limits increases in the prices of domestic products. The authors add: "our price mechanism presupposes the market mechanism, and much of our problems are due to this fact or to the situation that in practice we have a simulated rather than a real market. We can expect an appropriate solution only if steps are taken to establish a real market mechanism and competition" (Berényi-Holé, 1981, p. 4).

^{2/} For a similar proposal, see János Deák, 1980. -- Beginning in 1983, averaging will in fact be used in determining changes in the forint value of exports referred to above.

criterion has the disadvantage that it disregards differential changes in input prices between products destined for export and for domestic sales. Reliance placed on the profit motive under decentralized decision-making also favors the use of the profit criterion. But, this should be defined in terms of profit rates rather than the margin of profit on the sum of fixed capital and wages, which has no economic significance and conflicts with the use of the rate of profit on invested capital in decision-making on new investments. 1/

Apart from contributing to increased exports and improved efficiency, the proposed changes would lessen the possibility of intervention on the part of the authorities in price setting. This possibility has been acknowledged by László Rácz, Department Director at the Material and Price Bureau, according to whom "the firm will not have an interest in practicing a low price domestically when it can obtain a high price abroad, or vice versa. If it does so, it would not any more belong to the group of well-regarded firms and would lose all the advantages this entails" (1981, p. 4). Apart from the ambiguity of the reference to the advantages 'well-regarded' firms enjoy, this statement does not appear to recognize the need for lowering domestic prices in the event of excess supply. In turn, in the more frequent case in Hungary, when sufficient quantities are not available at the 'constructed' prices, imports should be permitted.

More generally, adjustments in prices or in import quantities need to be made whenever domestic supply and demand are not equated at the constructed

1/ In fact, as of January 1982, the export price condition has been eliminated in the case of firms that earn foreign exchange in convertible currency trade at less than the official exchange rate adjusted for the tax rebate and increase the forint value of their exports in the proportions indicated above; however, the profit criterion continues to be defined in terms of profit margins rather than profit rates.

prices. The lack of market equilibrium, then, adds to the difficulties associated with constructed prices. Thus, while the new price regulations represent a step towards aligning producer prices in the manufacturing sector to world market prices, full alignment would require the freeing of imports. Although this could not be done overnight, steps would need to be taken to gradually free imports, with first priority given to raw materials, intermediate products and machinery.

The liberalization of imports would also encourage efficient import substitution. This is apparent in the case of industrial materials where alignment to world market prices has led to efforts to save on imported materials and to make increased use of substitutes. At the same time, as noted in Section II below, there is need to reduce import protection that discriminates against exports.

Consideration should finally be given to the relationship of consumer and producer prices. Disparities in the structure of consumer prices and producer prices were reduced through decreases in subsidies and the imposition of turnover taxes in 1979 and 1980. At the same time, tax rates vary among commodities, with higher taxes applying to products the consumption of which is to be discouraged (e.g. tobacco and alcoholic beverages), and tax exemptions (e.g. children's clothing and construction materials) or subsidies (e.g. certain drugs and services) provided for social reasons. The scope of subsidies is especially large for services, including housing, heating materials, and public utilities, which are not consumed by tourists.

Consumption subsidies continue to be applied to major agricultural staples where producer prices are determined on the basis of production costs, with certain adjustments made in accordance with world market price relations. Processed agricultural exports also receive higher tax rebates (28

percent) than manufactured exports.

Notwithstanding these changes, the system of consumer prices in effect does not ensure the satisfaction of consumer needs at least cost to the national economy, and consumer prices lack sufficient flexibility to transmit changes in demand to the producer (Gadó 1979, p. 75). Consumption subsidies are largest for heating materials (73 percent) and public utilities (41 percent) while, apart from luxuries and semi-luxuries, the highest taxes apply to clothing (19 percent) (Rácz, 1980, p. 141). At the same time, free price formation occurs in only 50 percent of retail trade, albeit representing an increase from a share of 37 percent in 1978 (Csikós-Nagy, 1980, p. 224). It would be desirable to further reduce differences between producer and consumer prices, while ensuring the flexibility of the latter, at a more rapid rate than it is now envisaged (Rácz, 1980, p. 141).

II. The Exchange Rate and Protection

Prior to, and immediately after, the introduction of the NEM, the debate raged as to whether the commercial exchange rate (then called 'the foreign exchange conversion ratio') should be equated to the average cost or to the marginal cost of exports, which was defined as the domestic cost of earning foreign exchange in 10-15 percent of the highest cost exports. In the event, the average cost principle was applied, necessitating the subsidization of about four-fifths of exports (Balassa, 1970, p. 16).

Data exists for the period 1970-80 on changes in export prices in convertible currency trade for Hungary that are comparable to export price data for other countries. The calculations show that changes in relative prices in Hungary and in its major trade partners exactly matched the appreciation of the exchange rate from 60 forints to the U.S. dollar in 1970 to an average of 32.5 forints to the dollar in 1980, thus maintaining the

exchange rate constant in real terms.^{1/} And while the introduction of indirect tax rebates in 1980 benefited exports, a substantial part of exports in convertible currency trade continue to require compensation payments.

At the same time, the focus of the debate has shifted, with the holders of opposing views suggesting that the exchange rate be used to combat imported inflation or that its main function be to equilibrate the balance of payments. The first view, prominently held by János Fekete, First Deputy President of the National Bank,^{2/} is based on the relative version of the purchasing power parity doctrine^{3/} and it assumes low import and export elasticities.^{4/}

1/ This result represents a devaluation in real terms vis-à-vis the French Franc and the West German mark, an appreciation vis-à-vis the U.S. dollar and the Italian lira, and no change vis-à-vis the Austrian shilling (Hungarian exports to these countries were used as weights in the calculations, with the West German mark taken to be representative of the currencies of the smaller Common Market countries participating in the snake).

2/ Fekete expressed the view that "the forint exchange rates of foreign currencies should correctly reflect -- individually and in their totality -- domestic and foreign price ratios; in other words, they should provide a realistic picture of the relationship between the purchasing power of the forint and that of the foreign currencies and they should adequately keep up with changes in these relationships, thus ensuring the stability of the forint." (1976, p. 58; cited in Marer, 1981, p. 538).

3/ The relative version of the purchasing power parity doctrine requires the exchange rate to parallel changes in relative prices at home and abroad. (For a critical appraisal, see Balassa, 1964.)

4/ Béla Csikós-Nagy (1980, p. 92) also makes reference to the experience of West Germany, Japan and Switzerland that revalued their exchange rate for the sake of keeping the prices of imported inputs low. As Csikós-Nagy notes, however, these countries have a particular export pattern dominated by products that have few substitutes, at least in the short run, which is not the case in Hungary. Furthermore, following the quadrupling of oil prices in 1973-74, these countries initially revalued their exchange rate in nominal but not in real terms and, once revaluation occurred in real terms, their balance-of-payments were adversely affected.

As to the relevant elasticities, Paul Marer explicits the view that "the elasticity conditons were unlikely to be satisfied for a devaluation to improve the BOP" in Hungary (1981, p. 539). However, the empirical basis for this conclusion, cited by Tarafás (1980, pp. 914-16), is weak. Also, questions arise regarding the relevance of the customary justification, or rationalization, of estimated or assumed low elasticity values to the conditions existing after the 1980-81 reforms.

It has been suggested that the import demand elasticity is low because in convertible currency trade Hungary imports mostly material inputs that have no domestic substitutes. However, 15 percent of imports in convertible currency trade are producer goods, 6 percent industrial consumer goods, and 13 percent foodstuffs. Also, the estimates have been derived by the use of least-squares techniques that are known to have a downward bias. Finally, the low elasticity of import demand in the past may reflect the large profits made in transforming imported inputs into goods sold domestically, in ruble trade, and in convertible currency trade as the prices of these inputs were kept artificially low 1/, as well as the fact that the operation of the profit motive was hampered by the pervasiveness of taxes and subsidies in the second half of the seventies.

There is evidence that firms have attempted to reduce their demand for imported materials in response to the rise of material prices and the increased importance of the profit motive after January 1, 1980. Furthermore, consumers have economized with the use of energy as increases in world market

1/ Marer refers to Hungarian press reports, according to which it was profitable to export in convertible currency trade even if net foreign exchange earnings were small and, in extreme cases, negative (1981, p. 532).

prices have been partially transmitted to the consumption sphere (Medgyessy, 1981, p. 40).

In turn, in a simultaneous equation analysis of Hungarian exports to West Germany, its largest trading partner among capitalist countries, statistically significant results with the correct sign have been obtained for the supply of exports in regard to about one-third of the products, with the elasticities clustering around two (Wolf, 1981).^{1/} This has been the case in particular for products where a priori considerations indicate that profit maximizing behavior predominated. After 1980-81, such behavior is expected to be the general rule. In fact, the positive correlation between export expansion and the profitability of exports, noted above, points to the responsiveness of export supply.

At the same time, the system of incentives introduced in January 1980 puts a premium on setting a realistic exchange rate in Hungary. Failing this, the firm will be discouraged from undertaking exports that are produced at a domestic cost exceeding the actual exchange rate but falling short of the equilibrium rate. This latter is defined as the rate that would keep the balance of payments in equilibrium without the application of export subsidies and with foreign borrowing not exceeding desirable levels.

Under the reforms introduced in January 1980, compensation payments to industrial exports would be phased out within five years. The elimination of these payments would require devaluing the exchange rate in real terms, i.e. after adjustment for changes in relative prices, since otherwise unacceptable

^{1/} Also, substitution elasticities were mostly between two and three, had the correct sign, and were statistically significant for about one-third of Hungarian export products in Germany. At the same time, as the author notes, difficulties of estimation may have contributed to the lack of statistical significance of the remaining estimates.

balance-of-payments deficits would occur.^{1/} At the same time, changes in real exchange rates phased over a five year period would permit the expansion of exports through increases in capacity, thereby raising the elasticity of export supply.

It should not be assumed, however, that the equilibrium exchange rate would exceed the average exchange rate for all exports, when the exchange rate for individual activities is defined as the sum of the official exchange rate and the rate of export compensation. Rather, the opposite is likely to be the case as the same export total will require fewer domestic resources.

With the devaluation of the real exchange rate, import protection rates would need to be lowered, lest the bias against exports increases. In fact, it would be desirable to reduce the existing bias against exports as the transfer of resources from higher-cost import substitution to lower-cost exports would improve the efficiency of the allocation of existing resources and contribute to the use of incremental resources in activities that have relatively low domestic costs per unit of foreign exchange earned or saved.

Tariffs average 24 percent in Hungary, with further import charges of 4 percent. While tariff rates are scheduled to be lowered under obligations taken in GATT, it would be desirable to liberalize import licensing that has allowed investments in the manufacture of products which cannot compete abroad, either because of high cost or low quality. Examples are the production of cleaning materials, the manufacture of gearshifts, and the making of automobile windshields (Török, 1980).

^{1/} Riecke Werner suggests that, in the absence of a devaluation in real terms, the new price mechanism will be overshadowed by the application of discretionary measures aimed at increasing exports (1980).

It would also be desirable to modify existing regulations that allow the same profit margin for firms in the noncompeting sphere as for firms which export at the existing exchange rate adjusted for the tax rebate. The absence of exports in convertible currency trade can be taken as prima facie evidence of the lack of competitiveness of firms in the noncompeting sphere. An additional consideration is that these firms can raise their profits above the allowed margin more easily than firms which are subject to the discipline of the world market. This has in fact been the case following the January 1980 price reform, when noncompeting firms raised their profits substantially more than firms that competed abroad (Medgyessy, 1980).

The decline in the average export exchange rate would have an anti-inflationary effect. The price of products subject to import protection would also decline following the liberalization of imports. And while these changes would be more than offset by increases in the domestic prices of imported materials that are subject to low tariffs, the resulting average increase should be manageable within the limits of the 4-5 percent annual rate of inflation foreseen for the period of the Sixth Five Year Plan as long as continued adjustments are made in the exchange rate to offset higher inflation abroad.

In 1968, the commercial exchange rate exceeded the tourist exchange rate by 100 percent. This difference was reduced over time, contributing to improvements in resource allocation. The unification of the two rates in mid-1981, however, has involved an economic cost. This is because tourism is effectively subsidized in Hungary through artificially low consumer prices, thereby raising the domestic cost of earning foreign exchange in this activity.

It may be added that while the unification of exchange rates for merchandise exports has been objected to on the grounds of the allegedly low elasticity of export supply, the limitations of tourist facilities -- in particular hotels -- have apparently been neglected in unifying the commercial and the tourist exchange rates. The result has been unsatisfied demand, coupled with the subsidization of those tourists who have been able to obtain hotel accommodations.

The unification of the commercial and tourist exchange rates has, however, been seen as a step towards convertibility and membership in the International Monetary Fund. Under the IMF definition, convertibility requires that there be no restrictions on the use of currency balances acquired by non-residents for current-account transactions (external convertibility). This means financial convertibility (the conversion of forint balances into another currency) as well as commodity convertibility (the use of forint balances to purchase Hungarian goods and services). Both of these forms of convertibility could be established under present regulations once foreigners are empowered to hold balances in forints.^{1/}

In fact, apart from conforming to the IMF conditions of external convertibility, the principal purpose of the unification of exchange rates appears to have been to induce foreigners to hold forint balances, thereby increasing the availability of foreign exchange to Hungary. The question is, however, at what rate of interest would the holding of forint balances be sufficiently attractive to foreigners, taking account of the exchange rate

^{1/} While Marer suggests that commodity convertibility could not be achieved since "the foreign holder is not free to command with its deposits goods produced in the issuing country..." (1981, p. 543), this is actually possible in Hungary where exports are not subject to limitations and no limitations are imposed on foreign tourism.

risk. It may in fact be cheaper for the National Bank to offer deposits denominated in terms of foreign currencies that would not be subject to the exchange rate risk in forints, in particular since foreigners may not anticipate the continuation of the policy of currency appreciation to offset inflationary developments abroad.

Marer, however, suggests that the adoption of external convertibility would be beneficial to Hungarian firms: "If the forint had external convertibility, commercial contracts could be concluded and payments made in forints, eliminating the ER [exchange rate] risk for Hungarian enterprises " (1981, p. 546). But this may well be a will 'o the wisp, since small countries generally denominate their foreign exchange transactions in U.S. dollars or in the currency of a large trading partner. It is difficult to see that foreigners would be willing to denominate their exports in forints; also, Hungarian firms may not wish to weaken their competitive position by denominating their exports in forints.

III. Wage Determination and Personal Incomes

In the years immediately following the introduction of the NEM, the regulation of wages generally took the form of limiting increases in average wages at the firm level. It soon became apparent, however, that this so-called relative wage-level regulation was not conducive to raising productivity through reductions in the labor force of the firm, improved work performance, or the upgrading of the labor force. Rather, inducement was provided to reduce average wages through the hiring of low-wage labor. These factors, in turn, contributed to a slowdown of labor productivity growth in Hungarian industry (Balassa, 1973, pp. 351-53).

In order to correct these shortcomings, wage regulations were modified in subsequent years. In sectors where the relative wage-level regulation was

maintained, allowable increases in average wages were tied to the growth of the sum of wages and profits per worker; in a number of sectors increases in the wage bill were regulated on the basis of changes in value added (relative wage-bill regulation) limiting, however, the extent of increases in average wages; and in several sectors increases in the wage level or in the wage bill were centrally determined. By 1978, the percentage distribution of workers among the four types of wage regulations was as follows: relative wage-bill, 55 percent; relative wage level, 14 percent; central wage-bill, 15 percent; and central wage-level, 15 percent (Løkkås, 1978, p. 178).

Under both the relative wage-level and the relative wage-bill regulations, increases in average wages in excess of 6 percent a year were made subject to a progressive tax at rates starting at 150 percent. In the large majority of cases, the rise of average wages reached or approached the 6 percent limit. However, only few firms raised average wages by more than 6 percent, so as to avoid the 150 percent tax.

The increased use made of wage-bill regulations apparently contributed to saving manpower (Løkkås, 1978, p. 81) and labor productivity increased on the national economy level. However, this mode of regulation is also subject to the shortcomings associated with the application of the basis-principle, under which changes in particular indicators compared to a base period trigger wage increases.

Thus, firms already operating at high levels of efficiency were unable to substantially raise wages because they had few possibilities for productivity increases, whereas firms having such possibilities were motivated to utilize such opportunities slowly so as to avoid 'bumping' against the ceiling. At the same time, the imposition of a ceiling for increases in average wages penalized firms that experienced fluctuations in profits due e.g. to changing

world market conditions. This was the case even though the regulations permitted setting aside wage reserves, because of the uncertainty associated with the utilization of these reserves; thus, the reserves accumulated in 1977 and 1978 were eliminated in 1979.

The elimination of wage reserves in 1979 may have responded to the situation existing at the time, when improvements in measured performance much depended on the ability of the firm to negotiate its prices, taxes and subsidies with the supervising authorities. The price reforms introduced in 1980-81 have reduced the scope of discretionary measures, but only few changes have been made in the system of wage determination.

The scope of wage-bill regulations has been extended to a larger number of sectors and the limit for tax-free increases in average wages has been raised to 9 percent (12 percent after January 1, 1982), with a 150 percent tax rate applying above this limit. The tax rate rises up to 800 percent, with the size of the increment depending on the ratio of profits to the sum of fixed capital and wages. Finally, wage preferences have been introduced to the benefit of firms whose actions aimed at pursuing long-term objectives have entailed temporary reductions in profits or special circumstances have led to the deterioration of performance.

Apart from the introduction of wage preferences, the changes in the system of wage determination have not affected the application of the basis - principle. At the same time, the system applied is rather complicated and involves discretionary action on the part of the supervising authorities in applying wage preferences. It also discourages structural change in the firm if this would involve increased labor intensity, even though such changes may be in the national interest in e.g. exporting in convertible currency trade. Reliance on value added as a performance criterion in wage setting represents

an additional shortcoming of relative wage-bill regulation.

Lajos Faluvégi, Deputy Prime Minister and President of the National Planning Office, states the need for an overhaul of the system of wage determination while adding that this could not be accomplished overnight, lest disruptions occur in the national economy (1981a, p. 25). In recent years, various proposals have been made to reform the system of wage determination in Hungary. They include further increasing the scope of wage-bill regulations (Lőkös, 1978; Pongrácz, 1979); taxing wages above a certain level and applying lower taxes to increments in profits than to the base-period profit (Balázs, 1978 and 1979); and regulating wage increases centrally, with a small additional distribution made from profits (Révész, 1978 and 1979).^{1/} Instead of providing a detailed evaluation of these proposals, in the following recommendations will be made for establishing a new system of wage regulations that would conform to the principles underlying the 1980-81 price reforms.

In accordance with the 1980-81 price reforms, emphasis should be put on the profitability of the firm rather than on changes in profits, or, for that matter, changes in value added. At the same time, it should be recognized that, through decisions made on product composition, market orientation, and investments, it is the management rather than individual workers who are responsible for the profitability of the firm. This conclusion has implications for the remuneration of both management and workers.

In order to encourage the profitable operation of the firm, the financial interest of management in profitability would need to be increased. This would require establishing a stronger link between the remuneration of

^{1/} These proposals are summarized in the June 3, 1981 issue of Figyelő.

management and the firm's profits and phasing out bonuses based on the evaluation of the management on the part of the supervising authorities that introduce subjective elements and reduce the managers' independence.

Increasing the financial interest of management in the profitability of the firm would also provide the basis for realistic wage setting. While for reasons noted above linking wage increases to increases in profits is not warranted, the profits of the firm could be increased if wages were linked to the productivity of the worker.

If wages were based on labor productivity and labor was mobile among competitive industries, efficiency wages would tend towards equalization across industries and firms. Such is not the case under the existing system of wage regulations, thereby creating inequities among workers performing equivalent tasks. At the same time, for labor migration to equalize efficiency wages, it would be necessary to establish the conditions of competition and to eliminate the present excess demand for labor that creates pressures for wage increases. Measures that may be taken to pursue these objectives will be considered in Section V below.

The necessary conditions could not be established overnight, however, hence there would be need for transitional measures. These could take the form of extending the scope of productivity-based wage determination, with wage increases being constrained by the profitability of the firm rather than by changes in value added or in profits. ^{1/}

^{1/} Szakolczai also proposes linking wage increases to the profitability of the firm, but the implementation of his proposal would lead to larger inter-firm wage differences than could be considered desirable (1981).

IV. Investment Decisions

Firms may finance investments from their own resources, including after-tax profits and 60 percent of depreciation allowances, from credits, and from budget support. While at the time of the introduction of the NEM it was assumed that the importance of budget support would decline over time, the opposite occurred and in 1976 budget support was provided for the financing of 61 percent of investment undertaken by industrial firms. The corresponding percentage for bank credit was 75 percent, with four-fifths of the credits given to firms that also received budget support. Correspondingly, only one-tenth of industrial investments were carried out from the firm's own financial resources alone (Deák, 1978).

Bank credits were often conditioned on the availability of budget support that, in turn, was increasingly made available in accordance with state preferences, the total number of which reached 60 in 1976. State preferences were formulated in most part in physical terms (Wiesel, 1981) and practically excluded the possibility of competition for state funds. Also, competition for bank credit was reduced by reason of the existence of 29 classes of credit preferences (Barát, 1981). At the same time, the sharing of responsibility for the investment decision was not conducive to efficiency and it provided firms with the possibility to request government aid in the event that the investment proved to be unprofitable (Mocsáry, 1981).

For the future, an important question relates to the extent investment by the firm will be self-financed or centrally financed. In recent years,

recommendations were made to limit the extent of self-financing and, the 1980-81 price reforms envisaged substantial reductions in profit margins.^{1/} In this connection, reference has been made to the need to avoid the expansion of firms that have low social profitability and to moderate investment demand in general.

As long as the firm's profits were much influenced by selective taxes and subsidies, and hence did not appropriately reflect social profitability, there may have been cause for criticizing the financing of their expansion from profits. However, the role of selective taxes and subsidies has been reduced under the 1980-81 reforms, which aim at aligning domestic prices to world market prices. As a result, the firm's profits will better correspond to social profitability and will show greater differentiation than in the past. High profits will be made by efficient firms whose expansion is desirable from the economic point of view while the low profits of inefficient firms will not permit their expansion.

These considerations indicate the desirability of reducing the central financing of investments under the conditions created by the 1980-81 reform. An additional consideration is that large reductions in profit rates would make it difficult for firms to repay credits they obtained at the time when

^{1/} It was originally planned to reduce the average profit rate from 15 percent to 6 percent under the 1980 price reform (Csikós-Nagy, 1979). As noted above, however, profits in 1980 were in fact higher than expected.

higher profit margins were allowed.^{1/} This is the case, in particular, since actual profits are overstated by reason of the use of historical depreciation and FIFO (first-in-first-out) accounting of inventories.

The central financing of investments also limits the responsibility of the firm for its own investments and increases the danger of central interventions. The central financing of investment often conflicted with economic objectives in the past and it reportedly lowered the average profitability of industrial investments (Sári, 1981).

At the same time, it would be desirable to ensure the transfer of funds from firms with low, to those with high, profitability. Apart from the establishment of joint subsidiaries noted below, this objective would be served by the establishment of appropriate financial institutions. In this connection, one may consider separating the central bank and commercial bank functions, extending the scope of operations of existing banks, envisaging the establishment of new banks, and creating the conditions of competition among banks.

Competition and the application of the profit principle to the banks would make them interested in attracting deposits from individuals as well as from firms and in providing self-liquidating loans. There would also be need to utilize additional financial instruments such as bonds and to ensure the participation of individuals in the financing of co-operatives.

The transformation of the banking system would represent a further step

^{1/} According to a study carried out at the National Bank, difficulties of repayment were observed even before 1980, with nearly one-half of firms with profit rates between 10 and 30 percent experiencing such difficulties (Weßres, 1980). Another study shows that, taking account of taxes on profits, a 20 percent profit rate would permit repayment only if the firm received one-half of its external funds from bank credit and one-half from budget support, which latter involves lower servicing costs (Cseresznyák, 1981).

in the implementation of the 1980-81 reforms, which envisage reducing the scope of credit preferences and giving greater role to economic considerations in granting credits. The new regulations establish a minimum profitability level of 14 percent for borrowers, with exception made for industrial and construction materials, food processing, mining, internal trade, transportation, and communication, where the minimum rate is 10 percent, and for agriculture and services where it is 8 percent.

At the same time, preferential credits for exports in convertible currencies will continue, with their share expected to reach 60 percent during the period of the Sixth Five-Year Plan (Faluvégi, 1981a, p. 783). One-third of the interest on these credits is repaid by the National Bank if the credit conditions, generally requiring net foreign exchange earnings to total the amount of the loan in the first three years, are met. In turn, one-fourth of the interest is repaid on loans for import substitution as well as on loans that lead to energy savings equal to the amount of investment over a five year period.

Granting preferential credits to exports in convertible currencies is warranted because of the continued discrimination against these exports in the incentive system and the risk they involve. Questions arise, however, about the desirability of introducing preferential credits for import substitution. Such credits should be subject to the condition that they finance the manufacture of internationally competitive products. As in the absence of import liberalization the only way to judge competitiveness is that exports actually take place, the application of this principle would necessitate financing manufacturing facilities that simultaneously provide for exports and for domestic markets, thereby ensuring efficient import substitution.

Interest rates on credits granted before, and after, September 1, 1981 are 8-9 percent and 9-10 percent, respectively, on investment credits, and 10 and 11 percent on credits for variable capital. In conjunction with increased profit margins, these rates would need to be raised to market-clearing levels, in order to eliminate credit rationing. Higher interest rates would also encourage the inter-firm transfer of funds as well as private savings.

The 1980-81 reforms have also brought improvements in regard to regulations on budget support for investment. Such support will be provided only in cases when the firm's profitability is adversely affected by centrally imposed deviations from world market prices and the choice among claimants will be made on the basis of profitability at undistorted prices. It will be given in the form of a loan, repayable in ten years. The same procedure will be applied in cases when large investments are financed from the budget.

The government may also make contributions to the capital of individual firms whose profitability exceeds the limit set for bank credits. Contributions will be made on the basis of competitive bidding, with firms paying a 15 percent interest from their pre-tax revenue over a period of ten years.

Finally, the government plans to limit its actions aimed at altering the industrial structure. According to István Hetényi, the Minister of Finance, "the sectoral and subsectoral structure of our industry is much nearer to the international level than the competitiveness of our firms. Correspondingly, adaptation to market possibilities and improvements in productivity are the principal objectives and the introduction of sectoral priorities will be warranted in exceptional cases only" (1980, p. 1300). There will be no new programs for large industrial complexes during the period of the Sixth Five Year Plan and outside basic industry only two priority areas have been

identified, pharmaceutical products and selected electronics products; in both cases, the government will finance basic research that may be warranted on external economies grounds. Assistance will further be given to investments aimed at effecting savings in materials and in energy, and funds will be provided for the development of the production of parts and components (Faluvégi, 1980, pp. 776-77).

These guidelines represent a welcome change from the previous two five-year plans when changes in the industrial structure were to a considerable extent centrally determined, involving investments in several large complexes, some of which (e.g. petrochemicals) were highly capital and energy intensive. Nevertheless, concerns have been voiced that, the volume of state-financed investments, including the considerable investments began during the previous plan period, will be overly large (Belyácz, 1981) to allow for a sufficient amount of investment by individual firms within the constraint imposed on total investment.

V. Organizational Structure

Industry in Hungary is highly concentrated by the standards of capitalist, as well as socialist, countries (Mocsáry, 1980, p. 1311). The extent of concentration observed today is largely the result of the mergers of independent firms effected during three separate periods -- the late 1940s and the early 1950s; the first half of the 1970s; and between 1972 and 1979.

The concentration movement was particularly strong in the first half of the sixties, entailing an increase in the share of industrial firms employing more than 1000 workers from 14.7 percent in 1960 to 35.4 percent in 1970. After a temporary reversal following the introduction of the NEM, this process continued in the wake of the Party resolution of November 1972. By 1979, the share of firms employing more than 1000 workers reached 44.8 percent while the

share of firms with less than 100 workers fell to 7.1 percent from 10.7 percent in 1970. The corresponding employment shares in Western European countries and Japan are 30-40 percent and 20-30 percent, respectively.

The process of industrial concentration involved reducing the number of firms from 1368 in 1960 to 812 in 1970 and, following a temporary increase in the next several years, to 702 in 1979; by comparison there are 6830 industrial firms in Austria. The extent of concentration was even greater if allowance was made for the fact that nearly one-half of industrial firms were organized into trusts in Hungary. If the 24 trusts and the 364 independent firms were considered as separate decision-making units, in 1977 twelve such units accounted for 40 percent of fixed capital and eight of them received 50 percent of government subsidies in Hungarian industry (Varga, 1979, p. 28). At the same time, trusts and most large independent firms were characterized by horizontal integration, as they consisted of a number of -- often relatively small -- plants producing identical or similar products. This may explain that in a variety of industries plants were not of efficient size (Román, 1978).

Also, Hungarian industry was oriented towards the production of final goods to the neglect of what has been called 'background industries,' consisting of small- and medium-size firms producing parts, components, and accessories (Bossányi, 1979). Yet, in modern industry, and in particular in the manufacture of machinery and transport equipment, ensuring specialization on an efficient scale requires a network of subcontractors that produce these inputs to precision.

In the United States, General Motors provides an example in having several thousand subcontractors. But, specialization increasingly cuts across national borders, leading to the international division of manufacturing

activities. Countries where skilled and unskilled labor is available at a relatively low cost play an important role in this process by producing parts, components, and accessories for assembly elsewhere (Balassa, 1981).

On the basis of the availability and cost of skilled and semi-skilled labor, Hungary would be well-placed to produce parts, components, and accessories for export. However, these products equalled only 22 percent of the exports of machinery and equipment in convertible currency trade in 1980 while they were 72 percent of the corresponding imports. In fact, the lack of availability of adequate parts, components, and accessories domestically made necessary the rapid growth of their imports. This was the case, in particular, for machinery and transport equipment exported in convertible currency trade.^{1/}

The lack of an adequate network of subcontractors further led to backward integration, with firms engaged in the production of the final product also manufacturing their own parts, components and accessories, entailing excess costs. This observation also applies to service inputs, such as the preparation of production plans and designs.^{2/}

The Hungarian industrial structure thus combined the disadvantages of fewness, thereby limiting competition; the existence of relatively small plants producing identical and similar final commodities, thereby foregoing economies of scale; and the lack of adequate specialization, thereby leading to the inadequate and high-cost production of parts, components, and

^{1/} An example is provided by IKARUS, a major exporter of buses, whose domestic suppliers are reported to be thirty years behind requirements (Nagy, 1981, p. 517).

^{2/} It has been reported that the 200 largest Hungarian industrial firms producing final goods design and manufacture 90 percent of their tools (Varga, 1979, p. 36).

accessories and failing to exploit Hungary's comparative advantages in these products. The 1980-81 reforms have introduced several measures aimed at improving the situation.

To begin with, 137 new firms have been created by breaking up horizontal trusts and large firms. Apart from increasing competition, these measures are expected to reduce the need for an administrative bureaucracy and to simplify the decision-making process. Also, they will make the newly-established firms responsible for their own performance, while in the past incentives for improvements on the plant level were rarely provided. Profitable units will further have the possibility to expand, in contrast with the earlier situation when the horizontally integrated trusts and large firms tended to equalize conditions for the individual plants.

While the re-organization has not been without difficulties, the findings of a survey covering over one-half of the newly-established firms have shown the beneficial effects of independence through the modernization of product structure, technological development, and market research, as well as the revision of investment plans in favor of less costly alternatives. In fact, the officials of the firms have stated that "considerable energies have been freed by reason of the fact that they can directly experience the impact of the market, that they have come under the pressure of the economic climate, and that they have to bear the consequences of their own actions" (Varga, 1981, p. 3).

It is further envisaged to promote the development of the production of parts, components, and accessories in the framework of the Sixth Five Year Plan. This would reportedly involve almost exclusively large firms, which would receive financial benefits in exchange for agreeing to manufacture some of the two dozen products that are included in the programme (Laki, 1980, p.

66). It is understood, however, that this alternative can offer only a partial solution.

To begin with, the number of products involved is small and their choice reportedly has not been made on the basis of social profitability calculations. At the same time, in selecting chiefly large firms for this purpose, the advantages of flexibility small- and medium-size firms possess may be foregone. Furthermore, apart from 'hardware,' there is need to increase the availability of 'software' in the form of computer, marketing and other services. Finally, consideration needs to be given to export possibilities, since the limited domestic market often does not allow for the production of parts and components on an efficient scale.

These objectives will be served by the practical implementation of the regulations in effect from January 1, 1982, which provide for the establishment of new, and the expansion of existing, small- and medium-size producers. By easing the limitations imposed on their scope of operations, production volume, employment, and the availability of capital, the regulations provide conditions for the development of cooperatives and private producers, which have increasingly contributed to the availability of parts, components, and accessories in recent years. Also, new, more flexible forms have been created for small- and medium-size activities -- public, cooperative, and private -- in agriculture, industry, and services.

The scope of operation of private artisans has been extended to cover the entire industrial sector. Artisans may hire up to three workers and utilize six family members. They may also let out piece work, not exceeding one-half of their production value. Artisans may further establish partnerships, in which the total number of workers can reach thirty.

Individuals may also establish partnerships, provided that their main

occupation is in a state firm or cooperative. The partnerships may employ workers to an extent not yet defined, except in cases when all partners are employees of the same state firm.

Existing cooperatives may set up specialized subgroups, with a minimum of five members, to carry out production and service activities on their own account but in the name of the cooperative. Cooperatives may also establish special units, consisting of at most 15 members, that pay a fixed fee to the cooperative based on estimated revenue and costs. Furthermore, individuals may set up small cooperatives, with 15 to 100 members, which are subject to simplified regulations. The members share in the income of the cooperative on the basis of their labor as well as capital contribution.

State firms may enter into contractual relationships with an entrepreneur to manage on his own account, for payment of a fee, a unit of the firm employing no more than 15 workers. Alternatively, the agreement may concern production on a fixed fee basis, again by a unit employing no more than 15 workers.

State firms and public agencies may establish small firms, to which simplified regulations apply. State firms, individually or jointly, may also establish subsidiaries. The subsidiaries are not necessarily small firms and may engage in a variety of activities, including foreign trade. At the same time, existing firms can diversify their activities, entering into new areas for domestic sales and exports.

In exporting machinery, and increasingly other commodities, producers can choose among trading firms. This creates the conditions of competition among trading firms, and it is linked to the greater freedom of the producer in choosing its own sphere of operation. At the same time, increasing numbers of firms and cooperatives, actually about 120, have been given the right to

export directly to capitalist countries, and some 90 foreign trade partnerships have been established with the participation of trading firms and of altogether 170 producing enterprises.

Another important organizational change has been the consolidation of the three industrial ministries into a single ministry, involving a reduction in the total number of employees by about one-half. With the transfer of responsibilities concerning price setting and material allocation to the Material and Price Bureau, and the lack of sectoral departments in the new ministry, the opportunities for intervening in the day-to-day affairs of the firm have been much reduced.

The possibilities for interventions by the supervising authorities could be reduced further by separating the functions of the state as the source of regulations and the owner of the means of production.^{1/} This purpose may be served by establishing independent boards for individual firms, with responsibility for hiring (and firing) managers, overall supervision of the operation of the firm, decisions on major changes in the scope of its activities and, if necessary, ending the firm's operations.

The initial members of the board may be appointed by the Council of Ministers for fixed terms while co-optation may provide an appropriate procedure to replace those whose terms have expired. The members of the board may include the representatives of the firm's management and workers in a minority position, with further representation from the government, the banks, the Chamber of Commerce, and independent experts.^{2/}

^{1/} For an early proposal to this effect, cf. Tardos, 1972.

^{2/} Retired high-level civil servants and managers may well be utilized in such a capacity as the retirement age is 60 years in Hungary.

In recent years, consideration has been given to the need to weed out firms that are not economically viable. Earlier, this was a practical impossibility as the government rescued failing firms by providing additional capital, subsidies, or permission to raise prices. At the same time, such rescue efforts often proved to be temporary, necessitating another rescue operation soon afterwards (Laki, 1978, p. 822).

It may be suggested that bankruptcy proceedings be initiated in cases when the price does not cover variable costs. In turn, restructuring may provide a solution in cases when firms are profitable in the short run but cannot recover capital costs. This may involve closing down some units or financial restructuring; the latter can be handled by the banks on the basis of profitability considerations; i.e. the loans provided would have to be repaid from future profits. The banks may also establish new firms, in which case they would have majority representation on the board.

The possible need to close down firms, or some of their units, and its implications for the reallocation of labor, are now apparently accepted in Hungary. Thus, János Kádár, the General Secretary of the Hungarian Socialist Workers' Party is quoted to have said that "the development and expansion of economical production, the contraction and finally cessation of uneconomical production, require the appropriate regrouping of labor" (Hewett, 1981, p. 521). At the same time, the introduction of this possibility will induce firms to be more selective in their investments and to limit wage increases.

These considerations point to the interdependence of the measures applied. The possibilities for making profits, together with the risk of bankruptcy, will provide inducement to the firm to improve productivity and to be cost-effective. This, however, requires that the firm has full

responsibility for its actions, thus excluding central interventions in the firm's operations.

At the same time, for profitability on the firm level to correspond to social profitability, there is need to adopt world market price relationships and to ensure competition. The logical conclusion is the liberalization of imports that would ensure the full transmission of world market prices to the domestic economy as well as import competition. Competition would also be served by continuing in the direction of breaking up firms where economic considerations so warrant and establishing new firms.

Import liberalization, together with the elimination of export compensation, would necessitate devaluing the exchange rate in real terms so as to establish its equilibrium level. Also, interest rates would need to be raised in order to eliminate credit rationing and to encourage interfirm transfers of funds as well as private savings. These measures would have to be accompanied by the use of macroeconomic policy instruments, both to ensure the effectiveness of changes in exchange rates and interest rates and to avoid the investment cycles of the past.

All in all, the measures applied in 1980 and in 1981 represent important steps towards improving efficiency in the Hungarian economy. The pursuit of this objective would, however, require further steps to complement the measures so far taken. This may be done over a period of time, so as to minimize economic disruptions abrupt changes entail.

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Evaluates the country's pragmatic and dynamic approach to economic problems and its general commitment to an open market-oriented economy, improved efficiency of domestic industry, and higher living standards.

The Johns Hopkins University Press, 1975. 504 pages (including 5 appendixes, glossary, bibliography, statistical annex, maps, index).

LC 74-24404. ISBN 0-8018-1702-1, \$27.50 (£16.50) hardcover; ISBN 0-8018-1715-3, \$9.95 (£6.00) paperback.

Yugoslavia: Self-Management Socialism and the Challenges of Development

Martin Schrenk, Cyrus Ardalan, and Nawal A. El Tatawy

Describes major development issues and the overall performance of the economy, showing that the new economic framework of the 1970s strengthens decisionmaking at the lowest microeconomic level and at the same time allows greater coordination of economic activity by extending self-management principles to the macroeconomic level.

The Johns Hopkins University Press, 1979. 410 pages (including map, appendix, glossary, index).

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Presents an integrated analysis of the difficulties experienced by the Zairian economy between 1975 and the first half of 1979 and suggests that the country needs to revamp its institutions and its system of incentives and adopt policies that will lay the foundation for a development pattern that will render it less vulnerable to changes in the world economy.

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