

Iván Berend (Hrsg.)

# Long-Term Structural Changes in Transforming Central & Eastern Europe

The 1990s

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# Long-Term Structural Changes in Transforming Central & Eastern Europe (The 1990s)

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Edited by Ivan T. Berend

**Südosteuropa-Gesellschaft**  
In cooperation with the  
**Center for European and Russian Studies,**  
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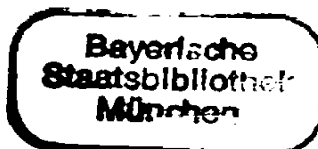
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## PREFACE

The collapse of state socialism in 1989-91 in Central and Eastern Europe and its consequences, and the painful but also promising transformation of the region, attracted a great amount of interest in recent years. Several journalistic reports and scholarly analyses have been published, and hundreds of conferences have been held throughout the world. An entire library of studies has been published on the central issues of transformation. The establishment of a parliamentary system, the holding of free elections and the creation of new democratic and market institutions have all been widely publicized. The same should be said about the attempts of macro-economic stabilization, the progress of marketization and the privatization of previously state-owned companies. Still, the huge literature of “transformatology” has hardly dealt with the undercurrent of long-term structural changes that began in and characterized the first half of the 1990s. Structural transformation in the political, social and economic arenas, however, have the most important and long-lasting impact on the future on the region. Is Central and Eastern Europe adjusting to the requirements of the modern Western technological-structural challenge? Has Central and Eastern Europe begun to restructure its societies based on modern requirements? The half decade-long transformation process has naturally been too short to be properly evaluated regarding long-term transformation. But some patterns have nevertheless emerged, and they offer us an opportunity to analyze them *in statu nascendi*. These questions have therefore yet to be addressed.

This was the central goal of a conference, jointly organized by the Südosteuropa-Gesellschaft and the Center for European and Russian Studies at the University of California in Los Angeles (UCLA), held in Weimar in May 1995. The finalized and edited papers presented at the conference are published in this volume. The authors present a very broad picture and expand on some (from several respects) important, pioneering ideas on the less handled long-term structural changes that are going on in the region. The analyses focus on the leading countries of the Central and Eastern European transformation, i.e., on Central Europe, the Czech Republic, Poland and Hungary. These countries had the best progress in transforming their previous systems and structures, and may very well be setting the most interesting trends that are representative for the future potential of the entire region. The scholars who gathered at the historic Hotel Elephant in Weimar in the spring of 1995 made the first attempt at presenting a comprehensive view on the structural transformation of Central and Eastern Europe. The performance and paths taken might change in the years to come. But the initial steps and the main direction of structural changes are of major importance, and they might also guide us as to the tasks and lessons ahead.

I am very grateful to the Südosteuropa-Gesellschaft, and personally to Dr. Roland Schönfeld and Dr. Hansjörg Brey, who made it possible to hold the Weimar Conference in such an ideal environment, and also to publish this collaborative work of the two institutions, the Südosteuropa-Gesellschaft in Munich and the Center for European and Russian Studies at UCLA in Los Angeles.

Finally, I have to mention the names of Ms. Gudrun Kuhlmann, who made all the technical arrangements as conference coordinator in Weimar, and Mr. Robert Levy, Ph.D. candidate at UCLA, who did the laborious job of “translating” the various Polish-English, Hungarian-English and Czech-English texts and doing the technical work on this volume. This work could not have been published without his assistance. Last not least the editor gratefully appreciates the assistance of Ms. Maria Prsa of the Südosteuropa-Gesellschaft staff in the preparation of this book.

Ivan T. Berend



IVAN T. BEREND

## Transformation and Structural Changes: Central and Eastern Europe's Adjustment in a Historical Perspective

### 1. "Transformational" or Structural Crisis

The emergence of a new Europe is one of the most challenging factors of an arising new twenty-first-century world system. The unification of Europe, an idea of idealist day-dreamers only a generation ago, is in the making. Between the mid-1970s and 1990s the European Community, now the European Union, gradually expanded by accepting several Southern and Northern European countries, as well as certain Central European countries such as former East Germany and Austria.

A window of opportunity opened in 1989 for a gradual continued broadening of the European Union by integrating some (or most) of the Central and Eastern European countries which had belonged to the "Second World," the "other" Europe east of the River Elb. The prerequisites of acceptance, however, demand a dramatic transformation, including macro-economic stabilization and radical change of the political, legal-institutional, and economic systems. A transformation of historical importance began in the area, and it characterized the first half of the 1990s from the new *Bundesländern* to the Caucasus. A painful macro-economic stabilization sought to consolidate the crisis-ridden economies of the former state socialist countries. Beside severe austerity measures, a parallel processes of marketization and privatization gained ground. Whether introduced overnight by economic "shock treatment" or in a gradual manner, these changes turned out to be long-term processes. Naive hopes and euphemistic forecasts soon disappeared: the "transformational crisis," as János Kornai<sup>1</sup> called the drastic 20 to 50 percent decline of output and income, became unavoidable, in a much deeper and broader scale than everybody had ever imagined. The economic turbulence and changes attracted a great deal of scholarly interest during the first half of the 1990s.

Macro-economic stabilization, building a consistent market environment and, as an inseparable part of this, privatizing a basically state-owned economy, are, however, not the goals but only the means. All these measures and institutions serve the central goal of creating a flexible, competitive economy which would adjust to a new and dramatically changing technological regime of the "fifth industrial revolution" as well as the new requirements of international trade. Central and Eastern Europe, therefore, faces not only a "transformational crisis" that requires an adjustment to the Western institutional-legal and economic system, and consequently has a more or less clear-cut program to follow, but is also challenged by the end-of-the-century structural crisis. The Schumpeterian "structural crisis," caused by a large "set of technological changes" that made former leading branches and export sectors obsolete, represents a crucial challenge and demands an appropriate response. All these require the rise of new competitive leading

<sup>1</sup> János Kornai, "Anti-Depression Cure for Ailing Postcommunist Economies," *Transition, The Newsletter About Reforming Economies*, 4.1 (February 1993), p. 2

sectors and export branches based on new technology. An infrastructure of the new "communication age" is needed, together with an entrepreneurial middle class and a highly skilled labor force, flexible enough to adjust to a rapidly changing employment structure. This is the essence of the adjustment to the advanced Western core. Without this, attaining a balance of trade and payments and a healthy economy would be unimaginable.

## *II. Growing Gap Between East and West - in a Historical Perspective*

Isn't it, however, naive and anachronistic to speak about the structural adjustment of Central and Eastern Europe and a process of catching up with the core of the world economy in a period when the gap between the core and the Central and Eastern European periphery grew dramatically and reached its worst historical record in two centuries? What are the real opportunities of adjustment? What are the real trends of structural changes in these transforming societies and economies? These are the focal questions of the end-of-century Central and Eastern Europe.

The authors of this volume paint a comprehensive picture on structural changes, including their political framework and social and economic content. Their analyses aim to go much further and deeper than the traditional approach of an already exhausted "transformatology." The goal of this introductory study is to provide some central questions of the structural changes in a historical perspective and to help the reader sum up the main findings of the authors of the volume.

The point of departure is a historical evaluation of Central and Eastern Europe's bold and desperate attempts - characterizing the nineteenth and twentieth centuries - to take off from the backward periphery of the world system and safely land in its core. The countries of the region pursued this goal in various ways. For the half century between the 1860-70s and World War I, they enthusiastically copied the Western pattern, introduced Western institutions, joined the international *laissez-faire* system initiated by Great Britain, and launched an export-led industrialization policy. They definitely achieved certain successes by modernizing their economies. However, they could only slow down but not halt their relative decline and the increase of the gap with the West, which characterized the first half of the nineteenth century. In 1820 and 1870, the countries of the region- according to Angus Maddison's newest calculations<sup>2</sup> - reached only 58.1 and 48.8 percent of the West European core's per capita GDP level respectively. In 1913, they declined to 42.0 percent of the Western standard.

The semi-success (or semi-failure) generated a desperate revolt against Western values and models. After World War I, export-led industrialization was replaced by import-substituting industrialization, and *laissez-faire* economics was overturned by protectionism and aggressive state intervention; this occurred simultaneously with harsh attacks on the previously adopted parliamentary system and the introduction of various types of authoritarian regimes. The comparative economic level of Central and Eastern Europe, however, stagnated during the first half of the twentieth century. While slowing down itself to a significant degree, West Europe preserved its advantage compared to the

<sup>2</sup> Angus Maddison, *Monitoring the World Economy 1820-1992* (Paris, 1995).

eastern half of the continent. The latter's position hardly changed between 1913 and 1938, and totaled 44.1 percent of that of the West by the outbreak of World War II.

The new revolt after W.W.II, and the adoption of the Soviet model of a planned economy and forced industrialization, made the East European modernization dictatorships relatively successful for a quarter of a century. In quantitative terms (meaning per capita growth), this led somewhat to a narrowing of the gap with the West for the first time in modern history. With an average annual growth of 3.9 percent, Central and Eastern Europe achieved the fastest growth rate in a generally rapidly growing world between 1950 and 1973, improving its relative position and seeming to leave behind most of the other peripheral regions.

**Central and Eastern Europe's per capita GDP  
as percentage of the various regions of the world 1913-1973\***

	1913	1938	1973
Western Europe	42.0	44.1	46.6
Overseas West	29.7	34.9	35.7
Southern Europe	88.8	107.9	95.2
Latin America	102.8	105.5	120.9
Asia	209.8	238.3	341.8
Africa	270.8	291.7	450.7
World average	97.8	108.3	132.6

\*Angus Maddison's regional figures are based on the average of sample countries. Western Europe is represented by 12 countries; the Overseas West (he calls Western offshoots) is the aggregate of Australia, Canada, New Zealand and the US; Southern Europe is the average of Greece, Ireland, Portugal, Spain and Turkey; Central and Eastern Europe consists of Bulgaria, Czechoslovakia, Hungary, Poland, Romania, the Soviet Union and Yugoslavia; Latin America is represented by seven countries; Asia by eleven countries, including China, India, Bangladesh, Japan, Taiwan and South Korea; Africa is represented by ten countries; and the world average is composed by the average of the above 56 countries.

From the last third of the nineteenth to the last third of the twentieth century, Central and Eastern Europe could not break through and remained basically at the same relative place; as Maddison's figures demonstrate, it was the fourth-ranking region with the fourth-fastest per capita growth. Although Central and Eastern Europe rose well above the world average, and was much further ahead of the peripheries of the world economy (such as Latin America, Asia and Africa) in 1973 than it was in 1938, it still could only claim a 1:2 proportion of the economies of Western Europe, and 1:3 to that of Western core countries overseas. The "Second World" still remained the European periphery despite its neck-breaking drive of catching up with the West.

During the last third of the twentieth century, the endeavor to fundamentally and dramatically catch up totally collapsed. The countries of the region could not cope with the new structural crisis and could not adjust to its requirements, and thus slowed down from the late 1970s on. During the 1980s the economic crisis deepened. Growth was followed by stagnation and then decline. This was the economic basis of a rapidly emerging political crisis which ended in the collapse of the state socialist regimes in 1989-91.

Since that time, the painful consequences of Soviet-type industrialization, the collapse of the isolationist Comecon market, and the new efforts to change the economic model and revert to pre-World War I *laissez-faire* and export-led industrialization, all led to an additional 25 to nearly 50 percent decline of GDP and industrial output. According to Maddison, Central and Eastern Europe, as an annual average, reached a negative growth of 0.8 percent between 1973 and 1992.<sup>3</sup>

Although they experienced several recessions, stagflation and economic turmoil, the Western core countries successfully coped with the difficult task of adjustment to the structural crisis and emerged with their vitality intact. Their annual average growth between 1973 and 1992 reached 1.8 percent, nearly three times more than that of Central and Eastern Europe. As a consequence, the gap, or, more precisely, the abyss, has expanded from roughly 1:2 to nearly 1:4 between Eastern and Western Europe, and from roughly 1:3 to nearly 1:5 between Eastern Europe and the overseas West. For the first time in history, Central and Eastern Europe's per capita average GDP fell behind that of Latin America. Its former advantageous position *vis-a-vis* Africa eroded sharply as well. The average Central and Eastern European per capita GDP dropped to between one-quarter and one-fifth of the Western standards, which had never happened in modern history. Their position is far worse than it was at the beginning of the nineteenth century, when Central and Eastern Europe reached about 60 percent of the Western economic standard.

Even more important is the revitalization of the Western economy and the success of some of the Asian and other former peripheral countries, through the renewal of the technological base, i.e. the creation of a new communication infrastructure and the restructuring of industrial output and exports. In other words, growth was generated by a more or less successful adjustment to the requirements manifested in the structural crisis.

It should be noted that some of the former peripheries in Southern Europe and Asia quite successfully caught up with the core during the end-of-the-century structural crisis. Spain, Portugal, Greece, Turkey, and even Ireland, which had a somewhat lower average per capita income level than that of the Central and Eastern European region in the middle of the twentieth century (\$2,025 compared to \$2,604 in 1950), all gradually caught up with the West in an advantageous political situation. Having already profited from the Cold War division of Europe, Southern Europe achieved a 4.8 per cent annual average growth between 1950 and 1973, and rose from 39.5 to 49.1 per cent of the western level. In terms of average per capita GDP, the Mediterranean periphery surpassed its Central and Eastern European counterpart by a modest 5 percent during the mid-seventies. Between 1973 and 1992, after the collapse of the dictatorial regimes in Spain,

<sup>3</sup> Angus Maddison, "Explaining the Economic Performance of Nations, 1820-1989," in W. Baumol, R. Nelson, E. Wolf, eds., *Convergence of Productivity and Cross-National Studies and Historical Evidence* (Oxford, 1994).

Portugal, and Greece, and, due to the logic of the Cold War after their swift incorporation into the European Community, the region reached an annual average 2.2 percent growth rate, higher than the West during these troublesome years of world-wide recession. From a level rather similar to Central and Eastern Europe between 1950 and 1970, they surpassed Eastern Europe during the last two decades by nearly two times (179.5 percent) in per capita average GDP. Spain and Ireland reached 72.2 and 72.6 percent of the West European level respectively.<sup>4</sup> The former peripheries of Mediterranean Europe and Ireland are now catching up with the Western core. According to well-based forecasts, Spain may reach the Western level in one-and-a-half decades.

The historical road of the former southern and eastern European peripheries, which had rather similar economic performances during the two centuries between the 1770s and 1970s, has now diverted dramatically.

### *III. Success or Failure of Adjustment*

The reasons of the historical drama in Central and Eastern Europe is broadly discussed, and various, albeit often contradictory, interpretations seek to provide convincing explanations. Paul Marer speaks of a "misdeveloped economy" or "new elements" of structural and institutional misdevelopment during the state socialist decades.<sup>5</sup> The failure of state socialist modernization during the structural crisis of the seventies and eighties, and, consequently, the collapse and decline of the economies of the countries of the region have been an aftermath of previous "misdevelopment." In János Kornai's interpretation, the steep decline of output and income, while "on the surface... [is] similar to other cyclical phenomena and structural transformations..., is something rather different... [I]ts cause is the transition from socialism to capitalism."<sup>6</sup> The transformational depression is inescapable because of "disruption of coordination," a transitory collapse of "enforcement of financial discipline," and of the pain of the "shift from the sellers' to a buyers' market" and in the composition of output and foreign trade.<sup>7</sup> From this diagnosis follows the suggested therapy: "to end the decline one should not go backward, but forward..., and accomplish even faster the task still remaining."<sup>8</sup> The trauma and chaos caused by the economic collapse, according to these interpretations, might be rather remunerative since, as the Nobel-laureate economist Gary Becker argues, "chaos is not all that bad" because order will emerge out of chaos.<sup>9</sup>

If the crisis is a repercussion of the "transition from socialism to capitalism," then even chaos is a positive phenomenon. According to this argument, all the painful austerity measures and devastating social-economic effects may be compared to a bitter pill that must be swallowed to cure a disease. To arrive at the promised land, several experts

<sup>4</sup> Maddison, *Monitoring*.

<sup>5</sup> Paul Marer, "Comparative Privatization and Restructuring Experiences and Prospects: Russia, China, and the Countries of Central Europe," in this volume.

<sup>6</sup> János Kornai, *Magyar Hirlap*, December 24, 1992.

<sup>7</sup> Kornai, "Anti-Depression Cure," p. 2.

<sup>8</sup> Kornai, *Magyar Hirlap*.

<sup>9</sup> Paul Marer, "Comparative Privatization."

contend, the best way is to follow the most successful Western *laissez-faire* model and build the institutions of a self-regulating market economy. These are well-proven and will indeed work. The only questions are time, consistency, and patience. "If the people... can endure the hardship that the policies of stabilization, liberalization, and institution building inflict," stated Michael Mandelbaum, "they will emerge at the other end... of the valley of tears, into the sunlight of Western freedom and prosperity."<sup>10</sup> According to this school of thought, the first ray of sunlight illuminated the region in the summer of 1992, when Polish economic decline ceased and economic growth began. Poland soon reached more than 4 percent annual growth, the highest growth rate in Europe. Other countries recently followed: Hungary reached a 2 percent growth of its Gross Domestic Product, and the Czech Republic a 2.6 percent increase in 1994.

According to the forecasts for 1995, made by the European Bank of Reconstruction and Development in the fall of 1994, eleven Central and Eastern European countries, virtually all of the countries of the region (except some of the war-devastated former Yugoslav successor states), will have positive growth - with Albania, Slovenia, Estonia, and Poland in the lead with 6 percent growth of real GDP. Poland (97 percent), Slovenia (94 percent), Hungary (86 percent), and the Czech Republic (85 percent) are inching toward the 1989 level of their Gross Domestic Product. Slovakia, Croatia, and Romania also surpassed 80 percent of their pre-1989 level.<sup>11</sup> Václav Klaus proudly stated in February 1995: "The Czech economy and society has already entered what I call the early post-transformational stage, which is a stage where basic transformation tasks have been fulfilled."<sup>12</sup> This apparently applies even to most of the successor states of the former Soviet Union, including Russia, which are still in decline, and had GDP levels dropping to less than half of that of 1989: exuberant reports published in the summer of 1995 depicted the Russian economy as having bottomed-out, suggesting that recovery was about to emerge.

According to this interpretation of transformational depression, the end of decline and a positive growth rate already represent the first signs of a soft landing at the other end of the "valley of tears." Does this mean that, despite the still present economic difficulties and still unfinished macro-economic stabilization and privatization, the post-communist adjustment to the world economy is going essentially well in the region?

Here we've come to the heart of the matter. How can we measure the success or failure of adjustment and transformation? Is progress of privatization, as well as the increase, rather than decrease, of output and GDP, the appropriate parameters of measuring success? Nobody denies the importance and positive role of these factors. The progress

<sup>10</sup> Michael Mandelbaum, "Introduction," in Sh. Islam, M. Mandelbaum, eds., *Making the Markets, Economic Transformation in Eastern Europe and the Post-Soviet States* (New York, 1993), pp. 11, 15.

<sup>11</sup> *The Annual Report of the European Bank of Reconstruction and Development* (London, 1995).

<sup>12</sup> Nikolaj Ordnung, "Structural Changes in a Transforming Economy: The Case of the Czech Republic," in this volume. (One cannot escape from the historical *déjà vu*: Czechoslovakia was the first country in the Soviet Bloc that declared the end of the transformation from capitalism to socialism in the mid-sixties, and even changed its constitution accordingly.)

that was made in marketization and privatization,<sup>13</sup> in curbing inflation,<sup>14</sup> in restructuring foreign trade, and, finally, in halting the steep decline of output and achieving economic growth, were definitely great achievements of the transformation during the last five years.

The essential question, however, is whether all these changes served the appropriate structural changes that are the requirements of the turn-of-the-century international economy. Several analysts argue that even the adopted self-regulating Western market system was not tailored for Central and Eastern Europe, and that "design capitalism" cannot work because of the diverse historical-structural determinants that create a kind of "pathdependency."<sup>15</sup> Tadeusz Kowalik, for example, speaks of an inappropriate model being imposed by "shock therapy," which pushed aside the genuine plan of Solidarity to establish a self-managerial system and a Scandinavian type of social democracy.<sup>16</sup> Alec Nove underlined the potential of a Keynesian model of state-led transformation with a cautious gradualism that would better serve transformation.<sup>17</sup> I argued for a more organic transformation by introducing a "regulated-market" and a mixed economy with efficient, well-selected state interventions in structural and investment policies, and a well-planned combination of free trade and market protection to achieve better results in structural adjustment.<sup>18</sup>

The primary question of adjustment, however, is neither the adoption of the *laissez-faire* model and shock treatment, nor state interventionism and gradualism. If one accepts the fact that the flux of the world economy, with its tremendous shocks, recessions, inflations, new phenomena such as stagflation, and the increase of output without an increase in employment, were characteristic signs of a major structural crisis, then the essence of adjustment to the requirements of the "fifth industrial revolution" and the "communication revolution" is a *structural* adjustment. All the market incentives and private initiative measures have to serve this central goal of technological-structural adjustment, of creating competitive new industries and export sectors based on new technology, or revitalizing old, ailing branches, making them competitive and acquiring new markets for their products that had generally lost ground in international trade. (The latter was partly the case with Canada and Japan during the interwar structural crisis, when they gained significant ground in world exports by producing and marketing textile and traditional engineering products in the most competitive way, while these prod-

<sup>13</sup> The share of private sector in producing the GDP reached 60 to 70 percent in the Czech Republic, Estonia, Albania, Hungary, Poland, and Slovakia; and roughly 50 percent in Russia, Lithuania, Slovenia, Croatia, and Bulgaria.

<sup>14</sup> The inflation rate is already a one-digit figure in Albania and Croatia, and around 10 percent in the Czech Republic, Estonia, Slovenia, and Slovakia.

<sup>15</sup> David Stark, "Can Designer Capitalism Work in Central and Eastern Europe?" *Transition. The Newsletter About Reforming Economies*, 3: 5 (May 1992).

<sup>16</sup> Tadeusz Kowalik, "Towards a Free Market or a New Mixed Market Economy," in this volume.

<sup>17</sup> Alec Nove, "Economics of Transformation: Some Gaps and Illusions," in B. Crawford, ed., *Markets, States, and Democracy* (Boulder, 1995).

<sup>18</sup> Ivan T. Berend, "End of Century Global Transition to a Market Economy: Laissez-Faire on the Peripheries?" in I.T. Berend, ed., *Transition to a Market Economy at the End of the 20th Century* (Munich, 1994).

ucts generally lost ground in the world market.)

Thus, this volume concentrates on certain key elements of structural changes in the political-institutional system and in society, regarding shifts and modifications in income distribution and the status of large social groupings. Structural changes represent the essence of economic adjustment. The restructuring of the former state socialist economy - as defined by Paul Marer's study in this volume - thus acquires a central importance in our analysis of macro-economic sectoral changes in the composition of GDP, *mezzo*-economic changes in the branch composition of industries, and micro-economic changes on the enterprise and product level. Other structural transfigurations such as changing ownership structure and the size structure of enterprises will be only marginally touched on in some of the studies of the volume.

Technological-structural adjustment is not only an economic task; it is a very intricate process with far-reaching requirements. Its complexity might be expressed by its prerequisites and interrelationships with political institutions, societal preparedness (including the general level of education, and the flexibility of training and retraining), and the characteristics of entrepreneurial attitude and social behavior. New technology and industry definitely require a new type of labor force - one that is highly skilled and ready to be retrained to meet rapidly changing requirements. Since physical work is broadly replaced by intellectual activities in the emerging "age of communication," the role of higher education is exploding. The required exceptional flexibility in responding to market challenges, and the importance of small-scale firms (in addition to the major role of multinational companies), demand high-level entrepreneurial initiative and an internationally-minded managerial class. A safe and stable political environment with strong and shock-proof institutions of a pluralistic, democratic system, and an activated society making continual progress toward the ideal of a self-regulating civil society, represent an important prerequisite of adjustment in countries of these traditions. In other, mostly non-European cases, strong, centralized but also liberalized states might remain important agents of modernization for a long time. An appropriate political system might only be based on the culture and tradition of a society, and is even more "path-dependent" than the economy.

Adjusting to a structural crisis thus takes quite a long time. Can we thus evaluate a process that is still only half-a-decade long? Does it offer an appropriate perspective for making a balance-sheet? One cannot, of course, assume an "end result." Nevertheless, the main characteristics of an emerging era, as always in history, are most apparent *in statu nascendi*. The past few years clearly show certain major trends and idiosyncrasies. Did Central and Eastern Europe start on the right path toward structural adjustment? Can we recognize the progressive elements or, more precisely, the direction towards fulfilling the main requirements of a complex socio-economic adjustment? From this respect, the short history of the transformation in Central and Eastern Europe has a rather mixed record.



#### IV. Structural Changes in Politics

The most dramatic and spectacular positive structural changes occurred in the political arena of the former Soviet-type one-party-systems. If democracy was essentially the "practice of competitive political orders with universal suffrage" and "fairly and openly" conducted elections, and if policies were chosen "by constitutionally authorized bodies through legally designated procedures," and "as long as individuals [were] legally equal,"<sup>19</sup> then one could speak of a real transition to democracy in Central and Eastern Europe. The exceptionally rapid adoption of the Western constitutional-legal-institutional system, a prerequisite of political adjustment, is a major accomplishment of post-1989 transformation. Basic elements of political institution building that reshaped political structures in these countries were achieved.

However, as Ellen Comisso demonstrated in this volume, the success in introducing "procedural democracy," was not sufficiently accompanied with the establishment of a liberal or "substantive democracy," let alone an "egalitarian democracy." As she rightly concludes, "a profound structural change in the form of the political order has indeed occurred since 1989, but the content of the order is far from clear. The glass is thus half full - but by the same token, it is also half empty."<sup>20</sup> All these shortcomings, however, might be evaluated as consequences of the short period of time: the glass is still only "half full" because only the first steps were taken toward a later-developed proper democracy. This judgment seems to be too premature to be proven. Political traditions and the history of the area suggest a more skeptical view: the glass may indeed remain "half empty."

In historical perspective, feeling a certain *déjà vu* is hardly avoidable. The reappearance of a well-known *duality* of an adapted Western legal-constitutional-institutional framework and the political practice of clientalism, corruption, and criminality is strikingly present in several countries of the region. By reviewing only two historical examples, one around the turn of the century and the second in the post-World War I period, one can see how this duality undermined political democracy in the region. The late nineteenth-century Romanian constitution (an adoption of the most democratic Belgian one), the post-World War I Baltic and Polish legal-constitutional systems (made in the image of the Weimar Republic), and Hungarian or Bulgarian parliamentarism, to mention but a few historical examples, all embodied a historical pattern of adapting Western institutions but were mere facades of some form of authoritarian practice. After World War I, it took a decade until this facade collapsed. At that time, however, an authoritarian European environment and the most direct influence of Mussolini's Italy and Hitler's Germany played a decisive role in the triumph of authoritarianism in Central and Eastern Europe. This will not be reproduced in an entirely different, integrating democratic Europe.

<sup>19</sup> Ellen Comisso, "Is the Glass Half Full or Half-Empty? Reflections on Five Years of Competitive Politics in Eastern Europe," in this volume.

<sup>20</sup> *ibid.*

Still, the duality of a democratic legal-institutional system and authoritarian practice has already appeared in the government's actions in Slovakia, in the continuous efforts of presidential interventionism and rule in Poland, and in the clientalist practice of the late Antall government in Hungary, let alone Iliescu's Romania, Milosevic's Serbia, and Tudjman's Croatia. Authoritarian ideas, social forces, and political parties with influential demagogues are visibly present in the area. The road is not determined, but the dangers are strongly present.

### V. Structural Changes in the Societies

Structural changes in societies during the first half of the 1990s have been spectacular. A surprisingly impressive rise of a new entrepreneurial class, the foundation of millions of family firms, small and medium-scale businesses, and even big business, signal positive structural changes in the societies of the area. A skillful entrepreneurial stratum radically increased its income and became a "late-comer pioneer" of primitive capital accumulation. Although not without historical roots - sometimes going back to pre-war societies and more often to the state socialist *nomenklatura* - a new-old elite has emerged, including a political and managerial elite capable of governing a difficult transformation process. Equally as important, this goes hand in hand with behavioral changes, with the spread of new values and an entrepreneurial attitude. As Jacek Kochanowicz observed, a conquering Western ideology began to influence people to "internalize values necessary for the economic system to operate," as well as to accept the "rules of the game" and the "discipline of the market place and of political democracy" - even if that led to individual losses.<sup>21</sup> While old forms of social cohesiveness are thus evaporating, new ones are in the making.

The first difficult years of transformation, however, exhibited much more harsh, negative undercurrents, which counterbalanced the major positive trends. One of these destructive phenomena is the decline of a state socialist type of middle class. As Jacek Kochanowicz aptly argues, "communist modernization produced a specific, relatively numerous middle class, which cut across main socio-professional groups... Its most salient characteristic was education, or skill." Various groups of highly skilled workers, entrepreneurial elements, commercial farmers and intellectuals belonged to this stratum, which represented about 40 percent of Polish society.<sup>22</sup> The situation was rather similar in Hungary and in Czechoslovakia. During the first years of transformation, a great part of this middle class virtually collapsed. This was partly the consequence of the dramatic decline of the Polish farmer-middle class and the disintegration of the combined cooperative-private, highly commercialized Hungarian agriculture. Agricultural output often dropped by 40-50 percent, which followed the loss of eastern export markets, the abolition of state subsidies, and the opening of a previously protected domestic market. The intellectual layers of the former state socialist middle class suffer from the most serious budget constraints and austerity measures that have partially eliminated them

<sup>21</sup> Jacek Kochanowicz, "New Solidarities: Markets, Identities and Social Cohesion in a Historical Perspective," in this volume.

<sup>22</sup> *ibid.*

altogether. A great part of privileged skilled workers were dismissed with the collapse of previously leading branches and export industries. As Rudolf Andorka documented, the decline "threatens to pauperize the lower middle strata and even the 'middle-middle' strata, the families in the 3rd-7th income deciles."<sup>23</sup>

But as Zsuzsa Ferge pointed out, symptoms of the "breaking apart" of society were not only manifested in the decline of the "old" middle class but also, and even more markedly, by the dramatic emergence of poverty. According to UNICEF figures, people living in poverty (measuring the poverty line between 35 to 45 percent of the average wage level of 1989 in the various countries) strikingly increased: from 4 to 25 percent in the Czech Republic, from 25 to 44 percent in Poland, from 34 to 52 percent in Romania, and from 6 to 34 percent in Slovakia. Children living in poverty reached 50 to 60 percent of the child population in most of these countries.<sup>24</sup> According to Rudolf Andorka's detailed statistical calculations, the percentage of the Hungarian population having an income below the subsistence level reached 10 percent of the population in the 1980s, but their number increased by more than three times by 1994. The "losers" represent about 70 percent of the Hungarian population, while those who made important gains in real income totaled only 16 percent. UNICEF statistics reflect a major decline of consumption of high quality food products between 1989 and 1993: meat consumption decreased by 17 to 20 percent in Slovakia and Romania, and 10-12 percent in all other countries of the region. The consumption of milk and milk products dropped by 37, 23, and 22 percent in Bulgarian, Hungary, and Slovakia respectively.

While a sharply broadening income differentiation itself has important socio-political consequences, the problem has become, as Kochanowicz emphasized, not only a matter of "winners" and "losers" of the transformation, but also of "those who are unable even to take part in the game. Signs of an emergence of...[a] badly adapted underclass are already noticeable..."<sup>25</sup> In most countries of the region a marked demographic decline accompanied these phenomena: death rates increased by 5 percent in Hungary, and more than 7 and 8 percent in Bulgaria and Romania respectively. Average life expectancy decreased by one year in Bulgaria and Hungary, dropping to 64.5 years for men in Hungary, the lowest in the area (except for Russia, where there was a decline of more than 5 years, and the average life expectancy dropped to 59 years for men between 1989 and 1993).<sup>26</sup>

All this signals the reappearance of an early capitalistic class society in Central and Eastern Europe. Beside the explosive social-political consequences of this phenomenon, it might pave the road for various kinds of fundamentalism and extremism; and the

<sup>23</sup> Rudolf Andorka, "The Emergence of Poverty During the transformation in Hungary," in this volume.

<sup>24</sup> Zsuzsa Ferge, "Is the World Falling Apart? A View from the East of Europe," in this volume.

<sup>25</sup> Kochanowicz, "New Solidarities."

<sup>26</sup> Tibor Szamuely, "A közép- és Kelet-európai átalakulás társadalmi költségei," *Kritika*, 2 (February 1996), pp. 7-8. Szamuely speaks of a "demographic catastrophe" when commenting on the dramatic increase of "excess mortality" in Russia, from 73,300 to 545,000 deaths in 1990 and 1993 respectively. Excess mortality led to a human loss of 842,000 persons in Russia and Ukraine together during the four years of transformation, which was comparable only to the wartime death toll.

direct economic impact of these negative changes in the social fabric may be an important obstacle of modernization. Andorka speaks about the anomie and alienation as a natural consequence of ongoing social decline that "might be the deepest and gravest obstacles" of modernization. The negative structural changes in the Central and Eastern European societies are undoubtedly going against the requirements of the turn of the century world economy. An increasingly poor lower class may supply cheap labor for peripheral industries, but not the required sophisticated and educated labor for modern sectors. The social changes, though more a trend than an accomplished process, has still inspired a few Hungarian sociologists to warn of the danger of heading in the opposite direction than Europe- to the Third World.<sup>27</sup>

## VI. Structural Changes in the Economy

Positive changes impressively appeared in the economic structure of the former state socialist countries. To list some of their most important elements, a dynamic development of the previously neglected service sector should be noted first. According to a broadly accepted view, the backwardness of services and infrastructure have become the major bottleneck of economic growth and a successful adjustment to the end-of-the-century world economy in the region. Marketization and privatization in post-1989 Central and Eastern Europe led to a marked macro-economic restructuring, characterized by the decline of industry and agriculture and the development of services that changed the sectoral composition of GDP. Services are now exhibiting the fastest growth rate and the most spectacular relative prosperity. "Much of the expansion has taken place in retail and foreign trade, and privately-supplied services, such as tourism, construction, catering, finance, and insurance."<sup>28</sup> While, for example, the output of the material sphere, industry and agriculture, decreased by 30 percent in Hungary during the first years of transformation, the non-material sphere of services achieved a 5-7 percent growth. Trade, transport and non-material services represented, as Evá Ehrlich and Gábor Révész calculated, 44.8 percent of total employment and 46.7 percent of Hungary's Gross Value Added in 1989, but their share jumped to 55.7 percent of employment and 61.5 percent of the Gross Value Added in 1993.<sup>29</sup> According to United Nations statistics, the share of services in percentage of Gross Domestic Product similarly increased in Poland and in the Czech Republic, from 36 and 32 percent in 1989 to 53 and 50 percent in 1993 respectively. Paul Marer suggests that these figures were 56 and 53 percent in 1994.<sup>30</sup> The same trend characterized the less dynamically transforming Balkan countries as well: the share of services in Bulgarian GDP increased from 30 to 47 percent. Nikolaj Ordnung called our attention to the striking facts that banking and insurance tripled their share in total employment in Czechoslovakia during the first four

<sup>27</sup> Julia Szalai's study in Bob Deacon, et al, eds., *The New Eastern Europe. Social Policy, Past, Present, and Future* (London, 1992).

<sup>28</sup> Marer, "Comparative Privatization."

<sup>29</sup> Eva Ehrlich and Gábor Révész, "Structural Changes in Hungary, 1989-1994," in this volume.

<sup>30</sup> Marer, "Comparative Privatization."

years of transformation. Tourism expanded from 24 to 100 million visitors between 1988 and 1994, and generated a boom in trade, hotel, restaurant and banking industries.<sup>31</sup>

As one of the most important elements of the expansion and modernization of services and infrastructure, the telecommunications system, which was backward, outdated and paralyzed by COCOM restrictions before 1989 in Central and Eastern Europe, received the biggest Western investments in Hungary and Poland. German-American multinational investors began modernizing the telephone systems of these countries, creating the basis for the belated triumph of the computer age. The fruits of these market initiatives will become apparent in the decade to come.

Structural changes also highly characterized the previously dominating industrial sectors of the former state socialist countries. Since state socialist modernization failed markedly because of a mistaken model based on an outmoded branch and product structure of output and outdated technology, the restructuring of the mezzo-economic level acquired a primary importance.

Restructuring partly occurred in a passive and defensive way as a consequence of marketization and the opening up of national economies. Previously promoted leading branches of state socialist industrialization, such as iron and steel industries, and several branches of heavy engineering, lost their markets and state subsidies. A withdrawing state stopped investing in these branches, which then had to dismiss a great part of their labor force and decrease production. In several cases huge factories and entire branches were closed. As a consequence, the percentage share of the outdated former leading branches of industry sharply decreased. Leading Czech and Hungarian engineering industries lost their previous foreign (Comecon) markets and suffered a large decrease of exports. The export of machinery, transport equipment and other capital goods dropped to less than half of their 1989 volume in 1993 in Hungary. Machinery and equipment represented 55 percent of Czechoslovak exports before 1989, but their share declined to 25-26 percent during the early 1990s. These industries lost a great part of their domestic markets as well, and experienced a significant decline of output. While industrial output decreased by 36 percent in the Czech Republic between 1989 and 1993, metallurgy and metalworking dropped by 45 percent, and mechanical and electro-engineering by 55 percent - all leading to important structural changes of output. In Hungary, total industrial output declined by 30 percent between 1989 and 1993, but metal and engineering industries dropped by 41 to 45 percent. This passive and defensive restructuring caused mainly by marketization and privatization corrected the share of oversized, non-competitive, technologically-outdated branches in industrial production.

At the same time as this spontaneous restructuring, there was a promising though limited Western investment that established some new industries and infant export branches in the western rim of a transforming Central and Eastern Europe. Multinational companies played the pioneering role in establishing the Hungarian automobile industry and modernizing the traditional Czech and Polish automobile industries, as well as restructuring the Polish chemical industry, Hungarian pharmaceutical firms and Hungarian bulb production. The most promising element of restructuring was the emergence in the mid 1990s of Polish and Hungarian sub-contracting industries that are producing parts for Western, mostly German and American, companies.

<sup>31</sup> Ordnung, "Structural Changes in a Transforming Economy."

The process of restructuring had important results not only on the macro and mezzoeconomic levels, but also on the micro-economic, i.e. enterprise and product, level. The shift of exports from Comecon to Western markets encouraged and even mandated the improvement of several export items, and liberalized import competition has had a similar impact in the domestic arena as well. For example, industrial consumer goods, unlike engineering products, could preserve their volume of export while markets were shifted from the previous undemanding eastern Comecon region to the demanding and highly competitive West. Hungarian foreign trade made a sudden about face: eastern trade dropped back from 45 to 25 percent of its previous level while western trade grew from 54 to 75 percent of total trade during the first half of the 1990s. While total exports diminished by 20 percent, exports of industrial consumer goods declined only by 2 percent in the early 1990s in Hungary. Without major micro-structural changes (improvement in quality, cost of production, assortments, etc.), exports of these products would be unable to preserve their previous levels.

Regarding long-term structural economic changes, however, the positive signs are clearly mixed with negative trends. Although a spontaneous passive and defensive restructuring (i.e. the sharp decline of outdated oversized sectors of the state socialist economy) has an important positive effect on adjustment, the same process reflects a rather negative trend in terms of end-of-the-century modernization requirements. Foreign trade statistics, for example, reflect a negative structural change of exports ranging from processed and sophisticated products to unprocessed goods and materials with high energy content. This phenomenon is not only exhibited by the less advanced Balkan countries, but is characteristic as well of the more advanced Czech Republic, Hungary and Poland. While the volume of exports of engineering products and capital goods declined by 56 percent, the export of fuel and electric energy increased by 26 percent in Hungary, and the export of raw materials and semi-finished products was able to retain its previous volume in 1993. The collapse of exports of engineering products in the Czech Republic was accompanied by a relative increase of the exports of raw materials, fuels, manufactured goods classified chiefly by material, and food; their share in exports jumped from 31 to 61 percent. "On the whole," concluded Nikolaj Ordnung, "the structure of the Czech exports moved closer to that of the developing countries."<sup>32</sup> As a consequence of spontaneous, passive restructuring, decline was much more dramatic in sophisticated processing branches than in material and energy intensive branches of Hungarian industry. "The visible losers," stated Ehrlich and Révész, "are... metals and machinery. The relative winners, i.e. those who lost the least, are food, wood and electricity industries... The winners in this branch-level breakdown belong to less prestigious, or material producing profiles."<sup>33</sup> The same authors reported the virtual disappearance of "a large part of the historically developed Hungarian work culture." Micro-economic structural changes reflect the very negative trend of the disappearance of a nearly century-long industrial culture of sophisticated branches in the Hungarian engineering industry: employment in radio, TV, and the communication network and equipment plummeted dramatically by 72 percent, while the production of medical, precision, and optical in-

<sup>32</sup> *ibid.*

<sup>33</sup> Ehrlich and Révész, "Structural Changes in Hungary."

struments lost 67 percent of its work force.<sup>34</sup> Promising high-tech branches of Hungarian industry could not adjust but ultimately collapsed in bankruptcy. If it is true for the Czech Republic and Hungary, the most advanced countries of the region, it was even more so in the case of other, less developed former state socialist economies.

The future of structural adjustment depends on the possibility of investment in modern sectors. The transformation strategy unanimously adapted during the early 1990s in Central and Eastern Europe was built on an assumed major capital inflow into the region. That assumption was behind the idea of introducing a *laissez faire* policy, opening the borders for foreign imports, giving tax exemptions for foreign investors, etc. The first post-state socialist governments had entertained ardent hopes that capital inflow could cover roughly one-third of the required privatization investments. It was a major miscalculation.

After the collapse of the Soviet Union and the conclusion of the Cold War, Central and Eastern Europe lost its crucial political importance for the West. The first generous gestures, the \$62.5 billion in assistance pledged by the G-24 countries to six countries of the region, was only partially disbursed. During four years between 1990 and 1993, only \$10.6 billion was disbursed to five countries, totaling \$19.1 billion, and this included the Polish debt reduction of more than \$8 billion.<sup>35</sup>

Most of the hopes and promises stressed the importance of private direct investments. During the first four years of transformation the countries of Central and Eastern Europe received barely more than \$10 billion in direct foreign investments, 80 percent of it being channeled to Hungary and the Czech Republic. In 1993, the six countries received only \$3.5 billion in direct investments. These amounts are disappointing. In the case of Hungary, the biggest beneficiary of investments - Budapest itself received one-third of total Central and Eastern European investments, and the relatively small Trans-Danubian city, Székesfehérvár, alone acquired more than all the Balkan countries combined - it totaled only 3.8 percent of the GDP in 1993, instead of the assumed and forecasted 30-33 percent. In the Czech case the percentage was only 0.8 percent; it was 0.6 in Slovakia, 0.2 in Poland, and 0.08 in Romania.

Central and Eastern Europe was not correspondent with most other areas of the world regarding the role of foreign assistance. Southern Europe, the former Mediterranean periphery, received incomparably far more from the Community. Compared to the extremely modest \$36 and \$30 per capita capital inflow to Central and Eastern Europe in 1992 and in 1993, Portugal received \$173, Ireland \$262, and the Edinburgh summit in December 1992 agreed to transfer \$195 billion to the new member countries during the second half of the 1990s. It should be mentioned that the new *Bundesländern*, the former East Germany, gained roughly \$100 billion as an average annual capital inflow from the former *Bundesrepublik* between 1991 and 1994. On per capita basis, in contrast to the Central and Eastern European \$30, it reached \$5,900.<sup>36</sup>

If we broaden the comparative picture, we have to realize that Asia and Latin America is much more attractive for investors than Central and Eastern Europe. Tiny Singapore itself acquired 50 per cent more capital between 1990 and 1993 than did the six

<sup>34</sup> *ibid.*

<sup>35</sup> Krzysztof J. Ners and Ingrid T. Buxell, *Assistance to Transition Survey* (Warsaw, 1995).

<sup>36</sup> *ibid.*

countries of the region put together. Brazil and Mexico enjoyed a capital inflow of \$100 billion each during these years. The most telling example is the Mexican financial-economic crisis in 1994, which generated an immediate American action and an opening of \$40 billion in assistance. Mexico received nearly twice as much in a week than did the six Central and Eastern European countries during the first half of the 1990s.

The countries of the region are thus left to their own devices. Their resources, however, are rather shallow. Accumulation and investments from domestic sources decreased in the nineties. One should not forget that this was a natural consequence of the collapse of the Soviet modernization model, which was based on a forced accumulation pattern. No doubt, the central virtue of the Soviet model, and the main attraction for backward, agricultural countries, was the high rate of accumulation and investment generated by central planning, the destruction of market prices, and the stagnation or slow increase of consumption levels. As Paul Marer has documented, investments in the percentage of GDP reached the impressive level of between one-quarter and one-third, compared to the mostly one-fifth in the West, even in 1988.<sup>37</sup> As Frederic Pryor demonstrated, the gross fixed capital investments in the region surpassed the Western ratio by 50 to 100 percent for thirty years.<sup>38</sup>

On the other hand, the experience of the last half-century clearly documents the extremely high price these countries paid for this. The same model which generated exceptionally high accumulation and investment also killed incentive for technological advance, competitiveness, and undermined entrepreneurial interests. The famous Keynesian paradox, that "in the long-term we are all dead," was literally true in the case of this model: in the long-term it had a deadly effect.

Without the artificially forced accumulation, however, the countries of the region declined back to the typical low-level peripheral accumulation and investment pattern. The old catch-22 reappeared: the poor countries are unable to develop because they are poor. In the case of a transforming Central and Eastern Europe, the situation is especially difficult because of (albeit in varying degrees) the criminalization of the economy and the strikingly low citizenship and taxation discipline - an old legacy in the region where citizens were permanently alienated from their governments. Additionally, as a result of the heavy burden of the repayment of debts from the seventies and eighties, as well as the political uncertainties, the lack of confidence in the future, the frequent devaluation of the currency, and the attitude of a parvenu *nouveaux rich* elite, capital outflow has reached dramatic proportions in some countries, and might even surpass capital inflow in most cases.

Central and Eastern Europe thus has to face an unsolvable task: to adjust to the transforming world economy by modern structural changes, and by creating a new infrastructure, new technology and new export branches that are competitive on the world market - without having sufficient domestic and external financial sources. The history of the area, maintains the economic historian Scott Eddie, "suggests a highly

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<sup>37</sup> Paul Marer, et al, *Historically Planned Economies. A Guide to the Data* (Washington, 1991).

<sup>38</sup> Frederic L. Pryor, *A Guidebook to the Comparative Study of Economic Systems* (Englewood Cliffs, 1985).



pessimistic outlook both in short-term and long-term... [These countries] have to depend on their own resources for growth for a long time to come. There seems little chance of escape from the vicious circle."<sup>39</sup>

Does this mean that economic growth and relative prosperity will be impossible to reach? Certainly not. Economic growth has begun and will continue. Gross Domestic Product will increase. A relative prosperity is around the corner, especially if the world economy properly recuperates from the recent recession. What kind of prosperity and growth will thus be possible?

I can offer the lessons of Central and Eastern European responses to the challenge of previous structural crises of the 1870s-80s and the 1930s. At that time, when the second and third industrial revolutions in the mid-late-nineteenth century, followed by the fourth industrial revolution during the interwar years, challenged the fragile, partly modernized economies of the region, and made the traditional leading sectors obsolete and exports to the competitive world markets virtually impossible, the countries of the region were unable to invest and modernize their economies in an appropriate way. Hardly any new export sectors emerged, and barely no structural modernization prepared the way for a successful adjustment. Prosperity, however, still followed, and the crisis-ridden countries not only reached the pre-crisis level of output and income, but impressively surpassed them. In other words, *they became revitalized without structural adjustment*. The region's response was not an escape towards a higher stage of economic maturity, but rather a "reverse escape" to preserve the obsolete structures by isolation from the world market and competition via regional arrangements. The agricultural areas of the Austro-Hungarian Empire increased economic growth based on traditional sectors of output and exports, because the Habsburg Monarchy turned to protectionism and imperial self-sufficiency. The still agricultural countries of South-Eastern Europe would repeat this pattern during the 1930s by way of a regional agreement system, orchestrated by Nazi Germany and based on a series of bilateral agreements, which offered a safe market for non-competitive agricultural products of the East. Central and Eastern Europe were thus able to cope with the short-term negative side-effects of the structural crises, such as high unemployment, declining output and exports and a huge deficit in foreign trade, without adjusting to new technological and structural requirements. Although this "reverse escape" was advantageous in the short-term, it was rather destructive in the long-run. Since the countries could not adjust, they preserved their peripheral, dependent and backward status. They remained more and more defenseless during the repeated structural crises to come, and they remained on the periphery of Europe without narrowing the gap between themselves and the advanced world.

Will history repeat itself again? Although the possibility of a repetition of the old pattern might not be excluded, history definitely offers alternatives. In reality, not only rapid and successful adjustments and failed attempts have characterized the countries' efforts to respond to the world economy's challenge. A number of relatively backward countries that could not adjust rapidly to the most advanced technology and economic

<sup>39</sup> Scott Eddie, "The Transition to Market Economies, Lessons from Hungary and the Case for Pessimism," in David Good, ed., *Economic Transformations in East and Central Europe* (London, 1994), pp. 127-8.

structures have still found an exit from being trapped in the frozen old structures. During the structural crisis of the interwar decades, Japan and Canada (and several successful Asian countries in the 1970s-1990s) followed a strategy of undertaking an output of products that were not the last word in new technology and thus had lost their importance in the most advanced countries. Producing these technologically "expired" products, the less developed countries could exploit their comparative advantages, their lower wage levels and the geopolitical benefit of being near to one of the leading economic powers of the world, and establish close cooperation with it.

In this way huge capacities of the iron industry "migrated" from Germany to Japan, and then to South Korea. A similar trend characterized the less sophisticated branches of the textile industry that were relocated to Japan, and then from Japan to the neighboring "small tigers." The world market was filled with cheap textile products from Hong Kong and Taiwan. During the 1980-90s, China took over and gained ground in the markets of the core countries. The pattern is as follows: the "heart" of hi-tech industries, the newest products, a few steps before the present, are always produced by the most advanced core countries, the United States, Germany, Japan and some others. Hong Kong, Taiwan and South Korea, which emerged with a cheap output of traditional, mostly textile consumer goods, now turned toward the mass consumer goods production (the "second row") of high-tech branches such as TV sets, personal computers, and other more sophisticated products, and "gave up" producing earlier, more "primitive" traditional ones. China, still one row behind, follows in their footsteps.

The secret of the success of these countries that started from behind is their comparative advantage in the cost of production, their much lower wages, and their rapidly increasing labor productivity. The peripheries that were able to catch up with the core increased their labor productivity by leaps and bounds. Japan - according to my calculations based on the figures of Angus Maddison<sup>40</sup> - more than doubled its labor productivity between the two wars. Ireland, Spain, and China also doubled the gross income produced in one working hour during the quarter century after 1973. South Korea and Taiwan were able to increase their productivity level by three times during this same period. It pays to note that the productivity level in Japan reached less than one-third than that of Switzerland in 1913; today, they have roughly of the same level. The productivity of Spain was 20 percent of that of the United States in 1950; today it has reached 70 percent of it.

The strategy of "following from behind" is based on close cooperation with one of the most advanced countries, and on the efforts of rapid changes in the product mix if needed. Most of the successful Asian countries that started from way behind used strong state support, and combined domestic market protection with state-assisted export expansion.

Central and Eastern Europe did not follow this path and could not increase labor productivity while trying to cope with structural adjustment. During the decades since 1973, Czech labor productivity, with slight ups and downs, has stagnated. Poland and Hungary reached a minimal increase of 7 and 13 percent respectively. The productivity scissors, compared to the advanced core, consequently increased, since the countries of Western Europe, as an average, increased productivity by 50 percent, and in some cases

<sup>40</sup> Maddison, *Monitoring*, pp. 248-49.

by more than 60 percent. The Hungarian relative productivity level is thus declining: in 1973 it reached one-third, but now only one-quarter, of the West European standard. Compared to Spain, the Hungarian level dropped from two-thirds to one-third. (The productivity level of Argentina, Brazil, and Mexico exhibited similar tendencies; moreover, labor productivity of Venezuela and Peru, as well as Russia, are 15 to 30 percent lower than in 1973.)

Advancing from the "second row" by increasing labor productivity and competitiveness in less sophisticated branches, therefore, has not yet characterized Central and Eastern Europe. A potential alternative, however, might not be excluded, especially because of the striking increase of labor productivity in Hungary and Poland in 1994-95.

Which pattern will be repeated by history? If a historian may risk any kind of forecast for the future - a slippery field for the researcher of the past - the "reverse escape" pattern will be repeated in the cases of all those Central and Eastern European countries that won't be admitted into the European Union in the decade to come. Those countries that will remain outside, which might be the majority of the region's nations, will show a development in the traditional peripheral pattern without any hope of joining the advanced core of Europe. In their case Andrew Tylecote's forecast might be the reality: "Europe is tending to polarize into a dynamic core and a less dynamic periphery, the core being characterized by a tendency to rapid product innovation and low inflation, and the periphery by the opposite... The ex-command economies are taking their place, inevitably, as a new periphery."<sup>41</sup> The peripheries, although they can and will increase their income, may lag behind since the gap between the advancing core and the un- or semi-successful peripheries are consistently and considerably growing: inter-country income spread was 10:1 in 1913, 26:1 in 1950, and nearly 40:1 in 1989.<sup>42</sup> Other calculations reflect an even more dramatic opening of the gap.<sup>43</sup>

Those countries that will be accepted by the European Union, and the Western rim of Central and Eastern Europe, might have a historic opportunity to break out of the vicious circle of peripheral status; they will get access to Western markets and assistance, and may repeat the Mediterranean "miracle." Five or six countries at the eastern border of Austria and Germany, mostly relatively small with five to ten million inhabitants, but, together with Poland, altogether no larger than sixty to seventy million people, may have this opportunity because of a vital Western security interest. A relatively declining humiliated and chaotic East and South-East Europe, with its explosive ethnic and minority conflicts as well as an emerging nationalist extremism, might and will represent a dangerous challenge for the West, especially for neighboring Germany, and demand a response to safeguard the eastern borders of the European Union by creating a *cordon sanitaire* between its eastern borders and the crisis-ridden East and South-East Europe. Additionally, these countries with their relatively well-trained, well-educated and low paid work forces (with a labor cost of one-tenth of that in Germany) have started to emerge as a next-door sub-contractor of Western, and

<sup>41</sup> Andrew Tylecote, "Core-Periphery Inequalities in European Integration, East and West," in W. Blaas and J. Foster, eds., *Mixed Economies in Europe, An Evolutionary Perspective on their Emergence, Transition and Regulation* (Aldershot, England and Brookfield, Vt., 1992).

<sup>42</sup> Maddison, "Explaining the Economic Performance of Nations"

<sup>43</sup> See Ferge, "Is the World Falling Apart?"

particularly German, industry. If security and economic interests demanded it and were recognized, the western rim of Central and Eastern Europe, which advanced the most toward adjusting to the West and has a tradition of being the backyard of German-speaking Central Europe, might be consolidated and restructured on Western cooperation and by Western assistance, and accepted as part of an enlarged Europe.

## ELLEN COMISSO

**Is the Glass Half Full or Half-Empty? Reflections on Five Years of Competitive Politics in Eastern Europe***I. Introduction*

When I was a graduate student, the meaning of the word "democracy" was the subject of a heated debate. We, the young radicals, would sneer at the claim that democracy amounted to little more than elites competing with each other for majority support.<sup>1</sup> On the contrary, we insisted, democracy didn't just mean choosing your rulers, it also meant actively influencing what they did once in office. It was more than an organized process for delegating decisions to representatives; democracy should also be a means of insuring those decisions represented popular interests. And so we argued, when elections offered choices between tweedle-dum and tweedle-dee, and a large and hardly randomly selected portion of the electorate never even bothered to vote in them, how could simply their existence certify democratic rule?

Nor was the vision of democracy advanced by the various theorists of pluralism any more acceptable.<sup>2</sup> We questioned the assumption that simply the presence of civil liberties and the opportunity to organize and express opposition was sufficient for groups to compete on an equal basis, and we doubted that the "allocation of values" arrived at by the government represented a fair equilibrium among social alternatives. In practice, we argued, access to political resources was distributed highly unequally, and widely shared but "unorganized" interests often never entered the political process at all. Consequently, we were inclined to view the "rule of law" that resulted as roughly equivalent to the rule of those able to influence the lawmakers at key junctures.

Accordingly, we were skeptical of how happy the marriage between liberalism and democracy could be. From our point of view, the combination of formal equality with striking disparities of income, wealth, and status was a legal veneer for the reproduction of social inequality: formally equal rules governing the relationship of substantively unequal individuals and groups systematically and regularly produced predictably inegalitarian outcomes. Simply maintaining legal equality among citizens might well be sufficient for liberals, but "democracy" implied that outcomes as well as the process through which they were arrived at should bear an egalitarian stamp.

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<sup>1</sup> As suggested by Joseph Schumpeter, *Capitalism, Socialism, and Democracy* (London, 1976).

<sup>2</sup> See S. M. Lipset, *Political Man* (New York, 1963); David Truman, *The Governmental Process* (New York, 1951); Robert Dahl, *Polyarchy: Participation and Opposition* (New Haven, 1971); Harold Lasswell, *Politics: Who Gets What, Where and How* (New York, 1958).

Recounting this debate today makes it all too apparent just how anachronistic it is. Now, older and wiser, at the "end of history," we tend to view attempts to differentiate democracy from liberalism as self-defeating. Far from rejecting pluralism as a stacked game, even the left has warmly embraced it under the rubric of "civil society," a society in which groups negotiate with each other and make compromises that are then registered by a neutral, tolerant, and limited state.<sup>3</sup> From this perspective, the prime characteristic of a democratic political order is that its outcomes are "uncertain," resulting from the free play of domestic political forces; and as long as outcomes are uncertain, they need not be egalitarian to be considered as democratic.<sup>4</sup>

From this perspective, collapsing the concept of democracy into the practice of competitive political orders with universal suffrage is entirely justified, for it is the *process* through which leaders are selected and binding rules made and enforced that determines how democratic a given political order is. The question is no longer who wins an election but rather, was it conducted fairly and openly. As long as elites compete, the alternatives they offer are necessarily valid, and as long as we can vote them out of office, they are by definition accountable. The issue is no longer which policies governments choose, but whether they are chosen by constitutionally authorized bodies through legally designated procedures. And as long as individuals are legally equal, great diversity in personal circumstances is permissible and even desirable. Ironically, the persistence of the large inequalities in income and wealth that were once central in discussions of Latin American politics is not an obstacle to describing the past decade there as one of "transition to democracy."<sup>5</sup>

General consensus on defining democracy as a set of institutions, procedures, and constraints on the state has shifted the focus of political inquiry as well. Since the essence of democratic politics is primarily the competition of elites for majority support, stability depends less on the aspirations of the "masses" than on the strategic calculations of elites.<sup>6</sup> The politician is thus both the hero and the villain of the democratic political order, and public opinions and attitudes are as likely to reflect the "supply" of platforms emanating from political entrepreneurs as they are

<sup>3</sup> See Andrew Arato and Jean Cohen, *Civil Society and Political Theory* (Cambridge, 1992); Victor Perez-Diaz, "The Possibility of Civil Society," *ASP Research Paper 1/1994* (Madrid, 1994), mimeo; John Keane, ed., *Civil Society and the State* (London, 1988).

<sup>4</sup> See Adam Przeworski, *Democracy and the Market* (New York, 1991).

<sup>5</sup> See Scott Mainwaring, Guillermo O'Donnell, and J. Samuel Valenzuela, eds., *Issues in Democratic Consolidation* (Notre Dame, Ind., 1992); Alfred Stepan, *Democratizing Brazil*, (New York, 1989); Karen Remmer, "Democracy and Economic Crisis: The Latin American Experience," *World Politics* 42 (April 1990); P. Schmitter and T. Karl, "Modes of Transition in Latin America, Southern and Eastern Europe," *International Social Science Journal* 138 (May 1991).

<sup>6</sup> See Doh Chu Shin, "On the Third Wave of Democratization," *World Politics* 47 (October 1994) for a summary of the state of the art.

to represent "demands" for particular measures by a mass public.<sup>7</sup> The probability of institutionalizing procedural democracies rests not on the characteristics of the society it governs or even on whether a government's actions correspond with popular preferences; rather, it depends on whether the rules of the game - provisions governing everything from voting to the allocation of powers between branches of government - are designed in ways that provide incentives for elites to abide by them. Hence, that few of the polities (in Eastern Europe or elsewhere) currently described as "democratizing" have the traditional "social" prerequisites of democracy and that virtually all of them govern in highly unpropitious economic circumstances is not necessarily a fatal flaw.<sup>8</sup>

Yet although the academic and political argument over the meaning of democracy has now safely been deposited into the dustbin of history, the issues addressed in the debate over "procedural" versus "substantive" democracy are still very much with us, and they are highly relevant to an analysis of the structural changes that has taken place in East European politics since 1989. Moreover, distinctions between different meaning of democracy are critical to understanding why different observers of the political scene often come away with rather different assessments of the so-called "transition to democracy" in the region.

My discussion will thus proceed along the following lines. I will begin with the requirements of formal, procedural democracy, and assess the degree to which states in the region satisfy them. Here, I will try to show that despite occasional departures from some of the norms of procedural democracy, the situation in the region overall is quite satisfactory. I will then go on to discuss three variants of "substantive" democracy: the classical liberal, the national, and the egalitarian model. Each of these versions is "substantive" in the sense that they link democratic government to a particular social and economic order; as such, they each require certain outcomes to be accompaniments to democratic rule, although each, of course, envisions rather different outcomes as necessary.

Finally, I will use these distinctions to illuminate the dynamics of both policy choices and electoral results in the past five years. I will focus on two issues (restitution and privatization) for the former, and on the outcomes of "second" elections in the latter, i.e., elections which typically returned a reformed successor to previously ruling Leninist parties to office. Ultimately, I hope to explain the source of the pervasive sentiment in contemporary Eastern Europe to the effect the "it is democratic but it isn't."

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<sup>7</sup> See Barbara Geddes, "The Initiation of New Democratic Institutions in Eastern Europe," *Center for German and European Studies Working Paper 2.14* (Berkeley, April 1993), mimeo.

<sup>8</sup> Giuseppe Di Palma, *To Craft Democracies* (Berkeley, 1991).

## II. Procedural Democracy

Although there are a large number of definitions and typologies of procedural democracy, they all share several key characteristics:<sup>9</sup>

1. Government is based on the consent of the governed;
2. Consent is formalized in a constitution (written or unwritten) which specifies the powers of the government, how they are to be divided amongst its branches, and the rights retained by the citizen body;
3. Consent is expressed in competitive elections held at regular intervals, in which voters can choose among alternative candidates;
4. Suffrage is universal, and votes are secret and not coerced;
5. Citizens and leaders enjoy basic freedoms of speech, press, assembly, and organization; and
6. Binding rules are adopted through constitutionally and legally prescribed procedures by officials ultimately accountable to the citizen body via elections or some other legally designated mechanism.

How, then, do the post-socialist polities of Eastern Europe measure up against these features? Procedurally, political institutions based on competitive politics and universal suffrage have proved extremely resilient in the area, despite economic shocks that, in most cases, are greater than those of the Great Depression.<sup>10</sup> Indeed, initial fears that democracy would not "consolidate" quickly appear to have been groundless. That is, in procedural terms, democracies are said to undergo consolidation when parties alternate in power peacefully and in a manner consistent with electoral outcomes.<sup>11</sup> From this perspective, Poland, Hungary, Slovenia, Lithuania, Estonia, Bulgaria, and (although perhaps less clearly) Slovakia have all "consolidated" democracy far more rapidly than postwar Italy, Japan, or Germany.

At the current date, the same cannot be said for the Czech Republic, Albania, Croatia, Macedonia, or Romania. In the first two cases, there has simply been no second round of national elections within current borders, while Croatia and Macedonia are functioning under conditions close to war - a situation that invariably strengthens incumbents. Hence, the strong showing of incumbent parties in second elections there is not necessarily an indicator of what the political order might look like under "normal" conditions. Romania is thus the main real outlier to a general pattern of consolidated "procedural" democracy in the region. And even there, it is perhaps significant that a monocular government has given way to a coalition.

Procedures governing the conduct of elections and the counting of votes have been, for the most part, consistent with this picture. International monitors have

<sup>9</sup> The list is derived from Bingham Powell, *Contemporary Democracies* (Cambridge, Mass., 1982). See also Arend Lijphart, *Democracies* (New Haven, 1984); David Held, *Models of Democracy* (Stanford, 1987); Robert Dahl, *A Preface to Democratic Theory* (Chicago, 1956); Samuel Huntington, "The Modest Meaning of Democracy," in Robert Pastor, ed., *Democracy in the Americas* (New York, 1989).

<sup>10</sup> See Ivan T. Berend's introductory essay in this volume for a description.

<sup>11</sup> See Samuel Huntington, *The Third Wave: Democratization in the Late Twentieth Century* (Norman, 1992).



generally been satisfied, and the regular appearance of large numbers of small parties running limited tickets suggests that opportunities to present alternatives before voters have been real, regardless of final electoral outcomes. The fact that parties in office have sought to capitalize on the advantages of incumbency to reward supporters, channel benefits to actual or potential constituents, or claim a disproportionate share of media attention may well skew the distribution of political resources, but it is nonetheless consistent with the norms of procedural democracy as long as basic freedoms of speech, press, assembly, and organization are not abridged in the process. After all, it is precisely the desire to capture the benefits of government for one's own side that provides a critical incentive for oppositions to compete with incumbents to start with.

Certainly, there are some exceptions here, the major one at present being the current government of Slovakia in its attitudes towards the press and in the behavior of its parliamentary majority towards the opposition parties. Exactly how consequential such actions will be for the future of procedural democracy, however, is not clear; the first post-socialist Hungarian government also pursued some highly questionable practices vis-à-vis the media, and was rewarded with a massive electoral defeat.

Although electoral turnout has understandably declined after the first post-socialist elections - a pattern common in most newly democratizing states - it has generally varied in quite predictable ways. Thus, it has typically been lower in local elections than in national contests, and it has varied inversely with the frequency of elections (i.e., the more often elections are held, the lower turnout tends to be) and directly with the level of partisan contestation. The biggest problems appear to be in off-term elections in states which prescribe a minimal turnout for a valid election. In Hungary, for example, parliamentary by-elections for a seat have occasionally had to be called several times, owing to the failure of a sufficient number of voters to turn up at the polls.

Yet while the level of electoral participation is an important indicator for some forms of substantive democracy, low turnouts do not disqualify a state as a procedural democracy, providing failure to participate is the voluntary decision of an individual and not the product of legal (or illegal) barriers to casting a ballot. Thus, in procedural democracy, the voluntary choice of voters not to exercise the franchise by no means indicates a lack of consent to the outcome arrived at by those who do. On the contrary, "political apathy may reflect the health of a democracy,"<sup>12</sup> and the willingness of citizens to delegate voting to others with whom they share a basic consensus of values, regardless of differing socio-economic characteristics.

Turning to the conduct of government, here too the picture is relatively sanguine. Legislative output has been prodigious everywhere, even in legislatures in which party lines were poorly formed (e.g., Czechoslovakia prior to 1992) or where a multitude of small parties made voting coalitions difficult to maintain (e.g., Poland prior to 1993). Nor, despite the considerable regulatory powers still possessed by ministries and executive agencies, has it been necessary to resort extensively to decrees as an alternative to legislation; for the most part, even rather controversial

<sup>12</sup> Lipset, *Political Man*, p. 32; see also Robert Dahl, *Who Governs?* (New Haven, 1961).

statutes have been adopted by elected, parliamentary bodies according to legally specified rules.

Much of this legislation, too, has been of a truly "fundamental" quality even where it has not been of constitutional significance: new statutes governing such matters as the banking system, the reorganization of agriculture, the establishment of securities markets, commercial codes and patent laws, real estate transactions and the like have come into existence in the post-socialist states with startling rapidity.<sup>13</sup> Criminal codes have been reformed, the armed forces and police reorganized, tax codes revised, education systems restructured - all at rather breathtaking speed. Moreover, even where partisan divisions have been pronounced, a significant amount of legislation has been passed with MPs from opposition parties voting with the government.

"Constitutionalism" and the "rule of law" are also central features of procedural democracy. The former implies limits on the jurisdiction of government overall (e.g., a guarantee of rights to the citizen body) and a coherent assignment of the power left to it among its various branches; constitutionalism also means that such provisions should not be amenable to frequent alteration. As such, a constitution can be understood as a "pre-commitment" device through which the body politic chooses to bind itself to a given political order, even should circumstances arise that make departures from that order tempting to key political actors.<sup>14</sup>

Here, the situation is somewhat murkier, as several states (Poland, Hungary, and Albania, to name a few) are in the process of rewriting their constitutions. In some cases, legislation implementing key clauses in constitutions has yet to be adopted (e.g., the Czech Senate), while in others (Slovakia, Romania) key provisions are poorly spelled out and carry contradictory import, reflecting perhaps the haste with which they were drawn up. The result is that partisan conflicts are often fought out as trysts between branches of government (typically, the legislature and executive) rather than between contending political forces subject to uniform rules.

Nevertheless, even in some of the most questionable cases, constitutions are far more than paper documents lacking the force of law. For one thing, the establishment of Constitutional Courts in virtually every state in the region means that a legal mechanism exists to adjudicate such controversies and to protect the rights of subnational actors - be they individuals, groups, or local governments - against the encroachments of central authorities.<sup>15</sup> The recent reinstatement of a mayor associated with an opposition party in Romania is a case in point. Where constitutional revisions are taking place, the process follows pre-existing rules of

<sup>13</sup> For a summary of legislative enactments up to 1992, see Roman Frydman, Andrzej Rapaczynski, John Earle, et al, *The Privatization Process in Central Europe* (New York, 1993); see also Gale Stokes, *The Walls Came Tumbling Down* (New York, 1993).

<sup>14</sup> See Stephen Holmes, "Pre-commitment and the Paradox of Democracy," in J. Elster and R. Slagstad, eds., *Constitutionalism and Democracy* (New York, 1988), pp. 195-240; William Riker, *Liberalism against Populism* (San Francisco, 1982); Peter Ordeshook, "Some Rules of Constitutional Design," in Ellen F. Paul, Fred Miller, Jeffrey Paul, eds., *Liberalism and the Economic Order* (New York, 1993), pp. 198-223.

<sup>15</sup> See Herman Schwartz, "The New East European Constitutional Courts," in A.E. Dick Howard, ed., *Constitution-Making in Eastern Europe* (Baltimore, 1993), pp. 163-207.

change, and although the revised documents will surely have a political impact, it is doubtful that they will change the character of government to something outside the pale of "procedural democracy" altogether. Clearly, the tendency for partisan conflicts to emerge as showdowns over what a branch of government may or may not do is potentially destabilizing, but it is far from unprecedented even in well-institutionalized procedural democracies. At the same time, the possibility of resolving such conflicts with the calling of fresh elections - as was recently done in Bulgaria - act as somewhat of a safety valve and more importantly, as an incentive for compromise.

Constitutionalism is a key prerequisite for the "rule of law," another attribute of procedural democracy. By prescribing how to recognize authoritative rules from a non-binding or invalid act (i.e., a "rule of recognition"), how to alter existing rules (a "rule of change"), and how to adjudicate disputed cases, constitutions provide the framework for the creation and alteration of public rules that are the basis for social cooperation.<sup>16</sup> Significantly, the fact that legislative enactments may blatantly privilege one group over another in their effects does not necessarily deprive them of the status of law. On the contrary, all that is relevant to the legal status of such rules is their formal attributes: they must be adopted by constitutionally authorized bodies within their specified sphere of jurisdiction, be public and transparent, apply equally to all, prescribe for classes of actors rather than specific individuals, be subject to change through similar procedures, and be enforced by a neutral third party.

Here, too, although many questions can be raised about both the wisdom and fairness of many recently enacted statutes in Eastern Europe, they nevertheless conform relatively well to the criteria listed above. One may, for example, object on both moral and political grounds to Poland's restrictive abortion statute, but it can hardly be held in contravention to the rule of law. Likewise, the political neutrality and fairness of the recent Bulgarian statute establishing eligibility requirements for judges and prosecutors are open to some question, but its conformity with the formal requirements of the rule of law is not - particularly in light of its review and modification by the constitutional court there.

The major reservation in the rather positive picture of procedural democracy in post-socialist Eastern Europe sketched above is in areas touching on ethnicity and national minority rights, where even the definition of what constitutes legal discrimination is hotly contested. For example, it is one thing to limit the norms of procedural democracy to the citizen body, but quite another when a substantial percentage of adult residents in a state are barred from entering the citizenry at all on the basis of linguistic or "ancestral" criteria, as in Latvia or Estonia. But in other cases, where citizenship is granted but certain linguistic or religious groups find themselves a permanent minority vis-à-vis the dominant nationality, the prescriptions of procedural democracy themselves offer no straightforward answer as to exactly what the status of minorities should be. Presumably, members of, say, linguistic minorities should have the same rights as do those in the majority but

<sup>16</sup> See H. L. A. Hart, *The Concept of Law* (New York, 1961); Niklas Luhmann, *A Sociological Theory of Law* (London, 1985).

this can be interpreted in quite contradictory terms: Hungarians may have the same right to attend Romanian public schools as do Romanians, or they may have the same right to be taught in their native language as do Romanians. Alternatively, banning all political parties from organizing on an ethnic basis in Bulgaria can be defended as a means of protecting the Turkish minority from a potential nationalist party of the majority or condemned as depriving it of a political means to defend cultural claims. Politically, which interpretation we buy into makes all the difference in the world, but in formal terms, either is compatible with procedural democracy.

Indeed, precisely because the definition of procedural democracy is so formalistic, its requirements can be satisfied quite independently of the way in which governments deal with substantive political issues. But for procedural democracy, as long as individuals can vote for the party of their choice in a competitive election, the fact that it is destined to never participate in government does not disqualify the electoral process itself. As long as individuals can voice their claims - in either their own or the dominant language - the fact that no one pays any heed to them does not make government less democratic. And as long as laws are adopted and enforced through constitutionally designated procedures and apply to everyone, the fact that one person is not in the same practical position as his/her neighbor to avail him/herself of the opportunities they offer does not make the state any less neutral. Evaluations of a political order with a substantive definition of democracy in mind, however, may be quite different; to these we now turn.

### *III. Liberal Democracy*

The set of conditions associated with procedural democracy include specifications as to how individuals come to occupy positions of state authority and restrictions on how and over what they are to exercise that authority, but they normally do not specify a particular property rights form as necessary. More precisely, while "constitutionalism" is associated with the right of individuals to own property and with restrictions on the ability of states to infringe on that right, it does not by definition preclude state ownership of assets: postwar France, Italy and Austria have always satisfied the criteria of procedural democracy while maintaining large state sectors. Nor does procedural democracy preclude extensive state intervention in the economy, whether it takes the form of regulation, subsidies, differential taxes, or even planning, provided such policies are adopted and implemented through appropriate procedural mechanisms.<sup>17</sup>

It is precisely on these grounds that we can distinguish liberal from procedural democracy, and consider it as a "substantive" form of democracy in that its

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<sup>17</sup> See, for example, Robert Dahl and C. E. Lindblom, *Politics, Economics and Welfare* (New York, 1953); Andrew Schonfeld, *Modern Capitalism* (New York, 1965); Gosta Esping-Anderson, *Politics Against Markets* (Princeton, 1985); Stephen Cohen, *Modern Capitalist Planning: The French Model* (Berkeley, 1977).

realization depends as much on the outcomes as the forms of the political process. In particular, political outcomes in a liberal democratic order must be such that they create and sustain a "free enterprise economy" and a social order based on it, namely, one in which factors of production are owned by private individuals and resources are allocated through open and competitive markets.<sup>18</sup>

Politically, the right of individuals to consume, obtain income from, and alienate assets is seen as an indispensable condition of individual liberty, without which the pluralism procedural democracy requires cannot survive. In this regard, property rights stand not only as human rights, but as the "core" right on which the exercise of all others depends.<sup>19</sup> More profoundly, the basic justification for democracy itself from a liberal democratic perspective is not its guarantee of political equality, but its ability to protect and enhance individual freedom, i.e., "the ability of individuals [to] act on the basis of their own knowledge and in the service of their own ends."<sup>20</sup>

Accordingly, the arrangements that describe procedural democracy (universal suffrage, holding periodic elections, etc.) are not construed as mechanisms through which majorities can use the state for their own purposes; rather the primary purpose of these arrangements is to increase the "bargaining power of constituents" in order to restrain the ambitions of rulers.<sup>21</sup> It follows that "rent-seeking coalitions" are to be resisted, regardless of how numerous or needy their membership may be and regardless of whether they originate in the public or private sector.<sup>22</sup> On the contrary, liberal democratic outcomes are those that maintain a clear boundary between public and private, state and economy, spheres.

In particular, any politically determined, patterned distribution of values different from the allocation arrived at through "spontaneous" processes of economic exchange must be avoided. While the state - or more precisely, the electorate acting through its representatives - may choose to guarantee a minimal subsistence to its population, it cannot do so through direct intervention in market transactions. Far from economic equality being a necessary complement to the political equality of democracy, attempts to politically engineer economic equality are seen as inimical to the personal autonomy and choice democracy must guarantee: "...no end-state

<sup>18</sup> See Erich Streissler, "What Kind of Economic Liberalism May We Expect in 'Eastern' Europe?" *East European Politics and Societies* 5 (Winter 1991), pp. 195-201; Janos Kornai, *The Road to a Free Economy* (New York, 1990); James Buchanan, *The Limits of Liberty: Between Anarchy and Leviathan* (Chicago, 1975).

<sup>19</sup> See Yoram Barzel, *Economic Analysis of Property Rights* (New York, 1989); Robert Nozick, *Anarchy, State, and Utopia* (New York, 1974); Milton Friedman, *Capitalism and Freedom* (Chicago, 1962).

<sup>20</sup> Friedrich Hayek, *Law, Legislation, and Liberty* Vol. 2 (Chicago, 1976), p. 86; see also Norman Barry, "The Social Market Economy," in Paul, et al., *Liberalism*, pp. 1-26.

<sup>21</sup> See Douglass North, "A Neoclassical Theory of the State," in J. Elster, ed., *Rational Choice* (New York, 1986), pp. 248-61.

<sup>22</sup> See Mancur Olson, *The Rise and Decline of Nations* (New Haven, 1982); Anne Krueger, "The Political Economy of the Rent-Seeking Society," *American Economic Review* 64 (1974), pp. 291-303; Gordon Tullock, "The Costs of Special Privilege," in James Alt and Kenneth Shepsle, eds., *Perspectives on Positive Political Economy* (New York, 1990), pp. 195-212.

principle or distributional patterned principle of justice can be continuously realized without continuous interference in people's lives."<sup>23</sup>

If the post-socialist states of Eastern Europe stack up fairly well against the requirement of procedural democracy, their accomplishments in the past five years do not seem nearly so impressive when judged from the liberal democratic perspective. Yet the picture is far from totally negative, and one can argue that much of the economically-oriented actions that introduce "new" elements in Eastern Europe are indeed cast within a liberal democratic framework.

For example, the creation of relatively independent central banks in many states is an important step towards driving a wedge between the state and the economy and forcing the former to operate within the latter's constraints. Liberalized trade policies have opened domestic economies to import competition, and the rapid growth in the number of small and medium-sized ventures has had similar effects. Prices have been liberalized everywhere, wage regulations and employment guarantees relaxed. Securities markets are beginning to operate in many countries, while legal forms for private ownership have been created and legal protections to property and contracts granted. Indeed, one of the primary rationales for the restitution programs enacted in virtually every state in the region was precisely that restitution would both signal the state's new commitment to the "sanctity" of private property and instantly create a large number of property holders in the population.

Nevertheless, after 5 years of such reforms, post-socialist states remain far from having created the "free enterprise economy" required by proponents of liberal democracy. State assets are only beginning to be divested, and large enterprises in most countries continue to enjoy privileged access to still state-owned banks and various governmental bailout facilities. To the degree privatization has occurred, it has normally been anything but transparent, with "insider" deals playing major roles in most state divestments.<sup>24</sup> It is perhaps significant here that a study of elite circulation in Poland, Hungary and Russia found members of the former socialist elite dominating managerial ranks not only in state and privatized enterprises, but also in the newer, theoretically more open, private sectors as well.<sup>25</sup> The rather unusual provision in the Romanian constitution to the effect that property is "presumed" to have been acquired legally is symptomatic in this regard.<sup>26</sup>

At the same time, the macroeconomic stabilization policies adopted have created hardships for large sectors of the population.<sup>27</sup> Income and wealth inequalities have grown and become more visible, unemployment or the threat of it have become serious problems for many, neither wages nor pensions have kept up with

<sup>23</sup> Nozick, *Anarchy*, p. 163.

<sup>24</sup> See Roman Frydman and Andrzej Rapaczynski, *Privatization in Eastern Europe: Is the State Withering Away?* (New York, 1994); Eva Voszka, "Privatization in Central East Europe: Can it be Designed?", paper presented at the conference "Institutional design and democratization in a contest of economic crisis," San Diego, CA. (May 1993), mimeo; Jadwiga Staniszkis, "Political Capitalism' in Poland," *East European Politics and Societies* 5 (Winter 1991), pp. 127-42.

<sup>25</sup> Ivan Szelenyi, *The Social Conflicts of the Post-Communist Transition* (Budapest, 1992).

<sup>26</sup> See Jon Elster, *Rebuilding the Boat in the Open Sea* (New York), forthcoming.

<sup>27</sup> See the essays by Zsuzsa Ferge and Rudolf Andorka in this volume.

inflations, and social services are underfunded. Even so, most states continue to run substantial budget deficits and high levels of external debt create continue to exert financial pressure on them. Equally important, the macroeconomic stabilization policies that marked "Phase I" of the transition have had the effect of hampering individuals from "spontaneously" taking advantage of opportunities, calling the viability of Phase II - microeconomic restructuring - into question. And ironically, the immediate beneficiaries of the privatization process to date appear to be less the public or even the purchasers of state property than the intermediaries (be they foreign consulting firms or state officials in privatization ministries) in charge of the process. In Hungary, for example, salaries in the State Privatization Agency have risen far more rapidly than wages and salaries generally.

By themselves, much of this economic fallout is not inconsistent with liberal democratic tenets. The dramatic drops in industrial and agricultural output that have occurred may be seen politically as a national tragedy, but from a strict economic point of view they can be construed as an indicator of adjustment and responsiveness to radically altered market conditions.<sup>28</sup> Growing unemployment has worked to reduce the rent-seeking capacities of organized labor and encouraged individuals to seek alternative sources of income; increased income and wealth disparities are a sign that an "artificial" and politically-imposed pattern of distribution has been lifted. Likewise, even "insider" privatizations are not necessarily an indicator of corruption or stealth; on the contrary, they may be attributable to the degree to which the real value of assets depends on the asset-specific human capital of the insiders acquiring them. As such, they are an economically defensible mechanism of separating out "good" from "bad" assets in a context in which standard procedures for evaluation are meaningless.

The political impact of these economic consequences is another story, however. Far from creating a constituency for further reform, the impact of liberalizing measures has been to erode whatever support such measures had initially. That is, as a political form, liberal democracy requires "the presence of a powerful constituency in the economic sphere which perceives its own interests as incompatible with an excessive level of state intervention and which protects these interests through the use of its political and economic power."<sup>29</sup> Yet to the degree such a constituency exists in contemporary Eastern Europe, it is formed primarily on the basis of ideological commitment to the liberal democratic model and not on the basis of the real economic interests needed to support the practical realization of such a society.<sup>30</sup> Even the private sector, in theory the "vanguard" of liberalization, is far from opposed to a strong state role, particularly insofar as a substantial portion of it remains "parasitic" on state suppliers and buyers. In effect, the current situation is one in which one is far more likely to find support for the political outcomes of liberal democracy among political elites shielded from direct market outcomes than among economic actors who experience them directly.

<sup>28</sup> As implied by Paul Marer's essay in this volume.

<sup>29</sup> Frydman and Rapaczynski, *Privatization in Eastern Europe*, p. 143.

<sup>30</sup> See Andrzej Rychard, *Reforms, Adaptation, and Breakthrough* (Warsaw, 1993).

This peculiar distribution of support for the liberal economic model has led to what is rapidly emerging as an iron law of electoral politics in Eastern Europe: electorates consistently vote for parties promising a soft landing, while elites once in office find themselves promulgating socially costly liberalizing reforms, losing their base of support in the process. Poland is perhaps the paradigmatic case. Electoral success has invariably gone to parties attracting support from labor and agriculture while governmental policies have typically had the harshest consequences for exactly those groups. Hungary reflects the same pattern - the most accurate predictor of the "losers" from reforms is knowing which groups in the electorate who voted for the parties promulgating them. Meanwhile, precisely because governments cannot count on a secure constituency for the policies they follow, political time horizons are shortened. As a result, macroeconomic decisions wind up being undercut by microeconomic interventions designed to resuscitate political support from those injured by the initial decisions - a pattern not all that different from the story of economic reform under socialism.

Thus, the economic logic of the transition is complemented by its political logic. In the former, the recessionary impact of macroeconomic stabilization jeopardizes microeconomic restructuring efforts and privatization possibilities. In the latter, liberalizing macroeconomic reforms dissipate the constituency for microeconomic change.

The one state that appears to have avoided this logic is the Czech Republic, and it is worth examining why.<sup>31</sup> First, precisely because there had been little attempt to reform the economy under socialism, the problems of macroeconomic disequilibria that led states like Poland and Hungary to borrow extensively abroad were minimal. Hence, the government elected in 1990 did not confront a massive foreign or internal debt and so had considerably more flexibility in making strategy choices. In particular, there was little pressure to sell state assets in order to raise cash, and social benefits could be covered out of existing revenues with relatively minor cutbacks.

Second, the social costs of liberalization were concentrated in Slovakia, which conveniently accepted independence over blocking changes that appeared to favor the two Czech provinces. Hence, a situation unique in Eastern Europe arose in the Czech Republic, in which nationalism was harnessed to the ideological liberalism of the political elites who negotiated the "divorce" on the Czech side.

Third, within the Czech Republic itself, a relatively small proportion of the population derived its income from agriculture, a sector of the economy that was exceptionally hard hit everywhere by trade liberalization, altered price relations, and the collapse of CMEA markets.

Finally, political elites proved far more ideologically liberal in words than in deeds - just the opposite of political leaders in other states. Thus, although monetary policy was restrictive and the initial devaluation of the currency sharp, little was done to curb inter-enterprise crediting and bankruptcy laws were applied in the most lenient way. Little pressure was put on enterprises to restructure, such that employment was maintained despite a drop in output and labor productivity.

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<sup>31</sup> See the essay by Nikolaj Ordnung in this volume.



Instead, the government relied on the mass privatization program to produce pressures from new "owners" for enterprise restructuring. The voucher program, in turn, was a huge political success, but brought extraordinarily little pressure on enterprises to restructure, since the simple conversion of "investment points" into monetarily denominated shares meant immediate "profits" for "investors." Meanwhile, that enterprises find that the value of their equity is likely to drop when they seek to raise capital by floating new issues on the stock exchange has in no way detracted from the program's political popularity.<sup>32</sup>

As a result, the government emerged politically strengthened and could move to make reforms in pensions and social services. At the same time, the claims of labor unions were dealt with reasonably generously, weakening their ability to form a base for the political opposition. In short, insofar as the government has not been forced to move aggressively to apply liberal formulas in the economy, the model of liberal democracy continues to enjoy widespread support.

#### *IV. National Democracy*

In liberal democratic theory political communities are formed in order for individuals to pursue their private goals. In contrast, national democracy sees political communities arising on the basis of certain characteristics individuals share with each other regardless of what their individual goals happen to be. The shared characteristics are what make the community into a nation, and democracy is a means through which governments can reflect communal as well as individual considerations.<sup>33</sup>

Nowadays, it is common to see nationalism as antithetical to procedural as well as liberal democracy, and simply a glance at current conflicts in the Balkans or the Caucasus are a reminder of the destabilizing impact of nationalism and the affinity various forms of it have with authoritarianism. Nevertheless, this has not invariably been the case historically, and the desire to see governments reflect the aspirations of the people or peoples living under them has often been a critical factor in democratizing movements everywhere. Indeed, the reconquest of national sovereignty was a major force in the political landslide of 1989 in Eastern Europe, and the establishment of even procedural democracy would have been unthinkable without it. Hence, even in Eastern Europe, it would not be correct to treat "national democracy" as an oxymoron; rather it must be regarded as a specific substantive type of democratic order.

In this conception of democracy, communal rights do not exclude individual rights, but they are prior to them insofar as they are the primary foundation on which state sovereignty rests. Democracy thus consists of the exercise of national

<sup>32</sup> See Steven Bernstein, "Stock Markets in Eastern Europe," unpublished manuscript, 1995 (mimeo).

<sup>33</sup> See Ernst Gellner, *Nations and Nationalism* (Ithaca, 1983); Reinhard Bendix, *Kings or People* (Berkeley, 1978); Dankwart Rostow, "Transitions to Democracy: Toward a Dynamic Model," *Comparative Politics* 2 (April 1970), pp. 337-63.

self-determination via procedures through which members of the national community exercise their preferences by choosing between competing alternatives.

Although it is easiest realize national democracy where a population is nationally homogeneous, in principle it is also possible when ethnically diverse populations inhabit the same state.<sup>34</sup> That is, insofar as national democracy promises to protect the rights of specific national groups to protect and reproduce their specific "identities," procedural mechanisms can be utilized to this end. The list of such mechanisms includes federalism (should nationalities be geographically concentrated), proportional representation in the legislature, the granting of minority vetoes on issues of critical concern, and others. Such consociational arrangements seek to institutionalize power sharing among specific national groups, and in doing so often violate the one-person-one-vote rule common in nationally homogeneous societies. But insofar as group rights are prior to individual rights and maintaining a rough balance among national groups is the precondition of protecting individual rights, procedures that distort political equality among individuals in favor of maintaining it among nationalities is justifiable.

Where liberal democracy is contractarian, national democracy is communitarian in that outcomes are expected to sustain and preserve whatever particular national characteristics are held to be the basis of political community. Exactly what those characteristics are, however, is frequently a source of debate. Language is perhaps the most frequently invoked characteristic; religion, place of birth, ancestry and other basically ascriptive characteristics may also prove important.<sup>35</sup> Whichever characteristics are selected as the defining ones, the political outcomes of national democracy are expected to privilege individuals possessing them and organizations propagating them. It is hardly coincidental that support for some version of national democracy tends to be strongest where nation-formation precedes state creation - a situation prevalent east of the Rhine. From such a vantage point, the state's primary role is thus to protect an already constituted nation rather than to build one; citizenship rules designed to exclude more than to incorporate typically form a key device for doing so.<sup>36</sup>

The resulting economic and social order thus reflects these priorities. Claims of nationals are to be preferred over those of non-nationals be they for employment, ownership of assets, or schooling. Demographic policies are likely to be a central political concern, as reproduction of the "nation" is critical to state survival. If religion has the status of being nationally defining, churches are likely to have a protected position in the social and political order. The property rights order is also likely to be limited by the desire to preserve the national community and restrictions on transactions that would harm whatever is deemed to be the

<sup>34</sup> See Arend Lijphart, *Democracy in Plural Societies* (New Haven, 1977); Donald Horowitz, *Ethnic Groups in Conflict* (Berkeley, 1985); Joseph Montville, ed. *Conflict and Peacemaking in Multiethnic Societies* (Lexington, 1991).

<sup>35</sup> See Horowitz, *Ethnic Groups*, for a full discussion; see also Benedict Anderson, *Imagined Communities* (London, 1983), for a more historical and literary treatment.

<sup>36</sup> See Rogers Brubaker, *Citizenship and Nationhood in France and Germany* (Berkeley, 1992).

"national" interest are legitimate. Symbolic and cultural issues are likely to figure prominently in political discourse.

Because of the association between nationalism and authoritarianism in Eastern Europe, it is important to emphasize that national democracy is not necessarily inconsistent with political pluralism any more than liberal democracy is. Both reject certain outcomes, but within the realm of what is left there is plenty of room for open debate. For example, requiring that media be owned by citizens of the state in which they broadcast or publish is quite different from regulating what they can say, and the latter does not necessarily follow from the definition of national democracy. Publishing government regulations or requiring parliamentary debate to go on in a particular language is not necessarily the same as prescribing their content. Insisting that national interest be a prime factor in government decisions does not necessarily preclude debate as to what the national interest actually is in any given condition, etc. But national democracy does require making a fairly sharp distinction between "nationals" and outsiders and giving institutional preferences to the former.

Just as liberal democrats in Eastern Europe found their expectations rather disappointed after 1989, national democrats have also found many of their aspirations frustrated. Again, the features of national democracy are far from completely lacking on the current political landscape, the removal of Soviet troops being one of the primary accomplishments. Governments do indeed respond to the domestic population, traditional national and religious holidays are once again observed, streets have been renamed and flags altered, small privatization programs have normally been designed to favor the national citizenry, restitution programs that are highly discriminatory towards non-national former owners have been enacted in most states. Fears that "foreigners" would buy up key assets have turned out to be greatly overblown; indeed, the major problem in Eastern Europe has turned out to be the lack of foreign investment rather than the threat of it.

Nevertheless, from a national democratic perspective, *de jure* national sovereignty is not complemented by *de facto* national sovereignty. Dependence on external funds and the agencies administering them have constrained economic policy decisions; traditional cultural institutions - from filmmaking to theater to universities - are having grave problems functioning due to the absence of funds; local cultural producers frequently find themselves undercut by foreign imports. Personal success - be it in business, politics or the professions - seems closely tied to an individual's links with western sponsors. Rather than leading to a renaissance of a national middle class, attempts to limit property holdings in business and land to nationals have merely delayed privatization or reduced productivity or the area under cultivation.<sup>37</sup> Opening borders in some states has had the effect of creating a substantial immigrant/refugee population, often of an ethnicity (be it Romani or Bosnian) different from that of the dominant nationality. Even the demographic

<sup>37</sup> For example, see Katherine Verdery, "The Elasticity of Land," *Slavic Review* 53 (Winter 1994), pp. 1071-1109; Peter and Sandor Agocs, "'The Change Was but an Unfulfilled Promise': Agriculture and the Rural Population in Post Communist Hungary," *East European Politics and Societies* 8 (Winter 1994), pp. 32-58.

picture is problematic, with mortality rates up and birth rates down in virtually all states in the region.<sup>38</sup>

The process of dismantling socialism, too, has been highly unsatisfactory to many in the national democratic camp. On the one hand, many of the individuals associated with the subordination of the nation to an external power in the past continue to play key roles in politics, administration, and the economy. On the other, institutional structures created under socialism that served to insulate the population from external influences are being dismantled rather than being harnessed to national purposes. The status of organizations involved in the shaping of culture has been extremely controversial everywhere, even in nationally homogeneous states like Hungary and Poland.

Indeed, perhaps one of the great ironies of the past five years is that the major political battles in Eastern Europe have not been fought so much around economic questions, but on issues of justice, cultural integrity, civil liberties, and - in non-homogeneous states - the status of minority populations. Here, even where the proponents of national democracy have triumphed, the victories have often been pyrrhic. Restitution programs, for example, have had just the opposite political impact of what was expected; the economic chaos in the countryside they caused resulted in a political windfall for opponents of the program in states like Bulgaria and Hungary. Various programs and proposals for "lustration" and reprisals against the former socialist leadership have not been able to bear the heavy symbolic burden of national cleansing and resurrection claimed for them; rather, they have been perceived widely as the product of narrowly partisan infighting. Legislation highly solicitous of Catholic Church concerns in Poland has prompted a backlash against it.

In short, the political logic of national democracy has in many ways been similar to that of liberal democracy in that precisely the actions that have been taken in line with its objectives have been the critical factors undermining support for it in the population. The main exceptions to this trend seem to be Slovakia and Romania, where nationalist parties put in a strong showing even in the second round of national elections. While it is tempting to attribute this to the problematic status of national minorities, the failure of parties of national renewal to win reelection in other states with minority populations (Lithuania, Estonia, Bulgaria) suggests ethnic heterogeneity by itself is only a partial explanation.

Instead, the strong hold on power of nationalist parties in these two areas may be more closely related to the nationalistic stands taken by the former communist parties during the socialist period. As a result, nationalist parties in these two states differ from their counterparts elsewhere in that they sought (successfully) to coopt existing incumbents into their own ranks rather than launch wholesale attacks on them. In Romania, for example, parties tend to be loose unions between new politicians and incumbent elites. Ties between the two are as likely to be personal

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<sup>38</sup> The situation is, of course, most pronounced in East Germany, see Rainer Munz and Ralf Ulrich, "Depopulation After Unification? The Demographic Future of East Germany," *Center for German and European Studies Occasional Paper*, (Berkeley, December 1994), mimeo.

as programmatic, with wider constituencies generated out of clientelistic, rather than organizational, loyalties. And while elections are held between parties, the real political battles are typically between individuals - for access to positions, assets, and protection.<sup>39</sup> Recent controversies in Slovakia concerning privatization and the staffing of the government information office suggest this pattern may be taking root there as well. In both cases, it appears to be the combination of national appeals, socialist organizational advantages, and formal adherence to procedural democratic norms that explains the distinctive dynamics of national democracy in the new states.

### *V. Egalitarian Democracy*

Egalitarian visions of democracy are based on a distinction between formal and substantive equality and the recognition that the latter does not necessarily follow from the former.<sup>40</sup> Indeed, the opposite is the case: a political community's ability to maintain even formal political equality is seen as depending on its ability to provide substantive economic equality to its members.

Unlike national democracy, egalitarian democracy does not start from the community, but from individuals. But unlike liberal democracy, egalitarian versions do not seek to maximize individual liberty as much as to guarantee political equality. Accordingly, democratization is seen as a process that includes more than simply the political institutions of a state, but also social and economic ones.<sup>41</sup>

Since hierarchies of all forms are suspect in egalitarian democracy, its association with socialism cannot be extended to an affinity for Leninism. Nor is egalitarian democracy incompatible with the vision of a "property owning democracy," providing property is distributed fairly equally among the citizen body. However, if maintaining that basic equality requires extensive state intervention in economic relations, majorities are expected to support such action in their own interest. Thus, restrictions on individual property rights are not viewed as compromising other key civil rights, but rather may be a necessary condition of making those rights accessible to everyone.<sup>42</sup>

<sup>39</sup> See Katherine Verdery, "Faith, Hope, and *Caritas* in the land of the Pyramids, Romania 1990-94," *Comparative Studies in Society and History*, forthcoming.

<sup>40</sup> See Michael Walzer, *Spheres of Justice* (New York, 1983); Richard Arneson, "Socialism as the Extension of Democracy," in Paul, et al., *Liberalism*, pp. 145-72; Steven Lukes, *Essays in Social Theory* (New York, 1977).

<sup>41</sup> See Robert Dahl, *A Preface to Economic Democracy* (Cambridge, 1985); Michael Burawoy and Janos Lukacs, *The Radiant Past* (Chicago, 1992).

<sup>42</sup> See Jennifer Nedelsky, *Private property and the Limits of American Constitutionalism* (Chicago, 1990); Jon Elster, "Introduction," in Elster and Slagstad, *Constitutionalism*; John Rawls, *A Theory of Justice* (Cambridge, Mass., 1971).

At the same time, egalitarian democracy typically emphasizes direct participation in political outcomes.<sup>43</sup> Thus, periodic competitive elections are an important mechanism of political accountability, but far from the sole or even most important one. Rather, democratic representation requires an active and involved public, organized and able to engage in a dialogue with elected officials both inside and outside the corridors of parliaments. Insofar as centralization of government increases the "costs" of participation, states should preferably be decentralized, with local governments enjoying substantial autonomy. Likewise, governance structures of corporate and quasi-public institutions should allow for all stakeholders to have input into decisions.

Like liberal and national democracy, egalitarian democracy requires some outcomes and excludes others, but within those constraints a wide sphere of choice is possible. Thus, maintaining a basic equality of fortunes is by no means expected to lead to a complete harmonization of interests; pluralism is thus by no means precluded. Nor is there a unique strategy governments may use to achieve equality: it may be by enlarging the number of public goods available to all, via progressive taxation, via measures to facilitate labor mobility, etc.

Egalitarian democracy has not fared well in the aftermath of socialism in Eastern Europe. While the opening of the political system has increased opportunities for political involvement, the costs of using them have also risen for the average person, such that what in the past was "forced" inclusion into political processes has rapidly given way to voluntary exclusion and apathy, as evidenced by the drop in turnout.<sup>44</sup> Further, declining membership in "socialist" mass organizations has not been complemented by increased adhesion to alternative organizations, be they political parties or NGOs. Rather, membership in all organizations appears to have declined. Thus, in Poland, Solidarity has collapsed into a large number of competing fractions with relatively small numbers of adherents; in Hungary, an environmental movement that was a robust source of opposition prior to 1989 saw its mass following evaporate while its activists moved into political parties.<sup>45</sup>

As noted already, income and wealth disparities are on the rise in all states; although the welfare state survives, the equalizing impact of many social benefits has been reduced substantially. Demographic factors - namely, an increasing number of pensioners at a time when the active labor force is reduced - are an additional bur-

<sup>43</sup> See Carol Pateman, *Participation and Democratic Theory* (Cambridge, 1970); C. B. Macpherson, *Democratic Theory: Essays in Retrieval* (Oxford, 1973); Joshua Cohen and Joel Rogers, "Associations and Democracy," in Paul, *Liberalism*, pp. 282-313.

<sup>44</sup> Nor should this be particularly surprising. See Ellen Comisso, "Property Rights, Liberalism, and the Transition from 'Actually Existing' Socialism," *East European Politics and Societies* 5 (Winter 1991), pp. 162-89; John Hall, "After the Vacuum: Post-Communism in the Light of Tocqueville," in Beverly Crawford, ed., *Markets, States and Democracy* (Boulder, 1995).

<sup>45</sup> See Ellen Comisso, Peter Hardi, and Laszlo Bencze, "Accession to and Compliance with International Environmental Accords in Hungary," paper prepared in conjunction with the SSRC project on International law and Global Environmental Change, (Ann Arbor, October 1994), mimeo; David Ost, "Labor, Class and Democracy: Shaping Political Antagonisms in Post-Communist Society," in Crawford, *Markets*, pp. 177-204.

den. The regional impacts of economic change have been an additional source of economic differentiation, with urban oases of prosperity matched by impoverishment in many rural areas and monoindustrial towns.

How strong a constituency for egalitarian democracy exists in contemporary Eastern Europe is unclear. On the one hand, its association with the forced redistribution of the *ancien regime* has limited its appeal. On the other hand, for the large sectors of the population who find themselves at the short end of the stick to date, it probably represents an attractive option. Indeed, the popularity of integration with western Europe was based not only on the expectation that it was the key to higher living standards, but also on the perception that higher living standards could be achieved within a relatively egalitarian framework, i.e., a "social market" rather than "capitalism."<sup>46</sup>

The main forces pushing for a more egalitarian transition turn out to be organizations whose members operate in the economy and derive their income from wages and salaries, in particular, what is left of former cooperatives in agriculture and labor unions in industry and social services. Their efforts in this direction, however, have had rather contradictory effects. That is, to the degree they have been successful, privatization efforts have been slowed, Poland being a good example. The consequence, however, is that the income spread between individuals employed in the state sector and those engaged in private activities has probably grown. Likewise, attempts to allow workers to purchase shares in their own companies have also had paradoxical impacts. Normally, worker buyouts require external financing, be it directly by government or through banks; but when workers buy shares in their companies on credit, they place a mortgage on future profits, harming the enterprise's ability to survive.

As for agriculture, despite considerable sentiment among peasants to continue farming cooperatively, the breakup of collective farms that ensued from various restitution programs in Czechoslovakia, Bulgaria, Romania and Hungary hampered efforts to reorganize the farms as genuine cooperative associations; attempts to restore them have been accompanied by strong internal conflicts within the membership, as well as between it and outside land claimants. And frequently, the cooperatives that have survived did so only by selling many of their operations and cutting back on many of the services previously supplied to members.<sup>47</sup>

A major factor limiting the appeal of the egalitarian position, however, is that in current conditions, it can only be articulated as an equality of burden-sharing rather than as a demand to equally distribute the benefits of expansion. As a result, even the forces endorsing it appear more as if they are simply seeking to claim a larger share of a shrinking pie for themselves than as harbingers of a new and more egalitarian social order, i.e., as the proverbial "rent-seeking" coalitions. In short, the egalitarian impulse has not been harnessed to a strategy to restore economic growth.

<sup>46</sup> See Rychard, *Reforms*; Éva Ehrlich and Gábor Révész, *Hungary and its Prospects 1985-2005* (Budapest, 1995).

<sup>47</sup> See Agocs, "Rural Population."

Without such a strategy, substantive equality appeals only to the interests of "losing" groups, rather than to the values of the political community as a whole. In effect, it is the mirror image of liberal democracy: the basis for the liberalism is more in the ideological stance of elites than in the concrete interest of specific social groups, while the basis for egalitarianism is the interest of social groups but are not reflected in the normative stances of political leaders. Hence, far from being a source of political integration in turbulent conditions, desires for equality are more conducive to alienation and distancing many sectors of the population from political engagement. Despite what nominally ought to be a close connection between egalitarianism and democratization, in practice it serves largely as a platform for opposition than as a program of government.

## VI. Policy Implications

I will now try to show how, when combined within a procedural democracy, the various notions of substantive democracy converge and diverge on particular policy issues. My intention here is to explain why one particular package of measures - namely, compensating former owners for property nationalized under socialism - was rapidly undertaken in virtually every state in Eastern Europe (as we shall see, Poland is the exception to prove the rule), and why movement toward another widely proclaimed goal - privatization - has been glacial everywhere and why no uniform mode of privatization has been adopted anywhere.

Demand to "restitute" state property - particularly land and real estate - to its former owners emerged all over Eastern Europe by 1990.<sup>48</sup> Outside of Hungary, the demand did not play a role in electoral campaigns; rather, it was voiced by a relatively narrow Former Owners lobby. In some cases, former owners were part and parcel of a governing party coalition (Bulgaria), in others, they were an independent lobby (Slovenia, Czechoslovakia). In Hungary, the party that made reprivatization the single issue in its electoral campaign formed part of the governing coalition; in Romania, the former owners were in the opposition. Legislative, executive, and judicial institutions varied widely, as did the cohesiveness and political color of parties in the government, and specific enactments reflected these differences. Nevertheless, the broad outcome was the same everywhere: regardless of how owners had acquired their property, how indebted the property might have been at the time it was taken, who was currently using it, and what the fiscal capacities of the state were, as long as the property had been "lost" under Communism, it was either re-turned in kind or some form of compensation granted to those owning it nearly half a century earlier.

It would be convenient to see these restitution/compensation programs as an example of "democracy in action" - a response to a groundswell of support for doing justice to the victims of Communist Totalitarianism. But the demand for

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<sup>48</sup> My discussion of the restitution question is taken from Ellen Comisso, "Legacies of the Past or New Institutions? The Struggle Over Restitution in Hungary," *Comparative Political Studies* 28 (July 1995), pp. 200-38.



restitution was hardly a widespread one in any state. In Hungary, the Smallholders received only 11% of the vote, and even then, it was concentrated in the provinces where the party was historically strong, suggesting tradition more than restitution explained part of the vote. Elsewhere, the issue did not even surface in the electoral campaigns. At the same time, survey data indicated some desire to redress some of the worst ills of the past (particularly as regarded political prisoners), but they generally did not show strong sentiment for restituting property or privileging former owners in some way.<sup>49</sup> Hence, the persuasiveness of the restitution lobby appears to be in large part independent of the popular will.

But if we look at the versions of substantive democracy described above and realize that proponents of "liberal" and "national" democracy anchored the political spectrum in the newly elected legislatures, the strength of the demand can be explained. On such a political spectrum, a claim that harmonizes with projects on both sides is in a far stronger position than any one which rests on one side or the other. In effect, it comes to play the role of a "median voter," to whom parties with uncertain and volatile constituencies are invariably inclined to cater. Thus, even if the former owners were a fringe group in the larger society, they were smack in the center of the political spectrum that emerged in the various legislatures.

Insofar as they were a "traditional" and eminently "national" group, satisfying their claims allowed the nationalist parties to show their commitment to restoring continuity with the pre-socialist political order and with national traditions. Precisely for this reason, the date after which restitution/compensation claims were honored was chosen so that only nationals could apply. As such, the legislation stood as a second-order citizenship law, defining the body politic in the terms of national democracy (Slovenia, Hungary). At the same time, as private owners, their demands could be construed as consistent with the goals of liberal parties to enlarge the private sector as rapidly as possible (Czechoslovakia, Bulgaria). If establishing property rights appealed to liberals, restitution was also a convenient way for elements linked to the old order to demonstrate that they were making a genuine break with the past (Romania).

Equally important, privileging small owners over major industrialists, the Church, and owners of large estates meant maximizing the political gains from restitution - gains that would have been washed away had large-scale restitution been resorted to. Hence, the measure was partly justified on egalitarian bases as well. That the issue became vehicle of extensive logrolling, such that the number of claimants under final legislation was typically much larger than initially foreseen was also directly related to the partisan appeal of the measure. So too was the tendency to limit claimants to the newly-defined citizen body. Thus, the extension of compensation to German and Jewish property confiscated prior to 1949 in Hungary was not a political initiative, but a court requirement. And Poland, the one state in which non-nationals would have been the primary beneficiaries of restitution, was also the only state in which it never became a major issue; instead,

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<sup>49</sup> See Ethan Klingsberg, "Judicial Review and Hungary's Transition from Communism to Democracy: The Constitutional Court, the Continuity of Law, and the Redefinition of Property Rights," *Brigham Young University Law Review* 1 (1992), pp. 41-144.

only non-agricultural property confiscated in violation of socialist nationalization statutes was subject to reprivatization.

Again, the position of the former owners as the "median voter" was not a reflection of their position in the electorate. On the contrary, both survey and electoral data show them as a distinct outlier in the society at large. But in legislatures and governments, the former owners were in the center, and so able to pose as both the archetypal "victims" of communism and the harbingers of privatization and the new middle class whom parties on all sides were rushing to capture.

The methods used to privatize state assets, however, present quite a different story. In these cases, the "liberal" approach and the "national" approach militate in favor of quite different solutions; if we add in an "egalitarian" approach - making itself felt more through the labor unions than via a clear political representative - one has a multidimensional space and no clear "median" position. In such a situation, one would expect some cycling of preferences and generally a mixed approach (i.e., something for everyone), which is pretty much what has been the case to date. Thus, all states have used or are expected to use some form of vouchers (in Hungary, this was done through the compensation process); all states have made sales to foreigners; all states have experienced "insider" privatizations; all states have resorted to auctions in "small" privatizations; all states have some arrangement for employee purchases of shares; and all states are winding up with a substantial share of assets remaining in the hands of the state, either directly (e.g., a state property agency is itself the owner of equity) or indirectly (e.g., a dominant share in companies is held by other state-owned companies or banks or some other state-owned intermediary agency).

Several factors seem to explain the slow pace of privatization. The most obvious ones, of course, are economic, and include an absence of buyers (due in part to the glut of assets up for sale around the globe), inadequate savings on the part of the domestic population, and the recessionary impact of stabilization policies.<sup>50</sup> A second set of factors can be labeled the "legacy" effect: socialist states that introduced decentralized forms of management prior to 1989 created a situation in which "stakeholders" - like labor in Poland and management in Hungary - can create barriers to viable systems of corporate control that are a prerequisite for "outsider" purchases.<sup>51</sup> The third set of factors, however, are the ones this analysis stresses, and they are political and partisan.

Here, privatization is viewed not simply as an economic process of transferring assets from the state to private individuals and groups, but as a political process through which a government (or more precisely, the parties in the government) seeks to more narrowly benefit its own constituency and more broadly to engineer the kind of social order that will support it. In short, privatization is not only a means of transferring assets from "state" to "society" in the abstract but an

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<sup>50</sup> See Manuel Hinds, "Issues in the Introduction of Market Forces in Eastern European Socialist Economies," in S. Commander, ed., *Managing Inflation in Socialist Economies in Transition* (Washington, 1991).

<sup>51</sup> See Frydman and Rapaczynski, *Privatization in Eastern Europe*, Ch. 5.

inherently partisan affair likely to have major electoral repercussions on specific political actors in a procedural democracy.

As we have seen, these considerations explain a great deal of the popularity of using restitution as a means of privatization; they also explain why virtually all sales of state property to domestic purchasers involve at least an implicit - and often explicit - subsidy to the buyer. Likewise, it follows that divestment could proceed more rapidly in Germany than elsewhere, since the political constituency the government was most concerned with was in the western side of the country, a population more concerned with holding down the costs of the process for itself than with its distributive effects in the East.<sup>52</sup> Even then, one of the major obstacles turned out to be the various requirements that owners of East German firms conform to statutes and regulations designed on the basis of West German conditions, requirements that reflected western far more than eastern interests.

Elsewhere, however, it has proven to be extremely difficult to design a privatization process that would work to the political advantage of the government promulgating it, particularly where large enterprises in the state sector are concerned. Hence, there has been a marked tendency in all states to simply equivocate and delay, while using newly "corporatized" state firms as a source of patronage and holding up sales of assets that evoke political controversy. Not surprisingly, changes in government (e.g., Poland, Hungary, Slovakia) are accompanied by extensive "reviews" of privatization programs, nominally for economic reasons but more profoundly in order to assess their partisan impacts. Although in one sense, this is politics as usual in a competitive political order, when electorates are highly volatile, unpredictable and parties find their mandates unrealizable, the result is the "stop-go" strategies that have been the dominant mode to date. The upshot in most states has been neither a "liberal," "national" nor "egalitarian" democratic order as much as a procedural democracy in which the state remains the dominant economic player. That competitive forces have been much more visible in politics than in the economy is thus not an accident: it is precisely the sharpening of partisan cleavages that have raised the stakes and slowed the process of divestment.

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<sup>52</sup> See Wolfgang Seibel, "The Institutional Dynamics of privatization: East Germany and the Treuhand Phenomenon," *Center for German and European Studies Occasional Paper* (Berkeley, December 1993), mimeo.

## VII. Conclusions

Thus, five years after The Great Political Landslide, one finds competitive political orders relatively consolidated atop a social and economic order that is as yet rather undefined. Accordingly, while the situation looks satisfactory when assessed on the procedural checklist, it is much less so in terms of a substantive evaluation. But since most people are not neutral political scientists but rather expect government to reflect and act upon their substantive concerns - be they liberal, national, or egalitarian - it is hardly surprising that local assessments are highly critical.

Thus, from a liberal perspective, the state is still everywhere, markets are distorted, entrepreneurship is inadequately rewarded, security of property rights is all too often a product of political connections rather than the outcome of legal entitlements, and civil liberties still uncertain as long as non-liberal parties control governments. From a national perspective, the state is in hock to international finance, the traditional middle class is being plundered, the culture is being invaded from abroad, and ethnic minorities are collaborating with foreigners to create a protected position for themselves. From an egalitarian perspective, new civil rights can hardly be utilized by a population struggling to make ends meet and what was supposed to be democracy for everyone has turned into the rule of the few who only tenuously accountable to the many.

Moreover, such conditions are critical to understanding why socialist parties did so well in recent elections. While it would be tempting to interpret these electoral victories in terms of a majority opting for a more egalitarian transition, in fact, socialist platforms were distinguished more by their ambiguity than by any specific substantive preference. As such, their ability to attract support from the left actually allowed them to pose as a political force able to deliver liberal outcomes, i.e., they were more capable of "managing" the situation fairly. At the same time, the very vagueness of their commitments and the expectation that they would ameliorate the situation in the countryside allowed them to attract a healthy portion of the "national" vote as well. In effect, the socialists could more credibly appear as the party of national healing and unity than their more firmly nationalist opponents.

Furthermore, because no coherent set of substantive outcomes resulted from adherence to procedural norms, expectations on all sides were disappointed by the actions of governments elected after 1989. Thus, in many ways, the electoral gains of the socialists represented as a rejection of incumbents more than a positive response to a program.

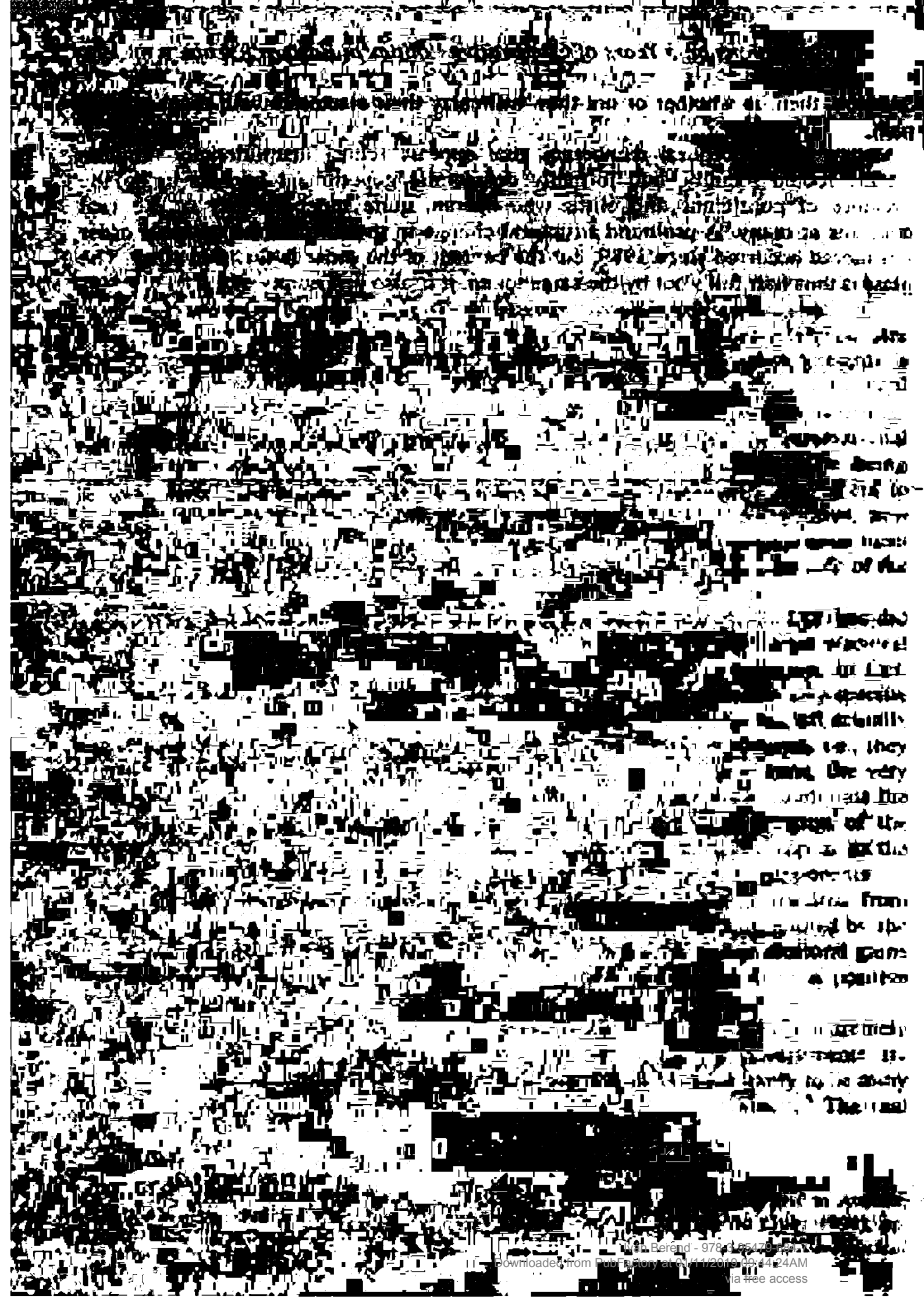
But precisely because of their extremely broad appeal, it turns out to be extremely unclear what substantive direction the new socialist-dominated governments are likely to move in. If their western counterparts are indicative, it is likely to be away from egalitarian and national democracy toward an ersatz liberalism.<sup>53</sup> The real

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<sup>53</sup> See Herman Schwartz, "Small States in Big Trouble: State Reorganization in Austria, Denmark, New Zealand, and Sweden in the 1980s," *World Politics* 46 (July 1994), pp 527-55; Geoffrey Garrett, "The Politics of Structural Change," *Comparative Political Studies* 25 (January 1993).

question, then, is whether or not they will carry their electorate with them on this path.

Meanwhile, procedural democracy that appears robust institutionally remains weakly rooted socially, and formally democratic government appears to be the province of politicians and elites who operate quite independently of the real concerns of many. A profound structural change in the form of the political order has indeed occurred since 1989, but the content of the order is far from clear. The glass is thus half full - but by the same token, it is also half empty.



JACEK KOCHANOWICZ

## **New Solidarities? Market Change and Social Cohesion in a Historical Perspective**

### *I. Introduction*

Social change is always painful. While many aspects of the newly emerging order undoubtedly meet the aspirations of Eastern Europeans, there is a price to pay, and not only in terms of a decreasing standard of living or of rising unemployment. All have to learn new ways of life, whole groups are changing their status, existing networks of social support break apart, and new social divisions are produced by rapid economic change. My concern in this paper is social cohesion, and my main question is: what will keep these societies together in the future?

If a society is to function and to last as a whole, then a substantial number of people must have a sense of belonging, of having emotional bonds with other people, in other words, a sense of common identity. There are many situations which demand sacrifices. Families have to care for their children, the disabled and the elderly. Citizens are expected to obey the laws. Young people are called to serve in the armed forces. Taxpayers have to support institutions from which they do not get any personal reward. Social insurance schemes have to be financed. It is hard to imagine that such sacrifices could be made were there not some feelings of bonds with other people.

One can put it another way: the functioning of the social order demands that members of the society comply with a given set of "rules of the game," even if that leads to individual losses. This, however, calls upon them to attach a higher value to a common cause than to their individual interests. This problem is by no means trivial, and it is also noticed by authors of impeccable pro-market credentials. Gary S. Becker, a Nobel prize winner in economics, observed that neo-classical economic theory, while very successful in interpreting the egoistic behavior, is much less so when altruistic behavior is concerned. He tried to solve this puzzle by reference to the findings of sociobiology.<sup>1</sup> Douglas C. North, another Nobel prize winner, asks the question: "Why do people obey the rules of society when they could evade them to their benefit?" His answer is that in order to make people comply with the rules, society invests not only in power, but also in ideology.<sup>2</sup> Ideology makes people internalize the values that are necessary for an economic system to operate. When I refer in this essay to the concepts of identity, social cohesion and social solidarity, I have in mind precisely those ideologies which make the actors observe the rules of the game.

Any far reaching social change, especially a dramatic one, breaks some solidarities, destroys certain feelings of identity and produces new ones. The degree

<sup>1</sup> Gary S. Becker, *Economic Approach to Human Behavior* (Chicago, 1976), pp. 282-294.

<sup>2</sup> Douglas C. North, *Structure and Change in Economic History* (New York, 1981), p. 11, see also pp. 45-58.

to which the change can be successful - successful in a sense that the new emerging social order is functional - depends, among other things, upon new forms of social cohesion being produced. The disintegration of communism is no exception. The future course of the societies undergoing this process depends very much upon their ability to produce new forms of social cohesion.

The process of breaking up the old forms of social cohesiveness and forming new ones is, of course, never the same. The purpose of this paper is a reflection on the specificity of this process in the case of the present change in Central Eastern Europe. The method is historical-comparative, although the level of generalization varies. My remarks on earlier transitions are fairly universal, while when commenting upon the present one, I mostly draw on the Polish experience.

## *II. Industrialism*

The nineteenth century witnessed, in Europe and North America, the "great transformation," to use Karl Polanyi's term - the change from agrarian society to industrial capitalism. The rules of social organization, and the mechanism of social solidarity in particular, also changed profoundly.

Several mechanisms of such solidarity existed in the traditional, agrarian societies. On the "low" level, it was secured by the "primary groups," characterized by "face to face" relations, of which the most important was the family, the main unit of economic activity as well as of social reproduction. Another sort of primary group was the village community, as were various urban corporations. On a higher level of social organization, people identified themselves as belonging to the same church, as subjects of the same sovereign, as vassals of the same lord.

Social change was relatively slow. If there was one mechanism which could be singled out as the most important, it was demographic pressure. It pushed people out from their settlements and produced migrations - from more densely populated regions to less densely inhabited, from the countryside to the cities, from Europe to the New World. But, before the advent of industrial civilization, migrations produced societies of a basically similar kind, as a dividing cell produces another cell of the same type.

The industrial revolution brought about an enormous acceleration of social change, but - most importantly - it changed its nature, producing a new type of society. If we keep to the biological metaphor, this time it was not so much the same cells reproducing themselves, but rather new mutations being born. Contemporaries were fascinated by processes unfolding before their eyes, as witnessed by the explosion of sociological writings. Classics of this discipline - Emil Durkheim and Georg Simmel, Ferdinand Tönnies and Max Weber, Thorstein Veblen and Vilfredo Pareto, and of course Karl Marx - all provided their own account, forging at the same time the modern categories of understanding social change.

Society became more individualistic, but also more atomized; more free, but with more anomie; more affluent, but with acute problems of poverty and exclusion. From our perspective, however, the most important aspect of these processes was



the breaking down of old solidarities. Family and traditional local communities ceased to be the all embracing units of social organization and identification not only because people moved out of them more easily than before (they moved out earlier as well), but primarily because the ways of life outside these traditional communities were now different in every aspect imaginable.

This enormous change produced a social and ideological search for new sorts of identities. The two - social and ideological - are closely connected, since the search for new identities was done through new social movements. The two most important types of response can be classified under the headings of "nation" and "class."

The idea of nation, as many authors show, is much older than the industrial order, and well precedes even the French Revolution.<sup>3</sup> It proved, however, highly functional to the new market, industrial economy. For various markets to function, some form of a unified cultural "communication space" is necessary. People have to be mobile spatially, professionally and socially, and therefore they need a basic common universal education.<sup>4</sup> Commerce, extension and unification of markets demanded a common way of understanding, both in the sense of a common spoken and written language instead of many local dialects, as well as in the sense of various technical "languages," serving such specific purposes as industrial standards. The Polish historian Witold Kula brilliantly described how the introduction of the metric system in Napoleonic Europe signified a profound change of the cognitive categories people used to understand the world around them.<sup>5</sup>

The "national state" became a main agent of these processes of unification of cognitive categories, and the "nation" was elevated to the status of the most important social entity, encompassing all other social groupings. In every case, the idea of nation, the "imagined community" in Benedict Anderson's words, was constructed by intellectuals out of blocks of local traditions, and then promoted by national movements and by the state.<sup>6</sup> State institutions - schools and the army first and foremost - became crucial in installing the notion of national identity among the wider masses of the population.<sup>7</sup> "Waving the flag" thus became a symbol of the late nineteenth and early twentieth century.<sup>8</sup>

The building blocks of various nationalism differed, but each of them served the same purpose of giving people a sense of unity, belonging and identity. In many

<sup>3</sup> Benedykt Zientara goes as far back as the early Middle Ages. *Swit narodów europejskich* [A twilight of European nations] (Warsaw, 1985). For Liah Greenfeld, the beginning is the early modern England. *Nationalism: Five Roads to Modernity* (Cambridge, Mass. and London, 1992).

<sup>4</sup> Ernest Gellner, *Nations and Nationalism* (Oxford, 1983).

<sup>5</sup> Witold Kula, *Measures and Men* (Princeton, 1986).

<sup>6</sup> Benedict Anderson, *Imagined Communities: Rethinking on the Origins and Spread of Nationalism* (London, 1983).

<sup>7</sup> See the brilliant account for France: Eugene Weber, *Peasants into Frenchmen: The Modernization of Rural France: 1870-1914* (Stanford, 1976).

<sup>8</sup> "Waving a Flag" is a title of a chapter on nationalism in one of Eric Hobsbawm's books, *The Age of Empire 1875-1914* (New York, 1987).

cases, nationalism developed a strong ethnic component, defining itself in terms of common blood and leading to racism, as was the case with German *Volkism*.<sup>9</sup> Nationalist sentiments in less developed, "peripheral" countries were often articulated in terms of *ressentiment*, a combination of feelings of admiration, jealousy and hatred towards more developed nations.<sup>10</sup> The state often played an even a bigger role in constructing a nation there than in more advanced societies. Thus there was a tendency in Central Eastern Europe to shift towards authoritarianism in the inter-war years, with the state proclaiming itself as a main builder of the social order and national unity.

Nationalism, one of the vigorously debated problems within the social sciences these days, obviously is not a phenomenon on which a clear balance sheet can easily be drawn. It has many facets, it is ambiguous and it escapes easy and all-encompassing definitions. It laid at the roots of the most disastrous events of this century, but at the same time provided an important answer to the question of social cohesion, which was most acute when the old pre-capitalist, pre-industrial order was breaking apart.<sup>11</sup> Some even argue that modern democracy could not function without a certain dose of national sentiment, since by itself democracy is a set of formal rules, which can hardly animate people for active citizenship.<sup>12</sup>

There were cases where nationalism was relatively successful, in the sense that it achieved a certain level of social unity without, at the same time, producing too much exclusion and internal or external aggression. England, France, the United States and the Scandinavian countries are those examples which can be cited most safely. Germany, on the other hand, is an extreme example of nationalism's disastrous consequences, though nationalism succeeded in producing feelings of identity and unity there. It would take us, however, beyond the scope of this essay to try to specify which conditions are necessary for nationalism to be successful in the above sense.

An idea born at the beginning of the nineteenth century, class was another answer for the decomposition and recomposition of the social order. This perspective stressed different social similarities than the idea of nation: not the cultural ones, but those produced by the social division of labor, or by the property structure, or by the power structure. Bonds resulting from these similarities were treated as more important than any other bonds. The idea of class gained importance with the emergence of a mass, urban society, and was accentuated in almost all the forms of the socialist movement - be it anarcho-syndicalism, social democracy, or trade unionism. It laid at the roots of mass political parties, which started to grow in the last quarter of the nineteenth century. It found its most extreme form in the case of Marxism, which stressed proletarian solidarities extending beyond the confines of a

<sup>9</sup> George L. Mosse, *The Crisis of German Ideology: The Intellectual Origins of the Third Reich* (New York, 1981).

<sup>10</sup> Greenfeld, *Nationalism: Five Roads to Modernity*.

<sup>11</sup> Daniel Chirot shows, how nationalism was one of the basis of what he calls "modern [i.e. based on ideological vision] tyrannies." *Modern Tyrants: The Power and Prevalence of Evil in Our Age* (New York, 1994), pp. 18-20 and *passim*.

<sup>12</sup> Charles Taylor, "Wieviel Gemeinschaft braucht die Demokratie?" *Transit* 5, (Winter 1992-93).

given country. In its communist version, the idea of class led to disastrous results, as did the idea of nation in the Nazi version.

The most important social category in the more developed countries, influencing class-like movements, were urban industrial workers. The beginnings of the welfare state are clearly related to the emergence of mass employment in modern manufacturing industries.<sup>13</sup> This new development brought about its own specific problems: the risk of unemployment and illness, the question of old age provisions, etc.; but it also brought about the political power of mass movements, which forced institutional changes of laissez-faire arrangements of early capitalism. The idea of class was rarely present in a clear form, however. Most often it was combined with national and/or religious ideologies, and that was reflected in organizational forms of class movements.

The question of class formation and class ideologies is even more confusing in countries that were less developed in the second half of the 19th and the first half of the 20th century, where agriculture dominated the economy and where rural overpopulation became a most acute social problem. The peasantry often acquired class-like characteristics in these countries. One case in point is pre-revolutionary Russia, where *narodniks* (populists), and later social revolutionaries, built an ideological and political movement, striving for cooperative socialism, upon the presumed strength of the peasantry. Another case is Eastern Central Europe. Even before the First World War, peasant movements acquired considerable importance in a number of countries in this region. The rising significance of the peasantry prompted intellectual elites and the upper classes to take an interest in them. A wave of ethnological and literary interest in the peasantry, until recently a non-subject, now swept throughout the region, accompanied by the development of various mythologies stressing peasant historical and future roles.

Poland serves as a good example of both the actual role of the peasantry and the ways this role was represented. To give only a few examples, a certain Bartosz Glowacki, a peasant soldier during the uprising of 1794, happened to get first to a Russian artillery position. He survived the war to die several years later, after drinking too much. At the end of the 19th century he was romanticized to the extent of monuments being erected to commemorate him. Another example is Wladyslaw Reymont's realistic novel, *The Peasants* (1902-9), for which he got a Nobel prize. The third is by far the most important Polish play, *A Wedding Party* (1901). Its author, Stanislaw Wyspianski, was able to see beyond these mythologies in this ironic story about a marriage of a noble and a peasant girl. Representatives of all strata of society, present at the party symbolizing an attempt at national unity, encounter in their drunken dreams the great figures of Polish history in order to see their own complexes, limitations and delusions.

Peasants became even more important in the newly independent countries after the First World War, when at least some strata of the peasantry became educated enough to take part in national politics and produce leaders like Wincenty Witos or Alexander Stambuliski, and when the introduction of popular franchise turned the rural population into the important part of the electorate. Agrarianism, so visible in

<sup>13</sup> Nicholas Barr, *The Economics of the Welfare State* (London, 1987), ch. 1.

the case of Bulgaria, and to an extent also in the case of Hungary, became the most extreme form of these movements. It claimed that peasant family farms should be the main building blocks of the national economy. Thus, in case of Central Eastern Europe, the class question became closely related to the national question in the first half of the 20th century.

### III. Communism

The emergence of communism also involved a process of social change, and problems of social cohesion had to be tackled somehow.<sup>14</sup> Communism, at least at its beginning, was an attempt to modernize - to catch up technologically with the more developed countries - and to construct a totally new social order, with new values, new culture, new identities and new solidarities. Its ideologues aspired for another kind of "great transformation," more progressive and more successful than the one leading to Western industrial capitalism. In fact, communism turned out to be no more than an introduction from above, with the methods of a war economy, of technologies already outdated in the West at the time of their implementation in communist countries; while at the political level it was an imposition of a sort of totalitarian order, which later changed into a slowly disintegrating authoritarianism, on societies atomized by wars and revolutions.

The societies of the countries which introduced communism were atomized by the revolution (Russia) or by the war (Central Eastern European countries), during which they also lost a substantial number of their former upper and middle classes, as well as their better educated people. Industrialization and urbanization moved vast masses of peasants to the cities, turning them into workers and a new intelligentsia, and produced a communist version of a mass society. The overall modernization and the upward social mobility were an important way of legitimizing communist regimes, even in such countries where, as in Poland, traditionally anti-communist and anti-Russian sentiment prevailed.

Communist regimes referred in their discourse to the ideas of a radiant future, a classless society, social justice, the common cause of workers all over the world, and so on. These ideas found their way only to young zealots, and only in the early stages of the period of "real socialism." In a more practical way, identities and solidarities were built not so much with words, as with actual social policies. These consisted, especially after the phase of mass terror, on massive income redistribution and on providing basic material security, albeit on very low level. These policies were realized thorough the bureaucratic paternalism of the state. As Daniel Chirot aptly observed, communism built its own kind of corporatist society, in which the place of work - the state enterprise - became the main provider of social security.<sup>15</sup> It is obvious now that this notion of *justice through entitlement*

<sup>14</sup> I use terms "communism" or "communist system" in a purely descriptive sense - referring to countries and societies ruled by parties, usually called "communist" - as much as I am conscious about the unending debate about the proper name for the system in question.

<sup>15</sup> Daniel Chirot, "The Corporatist Model and Socialism," *Theory and Society* 9:2 (1980).

became deeply embedded in the attitudes and feelings of Central Eastern European societies. In Poland, the Solidarity protest movement in 1980-81 (although a complicated phenomena which can hardly be interpreted in one simple framework) can at least be partly explained not so much as a movement against the socialist system, but as a movement demanding the fulfillment of previously-made promises. To an extent, the results of elections which in the early nineties brought ex-communists back to power in quite a number of the countries of the region can be interpreted as a manifestation of longing for the lost world of egalitarianism and social security.

If egalitarianism was one building block of the real ideology of communist regimes, nationalism- paradoxically- was the second. In a latent form it was present in the Soviet Union from the very beginnings of its history, to emerge fully during the Second World War. It was visibly apparent in Central Eastern European countries after 1956. Ceausescu's Romania is probably the clearest case, but nationalist tendencies were quite evident in Poland as well.<sup>16</sup> Returning to power in 1956, Gomulka advocated "the Polish road to socialism" and agreed to a return to traditional national symbols in the army and in school curricula. Nationalist and anti-Semitic tendencies were clearly evident within the party apparatus during the political crisis of 1968. The leader of this faction, General Mieczyslaw Moczar, being at the same time a chief of a national organization of veterans, skillfully played upon the patriotic feelings of many people who were very far from communism, but who had sentiments towards the wartime non-communist resistance and army. During the 1970s, Edward Gierek paid only lip service to communist ideology, and, when trying to modernize the economy with the use of Western credits, stressed the "moral and political unity of the nation." General Jaruzelski's regime, during the martial law period and after, constantly referred to Polish tradition and stressed the need for a strong state as a unifying institution.

Nationalist tendencies under communism are not hard to explain. First, the political system made each of these societies closed and self-confined, with as little contact with the outside world (including other socialist countries) as possible. Second, the ruling elites, aware of their doubtful credentials and dependent upon the Soviet Union, tried to legitimize themselves by emphasizing their local roots. In Poland, the communists also had to compete with a strong Catholic Church, acting as a guardian of national values. Finally, the sheer sociology of the party apparatus and activists worked in the same direction. The members of the first generation of communist leaders, formed before or during the war, often felt emotionally more attached to the international movement than to their own countries. The next generation, mostly coming from the ranks of the newly formed intelligentsia of popular origin, felt much less affiliation to the international, intellectual culture of their predecessors, and were much more bonded to local, popular traditions. Thus, while there may be many interpretations of the Polish March 1968, one is clearly a

<sup>16</sup> Katherine Verdery, *National Ideology Under Socialism: Identity and Cultural Politics in Ceausescu's Romania* (Berkeley, 1991).

rebellion of these new *apparatchiks* against the older, more cosmopolitan generation.<sup>17</sup>

While egalitarianism, corporatism and nationalism were introduced, let us say, from above, there was also another, particularly strong, spontaneous mechanism of social solidarity operating "from below": family bonds. I say this based on observations of the Polish case, but there are reasons to believe that it operated in other Central Eastern European countries as well. In Poland, most of the society was of peasant origin. The traditional peasant family is an all-encompassing form of social organization, targeted not only towards production for subsistence, but also towards providing social security, socialization, as well as social and cultural reproduction.<sup>18</sup> It organizes the world into "we" and "they," where the whole outside world - and first of all such institutions as markets and states - is viewed as alien and hostile. It teaches cooperation and mutual trust founded upon strong personal bonds. It produces a special kind of morality, where standards of honesty are different inside and outside this group. With a rapid shift of population from the villages into the cities in Poland of the 1950s and 1960s, peasant cultural values and patterns of social behavior were transmitted into the town life, where they hardly encountered countervailing cultural influences of urban culture. Writing on the low level of an overall social cohesion and solidarity, a pair of sociologists observed that Poles are "amoral familialist," as were Italian peasants analyzed in a famous book by Edward Banfield.<sup>19</sup>

While such a model of social behavior obviously could not survive in full-fledged form in the industrial society communism built in Poland and in other Central Eastern European countries, many of its characteristics showed extraordinary longevity. The mode of behavior of the peasant family, transferred into the urban environment of industrializing countries, proved to be functional within this new setting. The family group became the main institution defending an individual against the unfriendly environment of a state-dominated society and under conditions of an "economics of shortage." This tendency was not limited to the strictly private area: the mushrooming "parallel economy" was spontaneously organized on the basis of personal bonds of mutual trust.

<sup>17</sup> Students' and intellectuals' protests against cultural policies, culminating in the March 8 demonstration at the Warsaw University (brutally dispersed by police), led to an anti-intellectual and anti-Semitic campaign and a wave of repression. One of its consequences was a massive exodus of the remnants of Polish Jewry.

<sup>18</sup> Jacek Kochanowicz, *Spór o teorie gospodarki chłopskiej* [Controversy over the theory of peasant economy] (Warsaw, 1992).

<sup>19</sup> Edward C. Banfield, *The Moral Basis of a Backward Society* (New York, 1958); Elzbieta Tarkowska and Jacek Tarkowski, "Amoralny familializm' czyli o dezintegracji społecznej w Polsce lat osiemdziesiątych" [Amoral familialism or on the disintegration of the social life in Poland in the 1980s], in Edmund Wnuk-Lipinski, ed., *Grupy i więzi społeczne w systemie monocentrycznym* [Social groups and social bonds in the mono-centric system] (Warsaw, 1990), pp. 37-69.

Thus, paradoxically, communism produced bonds of solidarity and feelings of identity that were far from what could be inferred from the writings of the nineteenth century founding father of the movement, Karl Marx. They were, as Stefan Nowak observed in a famous essay, the family and the nation, with very little in between.<sup>20</sup>

#### IV. Transition

Despite atomization, homogenization and egalitarian redistributive policies, societies under real socialism were much more diversified than it might seem from their apparent sameness. Communist modernization produced a specific, relatively numerous middle class, which cut across main socio-professional groups (blue collar workers, farmers, white collar workers), and which was only partially identical to the ruling *nomenklatura*.<sup>21</sup> Its most salient characteristic was education, or skills. A highly skilled, experienced operator of precision tools, or a modern, entrepreneurial, commercial farmer, was socially and culturally much closer to a school teacher or even an academic than to a semi-skilled worker or a peasant owner of a minuscule plot with only a basic education. If income is an approximation of social status, then membership of this class could be estimated as around 40 per cent of the population in Poland.<sup>22</sup> Human or "cultural" capital, acquired by members of this group due to education and professional experience (and, in the case of the remnants of the "old" intelligentsia, family influence), made them much better prepared for the market than were the rest of the society.

Today, many members of this group have strongly pro-market, anti-statist views, supporting market reforms and privatization.<sup>23</sup> These views are representative for much less than half of the society, if measured by electoral results. It can be safely assumed that market-oriented voters cast their ballots in the September 1993 elections for the Democratic Union (10 per cent of votes), Liberal-Democratic Congress (4 per cent), and the Union for Real Politics (3 per cent). However, the percentage of pro-market voters was higher, since many of them cast votes for post-

<sup>20</sup> Stefan Nowak, "System wartosci spoleczenstwa polskiego" [System of values of Polish Society], *Studia Socjologiczne* 4 (1979), pp. 155-173.

<sup>21</sup> Jacek Kurczewski, "Polish Middle Class at the Close of the Eighties," *The Polish Sociological Bulletin* 3/4 (1992); Andrzej Jezierski, "The Formation of the Communist Middle Class in Poland," *ibid.* For the penetrating analysis of the rise of a middle class among the Hungarian rural population, see Ivan Szelenyi, *Socialist Entrepreneurs: Embourgeoisement in Rural Hungary* (Madison, 1988).

<sup>22</sup> Andrzej Jezierski and Barbara Petz, *Historia gospodarcza Polski Ludowej* [Economic history of People's Poland] (Warsaw, 1988), p. 438. I cite this figure for orientation only. The usage of the category of "middle class" for purposes of interpretation of communist society is by no means accepted by the majority of Polish sociologists, and there are few empirical works on the subject.

<sup>23</sup> Lena Kolarska-Bobinska, *Aspirations, Values and Interests: Poland 1989-94* (Warsaw, 1994), pp. 114, 135, 140.

communist parties: former communists are well represented within the new Polish businesses.

The open pro-market orientation of the part of the Polish white-collar classes, as well as intellectuals, is a relatively new phenomenon. At least since 1956, and maybe even since the end of the war, the predominant orientation of the Polish intelligentsia was social democratic, and most of the proposals for economic reform, put forward since the end of the Stalinist period, were formulated in the discourse of "market socialism."<sup>24</sup> Nobody proposed privatization during the Round Table talks in 1989. The rhetoric of the Solidarity movement in 1980-81, though it was very careful to avoid the actual word "socialism," could nonetheless be interpreted as falling within the same tradition, with its stress on autonomy of state enterprises and the role of workers' councils.

The roots of a liberal orientation were quite deep, however. The events of 1968 (both the Polish March and the invasion of Czechoslovakia) ended whatever ideological appeal Marxism may have had even in its revisionist form, and during the seventies the intellectual circles familiarized themselves with the neo-conservative change in the West. At the same time, the economic crisis (in Poland visible since 1978, if not since 1976) put a large question mark over any support of future attempts of merely "reforming" the system. So, if private property was still taboo in subsequent proposals for reform (such as Leszek Balcerowicz's well-known proposal in 1981), it was more and more so simply because of the implicit assumption that anything going further is politically unfeasible. That assumption began to be questioned sometime after 1985, with Gorbachev and *perestroika*. The last communist government of Mieczyslaw Rakowski then allowed for a de facto introduction of private property, which was an official acknowledgment of the change of climate.

Sociological research currently being done, as well as public opinion polls, both seem to confirm the view that a substantial number of better educated people support pro-market changes.<sup>25</sup> The sociologist Mira Marody analyzed the personal plans of Poles and inferred from this study that roughly one half of Polish society views the changes in an optimistic way and foresees a good future for themselves and their children, while another half is disoriented and scared.<sup>26</sup> The level of education is the main variable explaining these differences. Research on entrepreneurship - and there is a real explosion of entrepreneurial activity, with about 2m. family firms and tens of thousands of small companies - also seems to suggest that those with higher skills and better education are much more eager to apply themselves in this new world of rising opportunities.

Apart from education, another important factor is, obviously, age. Younger people, particularly if educated, support the changes. Also, education began to be viewed as an important step towards success. The number of university students are

<sup>24</sup> Cf. Włodzimierz Brus and Kazimierz Laski, *From Marx to the Market: Socialism in Search of an Economic System* (Oxford, 1989).

<sup>25</sup> Kolarska-Bobinska, *Aspirations, Values and Interests*.

<sup>26</sup> Mira Marody, "W poszukiwaniu zbiorowego sensu" [In the search of common meaning of life], *Polityka* 42, October 16, 1993.



rising quickly (it nearly doubled since 1989 in Warsaw University, Poland's largest, despite the fact that many students have to pay tuition fees), and new private business academies are being established everywhere. The age factor is also important because younger people have not learned attitudes typical for the previous system (sometimes referred to as a syndrome of *homo sovieticus*, or "learned helplessness"). This younger generation is also much more open to the outside world, as it is the most traveled generation in Polish history.

Nevertheless, this new, young, aspiring, ambitious, professionally-oriented middle and entrepreneurial class, although rising, is still a minority. As is well known, the market reforms produce other, less pleasant phenomena, of which some should be stressed here. One is unemployment, reaching 15 per cent. While the significance of actual figures can be debated, taking into consideration over-registration of the unemployed and employment in the grey sector, their social significance is unquestionable. For many families unemployment is becoming a permanent situation, and, given the disastrous long-term psychological consequences, it can easily turn into a situation familiar in many Western countries, where this status is being passed from generation to generation. The second is poverty, which, as the recent World Bank research shows, affects at least 15 per cent of population, or 10 per cent of families.<sup>27</sup> What is particularly worrying is the fact that, given very low real incomes, poverty strikes not only households of the unemployed or of broken families, but also some with more than one working person (the number of children being a crucial variable). The third is a housing crisis: while there is a mushrooming of construction activity for the new upper middle class, the overall figures are dramatically decreasing, leaving many families without the possibility of acquiring a place of their own. Finally, there is a decrease of budgetary expenditure for education (as well as for other social services), which in effect restricts access to good education only to children from better-off families.

These negative tendencies taken together might tend to produce a substantial group among the young population that is unable to function effectively in a competitive, market society. The debate on transition often uses a game metaphor of "winners" and "losers." In fact, we are dealing here not so much with the losers, but with those who are unable even to take part in the game. Signs of the emergence of such a poorly adapted underclass are already noticeable in the form of rising youth subcultures (skinheads), the spread of drugs, and rising criminality, though the latter still seems to be below Western standards. More generally, Polish society is visibly starting to break apart economically as well as culturally, with education being the main variable in the latter respect. The electoral shift towards post-communism, in Poland and in other countries of the region, is to a large

<sup>27</sup> The World Bank, *Poverty in Poland* (Washington, 1994). The poverty line assumed in this study was around \$70. According to the Polish government plenipotentiary for women, 20 per cent of families live below the poverty line; only 55 per cent are able to cover their expenses from wages alone, down from 68 per cent in 1989; the share of single-parent families rose from 21 per cent in 1989 to 38 per cent last year, largely because of a high mortality rates among men; 10 per cent of children do not get enough to eat, and almost half have health problems. *Rzeczpospolita*, July 25, 1995, as reported by *OMRI Daily Digest* 143, July 25, 1995.

degree explicable in terms of a rising dissatisfaction among the groups less prepared for the market economy. This kind of dissatisfaction is also a breeding ground for populism of all sorts, as was well shown during the Polish presidential elections of 1991.

As I have already stressed before, society under communism was also differentiated, but to a lesser degree. The differences were less pronounced due to a certain uniformity of the condition of all people; the networks of social support, in the form of the family on the one hand and state corporatism on the other, made one's personal situation relatively secure; the nationalist ideology (and Catholic religion in the Polish case) kept society together, even producing - as was the case with Solidarity in 1980-81 - an illusion and mythology of almost total national unity. It is worth mentioning that, as intellectuals of the turn of the century busily constructed mythologies of the peasant, their counterparts of the late seventies and early eighties romanticized and idealized the worker. The way the workers and their relation to intellectuals were represented in essays published first in samizdat form and then openly (before martial law was declared) is a worthy subject for an as yet unwritten chapter on Polish intellectual history.<sup>28</sup>

But today one finds various essays stoically reflecting upon the unfortunate historical irony that the workers, who brought about the change, now have to bear most of its costs, and they are more often than not full of the "usual complaints against witless and mindless 'masses' unable to see what is good for them."<sup>29</sup> The romanticization of the workers, as well as the myth of social unity, is over; and if there is a new romanticization, it is that of the entrepreneurs and the middle classes - not so long ago ridiculed for their uninspiring *petite bourgeois* mentality.

Taking into consideration the "breaking apart" of society, as Zsuzsa Ferge puts it another chapter of this volume, the question arises of which bonds will keep it together, and what will make people accept the "rules of the game" - the discipline of the market place and of political democracy - even if particular outcomes are not favorable to them? Will classical answers of social unity and cohesion, produced during the early industrial era - nation and class - work as well in the case of countries now undergoing a transition to the market?

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<sup>28</sup> Andrzej Wajda's two films, the superb "Man of Marble," made in the seventies, and the unfortunately much worse "Man of Iron," produced after Solidarity was legalized in 1980, are good examples of this tendency. Incidentally, it was Wajda who filmed Wyspianski's "Wedding Party," mentioned earlier.

<sup>29</sup> Zygmunt Bauman, "After the Patronage State," in Christopher G.A. Bryant and Edmund Mokrzycki, eds., *The New Great Transformation? Change and Continuity in East-Central Europe* (London and New York, 1994), p. 24.

## V. The Future

First, the nationalist answer. One may doubt whether nationalism can play such a unifying and solidifying role, as it did in at least some cases during the transition to industrial society in the late nineteenth and early twentieth century. There are several reasons for this doubt. First, there is the openness and globalization of economies in the post-industrial world. The economy today is not simply international (in the sense of a network of mutually dependent national economies), but global. We live in a world of multi-national corporations, of production chains of given commodities spreading over various countries, of capital flowing the world over at the touch of a computer key. Secondly, there is the unification of mass culture, due to the standardization of consumption patterns and the globalization of information (which is mostly a result of the electronic revolution). Third, there are mass movements of population, especially from poorer to richer regions, which means that the highly developed countries are becoming more and more multi-ethnic and multi-cultural. Fourth, there is a relative decline of the role and the prestige of the state, which in the late nineteenth and early nineteenth century was the primary builder of national identity.

Taking all these tendencies together, it seems that the prospect of realizing a nationalist utopia - a society ethnically and culturally homogenous as well as visibly distinct from other peoples, a society living within the confines of a given territory and ideologically attached to the state, regarded as a symbol of collective identity - is increasingly remote in every part of the world, and it is increasingly becoming a relic of the past.

In Eastern Central Europe, the nationalist project seems hardly attractive for those social groups who see their future in the modern sectors of an expanding international economy. Taking the Polish example, nationalist ideas do not appeal to better educated young people. There is an apparent change in the way the social identity is being constructed. Traditionally (and the Communist period is no exception) it was formed around the 19th century heroic values, of which the fight for national independence was the most important;<sup>30</sup> today, the appeal of these values is quickly waning. Polish romantic literature, which formed the sensitivity of earlier generations, is now hardly found attractive.<sup>31</sup> The study of foreign languages, travel

<sup>30</sup> A more systematic treatment of the prevailing patterns of Polish national identity would demand at least the inclusion of the role played by the Catholic religion (a relatively new element itself, for until the end of the 18th century Polish noble culture was religiously pluralist), as well as specific republicanism and anti-state attitudes. On the subject of cultural dimensions of Polish national identity, see Andrzej Walicki, "The Three Traditions in Polish Patriotism," in Stanislaw Gomulka and Anthony Polonsky, eds., *Polish Paradoxes* (London and New York, 1990).

<sup>31</sup> See the observations of the leading Polish scholar on 19th century romantic culture and its traditions: Maria Janion, "Kryzys jednolitego modelu kultury i szanse kultur alternatywnych" [The crisis of the monolithic model of culture and the chances of alternative cultures], in Piotr Lukasiewicz and Wojciech Zaborowski, eds., *Szanse i zagrożenia polskich przemian* [Chances of the Polish transition and the dangers facing it], (Warsaw, 1992), pp. 69-75.

abroad, and training in computer skills are currently forging the more affluent members of the young generation, preparing them for a future in a world of international markets and transnational mass culture. It would be nonsense to claim that Polish identity has lost any meaning for them; but its meaning is changing, and it is hardly imaginable that many would become attracted to an old-fashioned nationalism.

This is not to say that nationalism has ceased to be a powerful force, and that it will not play a significant role in the future in Eastern Europe. As Eric Hobsbawm observed, "the people of Central and Eastern Europe will go on living in countries disappointed in their past, probably largely disappointed with their present, and uncertain with their future," and will thus seek myths, most likely nationalistic and xenophobic myths, that would enable them to blame someone else for their misfortunes.<sup>32</sup> As we see daily in the Balkans and in some places in the former Soviet Union, nationalist tendencies are capable of causing enormous damage. It is particularly so in places where there are strong ethnic and/or religious differences between various segments of population. In such cases, the collapse of former state institutions (caused by their loss of legitimacy and, often, aggravated by fiscal crises), the breakdown of social support systems as a result of the disintegration of the communist welfare system, and economic chaos and the resulting frustration and fear are undoubtedly among the factors that explain territorial fragmentation and ensuing wars.

Nationalist tendencies are also evident in countries that are ethnically and religiously homogenous, such as Poland. On a popular level, they show up in polling results, revealing fears regarding the future unification with Western Europe, as well as in the rhetoric of rightist groups, targeted against foreign investment, or in occasional anti-Semitic incidents. Some intellectuals and politicians stress the role of tradition and religion as defining the Polish collective identity. Nationalist positions may seem attractive to some of the older generation, to those who fear the economic and cultural consequences of the openness to the West, and to many less educated youngsters who cling to some notion of identity against the barely understandable market forces. Taking all this into account, one cannot claim that nationalism is vanishing. What I am trying to suggest, however, is that nationalist ideologies, even in their mild form, are incapable of finding creative answers for the technological, economic and social challenges that face Eastern Europe.

The second unifying answer, upon which collective identities were built, was class. Leaving aside the case of communism with its disastrous consequences, as well as that of the extreme left, the most important and influential idea within this tradition was the social democratic idea. It emerged out of the workers' movements of the beginning of the century, to become an all-encompassing social project somewhere between the Great Depression and the late sixties, a project that pretended and appeared to find a lasting solution to the problem of merging economic efficiency with fairness and social security. The social democratic idea

<sup>32</sup> Eric Hobsbawm, "The New Threat to History," *The New York Review of Books*, December 16, 1993, p. 62.

stressed responsibility for the socially weak, while postulating a redistribution of income and an active management of the economy. Its most imposing achievement was the welfare state. But, once again, for many reasons this construct is presently showing cracks and is under a severe critique.

It is a confusing issue, since we are dealing here with at least three overlapping developments. The first are economic difficulties of the welfare state, related to the aging of populations, rising medical costs, high public expectations regarding the range and quality of services, etc., and resulting in budget deficits. The second is a perception of the relatively low efficiency of the public sector, as compared with the private.<sup>33</sup> The third are ideological attitudes of the Western middle classes, which displays a sort of inner solidarity stemming from common values and common lifestyles, while rebelling against high taxes and financial assistance to an underclass of poor, unemployed, ethnic minorities with whom they feel no particular bond. Members of the middle classes, confident in their ability to provide for their children through education, and for themselves in the future through private pension funds, tend to be ideologically libertarian and not see the state as an organizer of the collective welfare.

Whatever the reasons, the social democratic project lost this emotional appeal, which enabled Americans to call its transatlantic version "the Great Society." While it is unimaginable that the Western welfare state could be actually dismantled, it no longer provides a vibrant ideological model to be emulated in the East.

If the old projects really are increasingly less relevant for the future of former socialist countries, are there any new ideas that might offer them hope of keeping their societies together and avoiding profound social divisions? The two serious social projects most often referred to recently are neo-liberalism (if indeed it can be called a new idea) and the idea of "civil society."

The appearance and - for a time being - enormous popularity of liberal ideas in these societies, in which hardly any tradition of this kind existed prior to the advance of communism, seems paradoxical.<sup>34</sup> Liberalism was, of course, re-invented in Eastern Europe as a counter-proposal to the system of total domination of society by the state, perceived as an ultimate evil after several decades of the communist experiment. This re-invention reflected the universal disbelief of the capacity of the state, and public action in general, in organizing social life, as contrasted to the supposedly beneficial results of individual actions motivated by self-interest.<sup>35</sup> Liberalism, Jerzy Szacki observed, "revealed itself [...] as an utopia -

<sup>33</sup> Albert Hirschman has made some interesting comments on this, which led him to a position - contrary to the one that is more generally prevailing - that we are dealing with rather a passing problem here. *Shifting Involvements: Private Interest and Public Action* (Princeton, 1982), pp. 42-3.

<sup>34</sup> Cf. Janos Matyas Kovacs, ed., "Rediscovery of Liberalism in Eastern Europe," *East European Politics and Societies* 1 (1991).

<sup>35</sup> The rising (and falling) popularity of liberal economic ideas in Eastern Europe is a perfect example of Hirschman's "shifting involvements." Hirschman, *Shifting Involvements*., passim.

as a vision of a good society."<sup>36</sup> Of its two dimensions, economic and political, it was the former that appealed so considerably to intellectual and political elites in Eastern Central Europe, and - more paradoxically - even won the support of the trade union movement. That Eastern European neo-liberals put themselves in a self-contradictory position, advocating a "constructivist" approach of building capitalism from above, which hardly corresponds to either a spontaneous logic of its original emergence or to the basic values of political liberalism, is another matter entirely.

The question of to what extent the neo-liberal idea offers viable solutions to economic problems facing Eastern Europe is too complicated to be dealt here with one sweeping answer, especially considering the highly emotional character of the current debate on this subject. But we may leave it aside, since, after experiencing the beginnings of capitalism, the honeymoon of Central Eastern European societies with neo-liberalism is definitely over. The popularity of this idea is likely to be confined to narrow groups of intellectuals (especially a younger generation of Western-trained economists), because it is hardly compatible with prevailing economic interests. Perhaps more unfortunate is the fact that the ideas of political liberalism, with their emphasis on individual rights, liberties and the rule of law, may have a hard time taking root in societies with few traditions of this kind.

The second ideological project mentioned is the communitarian idea of civil society, "of people," as Michael Walzer puts it, "freely associating and communicating with one another, forming and reforming groups of all sorts, not for the sake of any particular formation - family, tribe, nation, religion, commune, brotherhood or sisterhood, interest group or ideological movement - but for the sake of sociability itself."<sup>37</sup>

The idea of civil society has indeed become popular recently among intellectuals both in the West and in the East, as "the new analytic key that will unlock the mysteries of social order," and as "an ethical vision [...] of the good life."<sup>38</sup> In the West, it have offered hopes of offsetting the dangers of extreme individualism as well as of invigorating the ailing, formal representative democracy. In Eastern Europe, one of the reasons was the importance of active, grass roots social movements for the dynamics of change during the late stages of communism. Another reason has been the hope, which now looks more and more utopian, that spontaneous public initiatives would play a decisive role in creating the new order.

The reality appears to be less romantic.<sup>39</sup> While it can be argued that civil society institutions are indispensable for the proper functioning of both a market economy

<sup>36</sup> Jerzy Szacki, *Liberalizm po komunizmie* [Liberalism after Communism] (Cracow, 1994), p. 256. It would be difficult to add much to this brilliant analysis. See also Szacki, "A Revival of Liberalism in Poland," *Social Research* 57:2 (1990), pp. 463-492.

<sup>37</sup> Michael Walzer, "The Civil Society Argument," in Chantal Mouffe, ed., *Dimensions of Radical Democracy, Citizenship, Community* (London, 1992).

<sup>38</sup> Adam B. Seligman, *The Idea of Civil Society* (New York, 1992), pp. 200, 201.

<sup>39</sup> In what follows, I am confining myself to a practical feasibility of civil society solutions, leaving aside the more profound philosophical questions. See Seligman, *ibid.* *passim*.

and political democracy,<sup>40</sup> it is doubtful whether there is an easy passage from semi-clandestine grass roots social and political activity of late communism to the creation of a strong, modern sector of non-government organizations within the democratic society.

First - apart from the experience of democratic opposition to communist rule - there is very little historical tradition upon which to build a civil society, as the "horizontal" associations were a rarity in Eastern Europe in the 19th and early 20th centuries, while the "vertical," paternalistic or authoritarian structures predominated.<sup>41</sup>

Second, civil society demands voluntary activity, which is not easy to achieve. The chances of participation are much higher in local communities or within social groups that are relatively affluent and well-educated. Therefore, the emerging structures will help form bonds within the given segments of society, rather than solve the problem of overall social cohesion.

Third, what is needed besides participation is also a proper legal infrastructure, adequate funding, and managerial skills. (A lot of apparently spontaneous activity must in fact be fully professional. The techniques of fund raising, for example, are hardly known in Eastern Europe.) In the West, the non-government organizations (which is a less romantic term for the civil society) are financed partly by the private sector, partly by the state. Since the first source operates to a large degree due to tax incentives, in an indirect way this is also public finance. In Eastern Europe, the private sector - even if willing - is still too weak to play such a role. The state does not seem to be particularly friendly towards the non-profit sector as well because of a paradoxical combination of two reasons: a monetarist ideology of fiscal discipline and an allergy towards spontaneous initiatives, characteristic of the post-communist political formations.<sup>42</sup> As it stands, many non-government organizations are dependent on foreign sources, which make them prone to attacks of nationalists, as happened several times to the Soros Foundations.

Each of the four ideas mentioned above - the nationalist, social democratic, liberal and communitarian - offers an overall and encompassing vision of social order. Neither is likely to achieve a predominant position; more probable are various syncretic combinations of some elements in each of them, since intellectual elegance and internal cohesion are rarely characteristic for political discourse and practical solutions.

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<sup>40</sup> Robert D. Putnam, *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton, 1993); Jacek Kochanowicz, "Capitalism and Civil Society," *Economic Discussion Papers* 9, (Warsaw, October 1994).

<sup>41</sup> If Robert Putnam (*Making Democracy Work*) is right in stressing (in the case of northern Italy, as opposed to the southern) the decisive role of historical tradition in forming civil society, then Eastern Europe has rather bleak prospects in this respect. For Polish traditions, cf. Jacek Kochanowicz and Irena Topinska, "Memoire d'Economies sociales en Pologne: des traditions 'en peu oubliees'," *Revue des etudes cooperatives, mutualistes et associatives* 41 (244), 1er trimestre 1992, pp. 41-8.

<sup>42</sup> Recent government attempts to introduce new restricting laws on foundations in Poland are a case in point.

Apart from these ideological answers, however, is also the likelihood of an emergence of various justifications of special interest groups. Let me briefly mention just one of them, which I would call a non-egalitarian neo-statism. What I have in mind are arguments in favor of state intervention, tariff protection and industrial policies which, in fact, serve to strengthen the monopolistic positions of certain firms or industries. Big state-owned enterprises and agriculture (especially in Poland) are typical forces behind this. The position they take would be justified by national interests and economic reconstruction. The danger is two-fold: on the one hand there is the possibility of a petrification of outdated types of economic activity; on the other hand it discredits any sort of industrial policies that may sensibly be needed.<sup>43</sup> Were such views to gain a wider response, the possible effect could be an overall shift into a kind of pre-war economic nationalism, mentioned by Ivan T. Berend in the first chapter of this book.

Of the same standing are those ideological answers, coming from certain strata of the population rather than from organized interest groups, that are usually called "populism." I am not very comfortable with this term because of its ambiguity and lack of analytical clarity, but I use it for the lack of a better alternative.<sup>44</sup> Its social democratic version consists upon flattering those segments of the electorate that rely upon budget transfers. Its more right-wing version tends to refer to national and religious values, as well as to anti-communist sentiment (while at the same time actually being quite "leftist" in its support of budget payments).

## VI. Concluding Remarks

As the social structure is unclear - although there is no doubt that it is less and less egalitarian - so are the views of society. All this is only beginning to take shape, still in a state of flux, and far from presenting a clear, consistent picture - probably reflecting the confused state of mind of many Central East Europeans. The crucial fact is, however, that there are many of these views, and that no single one of them, for better or worse, seems likely to take hold of the minds of most people.

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<sup>43</sup> I speak of this with mixed feelings, since I myself am convinced that Eastern European economies do, in fact, need a substantial measure of industrial policy to restructure and adjust to the conditions of the international economy. I am fully aware, however, that arguments of this sort are very likely to be used as a smoke screen by special-interest groups. About the needs of industrial policy, see Alice Amsden, Jacek Kochanowicz and Lance Taylor, *The Market Meets Its Match. Restructuring the Economies of Eastern Europe* (Cambridge, Mass., 1994).

<sup>44</sup> This term is sometimes used in its Latin American sense, of politicians relying directly on the masses while bypassing the institutions of representative democracy, or sometimes in reference to the Eastern European (and particularly Russian) tradition of treating the peasantry as somehow a special segment of society. But it is most often used in the sense of making gratuitous promises in order to please the voters.



Since it is impossible to formulate a final conclusion when talking about processes that are, in fact, beginning to unfold, perhaps I will say two things instead. One is that while we probably have to accept as a fact of life the growing economic and cultural (educational) differences within the Central Eastern European societies, as well as an apparent lack of ideologies that could help these societies cope with those differences, we should at the same time, as much as we can, persuade opinion makers and politicians to be sensitive to them and be aware of their responsibility in the face of these growing divergences. The second is an expression of hope that the present plurality of views will at least help to keep democracy alive.

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RUDOLF ANDORKA

## The Development of Poverty During the Transformation in Hungary

### *I. The History, Research and Debate on Poverty in Hungary*

In the interwar period Hungary was a relatively underdeveloped country, where about half of the population made its living from agriculture, but about two fifths of the agricultural population had no land and therefore had to engage in agricultural wage work, which for many was seasonal and provided very low income. Most of the smallholder peasants had very small farms, barely enough to assure the income needed for the subsistence of a family. Part of the relatively small industrial working class (about one fifth of the active population) also earned very low wages and was continuously threatened by unemployment. In the 1930s it was often stated that Hungary is "a country of three million beggars" (in a population which reached 9 million only in the mid-1930s). An estimation made on the basis of GDP-data in 1930-1931 showed that the income distribution was much more unequal in Hungary than in contemporary Germany and the United States. Poverty was a publicly and widely discussed problem, and critically-minded social scientists emphasized the need for economic and social reforms, including land reform, in order to alleviate poverty.

After the Second World War poverty encompassed almost the whole society as a consequence of the devastations of war. In 1945 a land reform was implemented. Soon a state socialist system was introduced with the claim that poverty would be abolished within a short time, by ending exploitation and creating rapid economic growth through socialist economic planning.<sup>1</sup> Shortly afterwards the whole problem of poverty disappeared from public and scientific debate; it became, indeed, a taboo topic. Since sociology was declared to be a "bourgeois science" and consequently prohibited around 1950, the scientific personnel and infrastructure to do research on poverty did not exist for several years. As, however, the per capita income level and the wage level hardly increased, and indeed in some years declined as a consequence of the very high investment rate necessitated by the forced industrialization policy, poverty continued to exist on a large scale.<sup>2</sup>

The science of sociology achieved a renaissance in the period of a relative softening of the totalitarian system during the first half of the 1960s. One of the first achievements of sociology was the initiation of a series of household income surveys in 5-year intervals beginning in 1962 in the Central Statistical Office.<sup>3</sup> From these surveys performed on large (0.5 per cent) samples of households, reliable data is available on the development of income distribution, among others the number and social characteristics of people with the lowest incomes.

<sup>1</sup> Zs. Ferge, *Fejezetek a magyar szegénypolitika történetéből* (Budapest, 1986).

<sup>2</sup> I. T. Berend, Gy. Ránki, *Gazdaság és társadalom. Tanulmányok hazánk és Kelet-Európa XLX-XX. századi történetéről* (Budapest, 1972).

<sup>3</sup> Zs. Ferge, *Társadalmunk rétegződése. Elvek és tények* (Budapest, 1969).

The existence of poverty in Hungary was, however, mentioned at a scientific conference only after the second household income survey, and the immediate reaction of the government was to prohibit any future mentioning of the existence of poverty. A strictly secret calculation of the minimum subsistence levels and a survey of the poorest part of the population were nevertheless performed, and they revealed that about one million Hungarians (10 per cent of the population) lived on a per capita income that was lower than the subsistence minimum, and that another 1.5 million had an income higher than the subsistence minimum, but lower than the "socially acceptable minimum." The rural population, the elderly and the Gypsies were overrepresented among the poor.

The public prohibition of the problem of poverty remained in force until 1981, when the Hungarian Sociological Association organised a scientific conference on poverty. Since then poverty has been discussed in public, the subsistence minimum has been calculated every year from 1982 on, and scholars began to study poverty and the welfare policies that could alleviate it.<sup>4</sup> Although these scientific analyses did not arrive at completely identical conclusions, it was usually accepted that about one million Hungarians (10 per cent of the population) were poor, and that their number did not decline in the 1980s. It should be added that the subsistence minimum calculated in the 1980s is not exactly comparable to the minimum calculated in 1970, and therefore the one million poor people estimated for 1969 cannot be strictly compared to the one million poor estimated for the 1980s.

After the transition in 1989 the conditions of poverty research and debate changed in three respects: poverty increased as the transformation proceeded; the Central Statistical Office did not publish the data of the new household income survey in 1991, as the registration of income proved to be very defective (incomes from private sources, that are difficult to verify, increased); and the debate on poverty not only became completely unrestricted, but was a central focus of the party-political debate. Therefore there is a great need for reliable data and analyses on poverty.

## *II. Sources of Data and Problems of Methods*

Lacking the household income surveys on big samples of the Central Statistical Office, the data collected on much smaller samples (about 0.06 per cent of the population) by the Hungarian Household Panel surveys is the available source for analyzing poverty. The Hungarian Household Panel survey follows the example of the income panel survey of the Institute for Social Research of the University of Michigan,<sup>5</sup> the Western German *sozioökonomisches Panel*,<sup>6</sup> and particularly the similar panel survey in East Germany.<sup>7</sup>

<sup>4</sup> R. Andorka, "Public Debate on Poverty since the 1960s," in C. D. Goodwin, M. Nacht, eds., *Beyond Government, Extending the Public Policy Debate in Emerging Democracies*, (Boulder, 1995), pp. 205-226.

<sup>5</sup> G. J. Duncan, *Years of Poverty, Years of Plenty* (Ann Arbor, 1984).

<sup>6</sup> U. Hanefeld, *Das sozio-ökonomische Panel. Grundlagen und Konzeption* (Frankfurt, 1987).

<sup>7</sup> B. Headey, R. Habich, P. Krause, *The Duration and Extent of Poverty - Is Germany a Two-thirds Society?* WZB Paper No. P (1990), pp. 90-103.

About 2,000 households, comprising roughly 4,500 adult members (aged 16+), who are all interviewed with separate questionnaires, as well as 1,200 children, are interviewed yearly (in April-May) about their income, employment and several additional topics, such as satisfaction levels, the desire of going into private entrepreneurship, the intention to emigrate, etc.<sup>8</sup> The great advantage of panel surveys is that they provide the possibility not only of a cross-sectional study of income, but also an analysis of the dynamics of household income.

Panel surveys also cause a lot of special problems, such as that of people dropping out of the sample from one survey to the next. Only those persons and households that are interviewed in each survey can be taken into consideration in the longitudinal analysis. The dropout is counterbalanced by the appropriate weighing of the individual data, so that the sample, in spite of the dropouts, remains representative of the total Hungarian population.

The problems of defining and measuring poverty are essentially the selection of the poverty line, as well as the weighing of the needs of members of different ages of each household, and of the smaller and larger households.

As there is no agreement on the definition of poverty, i. e. the selection of the poverty line, we decided to use *four poverty lines* in this paper. Two of them are based on the absolute poverty concept, and the other two on the relative concept of poverty. [1] We used the subsistence minimum calculated by the Central Statistical Office for different household types (differentiated by the number of adults and children, and by urban-rural residence), and define as poor those households in which the per capita income is lower than the subsistence minimum calculated by the Central Statistical Office for the given type and the given year. [2] We also used the statutory minimum pension, which is substantially lower than the subsistence minimum, and is considered as an existence minimum accepted by the social security administration, and indirectly by the government as well. [3] We defined poverty as the lowest quintile of persons in terms of per capita household income. [4] The fourth poverty line is fifty per cent of the average per capita income.

In the case of the lowest quintile we do not use any weighing, i. e., each person, independent of age and the size of the household, is assumed to have the same basic needs in terms of per capita income. In the case of the subsistence minimum no weighing is used, as the subsistence minimum for the different household types were themselves calculated with an equivalence scale. As for the minimum pension and the fifty per cent of the average poverty lines, the OECD equivalence scale is used, i. e., first adult = 1.0, additional adults = 0.7, children = 0.5.

<sup>8</sup> E. Sik, I. Gy. Tóth, *Jelentés a Magyar Háztartás Panel I. hullámának eredményeiről* (Budapest, 1992).

### III. The Macroeconomic and Macrosocial Background of the Growth of Poverty

The transition from a more or less planned economy (where market conditions played a certain role since the introduction of the first market-oriented reforms in 1968), based on the overwhelming state ownership of productive assets, to a market economy based on the overwhelming role of privately owned productive assets, proved to be much more difficult than expected in 1989-1990. Instead of an projected relatively short and not very significant drop of the GDP, the recession was very deep and lasted at least till 1994, when the first signs of an upturn of the economy seemed to be on the horizon. It has to be added that, at the time of writing (April 1995), it is still questionable whether the slight growth of the GDP initiated in 1994 will continue in 1995.

It should be noted that the economic recession was caused not only by the transformation of the economic system, but also by both a collapse of the export markets in the former socialist countries and a worldwide depression. None of these developments were expected in 1989-1990.

Whatever the causes of the deep recession, the GDP declined by 21 per cent from 1989 to 1993, and both the real per capita income of the population and the real per capita consumption declined as well, albeit less than the GDP. The real wage index, which had already begun to decline after 1978, continued to decline after 1989 more rapidly than in earlier years. The two immediate causes of the decline of the real income of the population were: first, the decline of employment by 22 per cent, which was only partly due to the growth of unemployment, for more or less the same number of people simply withdrew from the labor market without being registered as unemployed; second, an inflation that caused a decline in the real value of incomes of all those who were not able to compensate by increasing their nominal income, i. e. all those who had a more or less fixed wage. (Table 1)

Parallel to the decline of the average per capita real income was the *increase of income inequality*. (Tables 2-3) It should be added that income inequalities also existed in the state socialist period, and were similar to the inequalities observed in the Scandinavian countries.<sup>9</sup> After the 1989 transition, the income inequalities began to increase rather rapidly, and has today essentially reached the level of inequality found in West Germany.<sup>10</sup>

Similarly, the inequality of the average per capita income level of social strata tended to increase after the transition. (Tables 4-5) It should be noted that income differentials of social classes or strata also existed in the state socialist period, and their rank order was rather similar to the rank order observed in advanced capitalist societies. After the transition, the former privileged strata - the managers, supervisors and professionals - increased their advantages relative to the national average; the simple clerical or non-

<sup>9</sup> R. Andorka, "The Use of Time Series in International Comparison," in E. Oyen, ed., *Comparative Methodology, Theory and Practice in International Research* (London, 1990), pp. 203-223.

<sup>10</sup> R. Andorka, B. Headey, P. Krause, "A gazdasági és politikai követelmények szerepe a rendszerváltozásban: Magyarország és Kelet-Németország 1990-1994." *Szociológiai Szemle* 4 (1994), pp. 61-82.

manual employees and the rapidly increasing stratum of the self-employed fared somewhat better than average; the skilled workers and the elderly pensioners were more or less at the level of the national average; and the semi-skilled and unskilled workers, the peasants and the inactive categories other than pensioners clearly fell back not only in absolute terms, but also relative to the average.

When trying to determine who are *the winners and losers of the transformation* up till now, one might say that in terms of social strata the losers are the non-skilled workers and peasants, those whose income derives from the social welfare system (with the exception of the old age pensioners), and those who do not have an income of their own, like housewives. The winners are the managers, supervisors, i. e., those who are in a powerful position, the professionals, who have cultural capital, and a part of the private entrepreneurs, who have economic capital.

In terms of the income deciles it might be estimated that the lower seven deciles, i. e., seventy per cent of society, are hitherto losers in relative terms, because their share of the (declining) total personal income has diminished, while the higher three deciles are winners in relative terms.

It is much more difficult to ascertain the number of winners and losers at the level of individual persons and households, as we do not have data on the pre-transformation income of those interviewed in the panel survey. Kolosi and Sik,<sup>11</sup> however, evaluated the change of real income from 1991 to 1992 of people and households in the panel survey, and found that in one year 9 per cent suffered a significant loss of income, 37 per cent a moderate loss, 22 per cent was able to maintain the real value of its income, 16 per cent achieved a modest gain, and 16 per cent a significant gain of real income. These percentages might not be very far from the percentages of winners and losers during the whole transformation period from 1989 to 1994.

Thus as a result of the transformation from a state socialist to a capitalist system, the Hungarian social structure has become more "structured" or "stratified" in the sense that the income differentials and differences of living conditions of social classes and strata have increased. While the income differentials in the state socialist period were similar to those existing in Western social democratic welfare states, during the first five years after the system change they reached levels observed in the European "core" capitalist societies, where left-of-center and right-of-center governments tended to alternate.

In terms of the socio-economic classes or strata existing in the social structure, the only important change is the growth of the number of self-employed persons and the appearance among them of very well-to-do private entrepreneurs. Otherwise the already privileged strata in the state socialist system have become even more privileged, while the underprivileged strata of the state socialist system have become even more underprivileged.

<sup>11</sup> T. Kolosi, E. Sik, "Munkaeropiac és jövedelmek," in Tóth and Sik, *Jelentés a Magyar Háztartás*, pp. 8-24.

#### IV. Incidence of Poverty

If, however, the social structure is analysed in terms of the whole complex of income, living conditions, psychological well-being and the of quality of life of each individual and family, a potentially different development of social structure is visible, namely the splitting of society into a privileged, affluent part and a permanently underprivileged poor part. Similar tendencies, but at a much higher average standard of living, were discussed in the West in terms of the "two-thirds society," meaning that one-third of the members of the most developed capitalist societies could not reap the benefits from a general improvement of the standard of living and living conditions, and consequently might be excluded from society.<sup>12</sup> Thus discussions about the "new poverty" deal with this underprivileged one-third minority.

In the present Hungarian debates the concepts are somewhat different: it is usually hypothesized that a highly privileged one-tenth is at the top, a highly underprivileged one-third is at the bottom, and the remaining 40-50 per cent are able with great effort to avoid serious pauperisation, but not to rise into the well-to-do elite of society. In this paper we are concentrating on the poorest part of Hungarian society, and are attempting to determine the composition of the poor stratum, the durability of poverty and the possible consequences of poverty.

On the basis of the microlevel data of the panel survey, it can from the outset be stated that poverty had indeed increased significantly. Using the subsistence minimum as the poverty line, the percentage of poor people was around 10% in the 1980s (we should add that it did not decline or only very slightly declined in the 1980s), and increased more than threefold by 1994. (Table 6) But this is far from the 50-60% level that was occasionally reported in rather journalistic articles in Hungary. Poverty is much less widespread, but is also on the increase, using the pension minimum as the poverty line. While the income differential is slowly and continuously increasing since 1992 as well, the percentage of those who have incomes lower than half of the national average is also increasing. (Using the fourth poverty concept, namely the lowest quintile, poverty obviously did not increase, as it is by definition 20 per cent.)

Although the number of poor people is at present the most hotly debated question in Hungary, we have to emphasize that the answer to this question depends on our selection of the line of poverty, and that all poverty lines are more or less relative and subjective. Therefore any scholarly discussion ought to be concentrated on the appropriate poverty line or poverty definition. This problem, however, has important socio-political connotations, since by selecting a given poverty definition, we are implicitly suggesting that those considered poor by this definition should be aided by socio-political measures. The higher the poverty line, the more people there are in need of assistance of the social welfare system, which obviously - and particularly in the present conditions of Hungary - has limited resources. Thus our main conclusion from the overall poverty rates is simply that *poverty has increased*.

More scientific information can be acquired by analyzing the poverty rates based on the demographic and social characteristics of people and households, i.e., by studying

<sup>12</sup> P. Glotz, *Die Arbeit der Zuspitzung* (Berlin, 1984).



the incidence of poverty or the percentage rates of the poor in different categories of people (Table 7) and households (Table 8).

On the basis of the poverty rates it might be hypothesized that there are at present three types of poverty or three types of factors causing a high risk of poverty: traditional poverty, new poverty and ethnic poverty.

Two large social categories, partly overlapping, can be ascertained today in Hungary, both having been highly overrepresented among the poor in earlier decades, in the interwar period and also in the 19th century: [1.1] the nonskilled workers and the peasants, [1.2] the population of villages and of small towns, which in Hungary have often a rather rural character. Although poverty in these categories increased since the transition both in relative and absolute terms, these traditional poor strata at present are not the worse off among the poor, nor have the highest risk of sinking into poverty.

The two subgroups of "new poverty" seem to be more endangered, namely [2.1] those who for some reason do not follow the "regular" occupational career patterns in Hungary (both for men and women) and were not continuously employed from the time of completing school until retirement - such as dependents, housewives, those women who because of old age receive a widow's pension, those who have to retire earlier than the statutory age and have a disability pension, and those who recently became unemployed (it should be added that seeking a disability pension became in recent years a way to avoid unemployment) - have a very high risk of being poor; [2.2] children and families having children, particularly families having three or more children, are strongly and increasingly overrepresented among the poor. The incidence of poverty among children depends on the equivalence scale used to gauge the needs of children: the lower the weight given to children, the lower their overrepresentation among the poor. Nevertheless the children and the families having more than three children have higher than average poverty rates in all four poverty lines used in this article. It should be added that the tendency of pauperisation of children and of increased income for the elderly could also be observed in the state socialist period in Hungary, and was observed in many or all advanced societies as well.<sup>13</sup> Therefore we tend to agree with the statement of the UNICEF International Child Development Centre<sup>14</sup> that children are among the big losers of the transformation in Eastern Central Europe, albeit somewhat less in Hungary prior to 1994 than in other former socialist countries.

The most numerous (about 500,000) ethnic subgroup in Hungary, the Roma or Gypsy population, was traditionally disadvantaged. In the pre-socialist period they lived on the margins of society, but had well-defined "niches" in the socio-occupational structure, doing work usually neglected by the non-Gypsy peasant population, such as making sun-dried bricks (used to build houses in the villages). In the period of socialist industrialisation these working tasks essentially disappeared, but the state made great efforts to integrate the Gypsy population into the Hungarian economy and society. The great majority of Gypsy men had jobs, albeit almost exclusively unskilled and semi-skilled jobs involving heavy manual work and assuring relatively low wages. After the

<sup>13</sup> L. Rainwater, *Inequalities in the Economic Well-being of Children and Adults in Ten Nations*, Luxembourg Income Study Working Paper No. 19 (1988).

<sup>14</sup> UNICEF International Child Development Center, *Public Policy and Social Conditions*, Regional Monitoring Report No. 1 (1993).

transition these jobs were mostly lost; in addition, the Gypsy population lives mostly in small villages and in the Eastern parts of Hungary, where the unemployment rate is much higher than on average. All these factors resulted in a very high poverty rate among the Gypsy ethnicity, which also increased from 1992 to 1994.

### V. Durable or Temporary Poverty?

Obviously, durable or long-lasting poverty is a much more serious social problem than temporary poverty. And obviously, it is unjustified to speak about a "two-thirds society," where one-third of the population is locked into poverty and is unable to share the benefits enjoyed by the affluent two-thirds, if an important part of the poor is only temporarily poor, like in West Germany.<sup>15</sup> Household income panel surveys are especially good sources to study the durability of poverty, and they usually reach the conclusion that only a small part of the poor of a given year remain poor in the following years. Duncan<sup>16</sup> found that more than half the poor in any given year between 1968-1978 in the United States was no longer poor the following year. Bernsten and Rendtel<sup>17</sup> noted that, in the period of 1983 to 1986, only 2.0 per cent of the population (of German nationality) in West Germany was below the "50 per cent of the average" poverty line in all four years, 2.9 per cent in three years, 5.3 per cent in two years and 9.5 per cent in one year, while 80.3 per cent was never poor.

The durability of poverty obviously very much depends on the poverty line: the lower the line, the less durably poor persons are found. The data from the first three years of the Hungarian Household Panel Survey (Table 9) confirm the findings in foreign countries in very different economic and social circumstances: *the greater part of poverty is temporary*.<sup>18</sup>

In scholarly discussions of these results in Hungary, it was brought up by way of an objection that the above-mentioned statement is misleading, because those who were able to leave poverty from one year to the other actually attained only a slightly better position, i. e., they became only "nearly poor," or might have been designated "not poor" without any improvement of their income simply because others became poorer during the same year, or because the 50 per cent of the average poverty line descended to a lower real income level.

This objection is, however, only partly justified, for, according to the "outflow" (Table 10) and "inflow" matrices between the income deciles, more than a few persons in the lowest two deciles were able to climb up two or more deciles. On the other hand, many belonging to the higher deciles in 1993 descended into the two lowest deciles in 1994.

<sup>15</sup> B. Headay, R. Habich, P. Krause, *The Duration and Extent of Poverty - Is Germany a Two-thirds Society?* WZB Paper No. P (1990), pp. 90-103.

<sup>16</sup> G. J. Duncan, *Years of Poverty, Years of Plenty* (Ann Arbor, 1984).

<sup>17</sup> R. Bernsten, U. Rendtel, "Zur Stabilität von Einkommensarmut im Längsschnitt," in U. Rendtel, G. Wagner, eds., *Lebenslagen im Wandel: Zur Einkommensdynamik in Deutschland seit 1984* (Frankfurt, 1991), pp. 457-487.

<sup>18</sup> R. Andorka, Zs. Spéder, "Armut im Transformationsprozess am Beispiel Ungarns." Paper presented at the Congress of the German Sociological Association, Halle, 1995.

Using the "below 50 per cent of the average" poverty line, we analysed the outflow from poverty to "near poverty" (defined by being between 50 and 60 per cent of the average) and the higher income brackets (above 60 per cent of the average). An important segment of the poor were able to rise above this 60 per cent of the average line in the subsequent year. (Table 12) Similar data from West Germany presented by Peter Krause showed more or less similar outflow rates from "below 50 per cent of the average" poverty. Thus it might be concluded that, in spite of the critical economic situation of Hungarian society, the chances of climbing out of poverty were no less favorable than they are in more prosperous societies.

This does not mean, however, that we should not be concerned about durable poverty. On the contrary, the *rates of durable poverty* seem to demonstrate the divergence of poverty risk more clearly than do the cross-sectional poverty rates of any given year. (Table 13) The poverty of children, the Gypsy population, and those with irregular occupational careers is very clearly exhibited in the 3-year-poverty rates. The percentage of the durably poor is rather low in the traditionally poor non-skilled worker and peasant strata, proving that those who have regular sources of income from work have a good chance of remaining only temporarily poor.

## *VI. Consequences of Poverty*

Poverty and its increase are themselves very serious social problems, and therefore deserve to be studied carefully. Below we will try to additionally point to some possible consequences of poverty and pauperisation that might have a negative impact on the transformation process in Hungary. The data on these consequences are not as "hard" as the income data, for they refer to subjective satisfaction, psychological problems and attitudes; hence our conclusions should be considered tentative or hypothetical.

From other sociological surveys<sup>19</sup> and public opinion polls, we know that Hungarians are very dissatisfied with their income level, their standard of living, and the general economic and political conditions in the country. Dissatisfaction seems to be among the highest in the former state socialist countries, though the economic conditions in some of these countries are clearly worse than in Hungary. In order to study the social differences of *dissatisfaction*, we included in the questionnaire of the Hungarian Household Panel Survey the questions on satisfaction from the German surveys. The level of satisfaction was based on an eleven point scale from 0 (very dissatisfied) to 10 (very satisfied). Those who answered from 0 to 3 were classified as dissatisfied. Those who belonged to the poorest quintile of the population were clearly more dissatisfied with almost every dimension of their private lives (with the possible exception of the family), as well as with the economic conditions of the country and their chances of having a voice in political decision-making. (Table 14) The only two dimensions in which the more affluent parts of the population were more dissatisfied or worried were public security and the environment.

<sup>19</sup> R. Rose, Ch. Haerpfer, *New Democracies Barometer III: Learning from What is Happening*, Center for the Study of Public Policy, *Studies in Public Policy* No. 230 (Glasgow, 1994).

The widespread dissatisfaction of the poorer segment of society might lead to political instability and ultimately to the delegitimation of the market economy and the democratic political system. The Eastern European Stratification Survey in Spring 1993 (main researchers: Donald Treiman and Iván Széleányi) revealed that 30 per cent of the adult population did not intend at the time of the survey to participate in an eventual parliamentary election (indeed, fully 31 per cent of the voters did not participate in the elections in the spring 1994), 25 per cent intended to participate and had no party preference, and 45 intended to participate and were able to name a party he/she preferred. Thus the percentage of both non-participants and potential floating voters was rather high. It should be added that, according to the data from the 1992 and 1993 wave of the household panel survey, more than half of those who had a party preference in 1992 changed their preference in 1993, and thus might also be considered "floating voters." The data from the stratification survey in 1993 shows that the percentage of both *non-participants* and *undecided or floating voters* was much higher among the poorer members of society than among the more affluent ones. Thus it might be concluded that the poor and dissatisfied members of society might be a source of great and sudden changes of voting patterns and, if they turn to non-democratic parties, might threaten the democratic political system.

The growth of the suicide rate and alcoholism since the mid-1950s alerted sociologists to the problems of mental health in Hungary. Social psychiatrists<sup>20</sup> concluded on the basis of mental health surveys in the 1980s that psychological problems, such as neurosis and depressive symptoms, are very widespread in Hungary. In order to study the social factors correlated to these problems, we included in the questionnaire of the 1993 household panel survey questions from German surveys on mental problems, especially those that were stress-related. These stress-related symptoms proved to be more widespread in Hungary than in East or West Germany, and were also more frequent among the poor than among the more affluent members of society. (Table 15) Thus the poorest quintile is not only poor in relative and absolute terms, but also more stressed, exhausted and anxious than the better-off parts of the society.

It was hypothesized earlier that the fundamental cause of the high suicide and alcoholism rate, of the widespread psychological problems, and indeed of many other problems in Hungarian society, is a crisis of *anomie and/or alienation*.<sup>21</sup> Anomie and alienation are concepts defined in various ways in the sociological literature. Here I use them as almost synonyms, or rather as two sides of the same coin. I would agree with the short definition of Etzioni that alienation is "the unresponsiveness of the world to the actor which subjects him to forces he neither comprehends nor guides."<sup>22</sup> Both anomie

<sup>20</sup> M. Kopp, Á. Skrabski, *Magyar lelkiállapot* (Budapest, 1992).

<sup>21</sup> R. Andorka, "Social Changes and Social Problems in Hungary Since the 1930s: Economic, Social and Political Causes of the Demise of State Socialism," in A. Seligman, ed., *The Transition from State Socialism in Eastern Europe: The Case of Hungary*, Comparative Social Research, Vol. 14 (1994), pp. 49-96.

<sup>22</sup> A. Etzioni, *The Active Society, A Theory of Societal and Political Processes* (London, 1968), p. 618.

and alienation include powerlessness, meaninglessness, unpredictability of the future, a lack of values, isolation from others, and self-estrangement.<sup>23</sup>

In order to study anomie and alienation we included questions from German surveys in the questionnaire of the 1993 household panel survey. We again found that with most questions anomie and alienation seems to be more widespread in Hungary than in both parts of Germany (with the exception of loneliness), and that these manifestations of anomie and alienation are almost always more prevalent among the poorer parts of society (the exception is a lack of values or the breaking of rules).

It might be assumed that a modern market economy and democratic political system needs self-confident, enterprising, innovative members of society, who are rationally planning their future and dealing with everyday problems, and who are willing to respect the norms of behaviour of modern business and democratic politics. Therefore anomie and alienation might be the deepest and gravest obstacles of the modernization of the Hungarian economy, society and politics. If anomie and alienation are in fact correlated to poverty in Hungary, then poverty has very wide-ranging consequences for future development.

### *VII. Conclusion: The Impact of Poverty on the Medium-term Development of Hungarian Society, and the Ways to Alleviate Poverty.*

The growth of poverty is clearly influencing all dimensions of the development of Hungarian society. It threatens to pauperise the lower middle strata and even the "middle-middle" strata, the families in the 3rd-7th income deciles, that are potentially the most important supporters of the market economy, democracy and the politics of transformation. It causes very widespread dissatisfaction and disenchantment with the present situation, and potentially with the changes initiated by the transition regime in 1989-1990 as well. It might also be feared that a deeply disenchanted society will not develop the civic culture needed for a well-functioning modern market economy and democratic political system. In rather simplified terms, the question is whether support for the transition to a market economy and democracy can last before the tendencies of increasing poverty are stopped and living conditions of the poorest part of society begin to improve.

The key to future changes of poverty is obviously the development of the economy. Poverty will not disappear soon, but will be alleviated if the economic crisis is ended and the GDP begins to grow. Various future economic scenarios are current today in Hungary: from continuing decline through stagnation to a "realistic optimistic" scenario,<sup>24</sup> which foresees the GDP growing by 3.0-3.5 per cent per year beginning in 1997. In 1994 the GDP already increased by about 2.0 per cent. The main goal therefore should be to create the preconditions of continued growth of the economy.

In the meantime the social safety net provided by the welfare system has an important role to play. Unfortunately the welfare system inherited from the state socialist period is

<sup>23</sup> M. Seeman, "On the Meaning of Alienation," *American Sociological Review* 24 (1959), pp. 783-791.

<sup>24</sup> É. Ehrlich, G. Révész, *Hungary and its Prospects 1985-2005* (Budapest, 1995).

far from adequate to handle the present problems. It was rather expensive, and had a built-in tendency of ever-increasing social expenditures, which indeed occurred for many years and especially since 1989.<sup>25</sup> By the end of the state socialist period, there were no unemployment benefits and few resources for the social assistance of the poorest Hungarians. The monetary and particularly the "in kind" benefits were far from targeted to the poorest part of the population, and indeed in some cases more benefits were provided to the affluent parts of society than to the poor (e. g. in housing). Some types of social expenditures encouraged a squandering of resources (e. g. in the health system), and others counteracted the market forces (e. g. in the domain of state-owned low-rent dwellings).

Hence a social safety net is on the one hand absolutely necessary, while on the other hand the inherited welfare system needs thoroughgoing reforms. The alternative reform proposals should be studied carefully, and their impact documented. We must also be aware of the fact that the implementation of every reform will encounter serious obstacles and resistance among parts of society, for it will necessarily not be in the short-term interests of some social groups.

Below is a summary of the recommendations of a paper we wrote for the Joint Hungarian International Blue Ribbon Commission.<sup>26</sup>

1. Gradual raising of the retirement age to 65.
2. Inflation protection of pensions only to retirees past age 65.
3. Earlier retirement strictly restricted.
4. Private pensions and health insurance funds encouraged.
5. Child care allowances and fees consolidated with upper limits. Family allowances included in the personal income tax base.
6. Local social assistance to poor families extended.
7. Investigate the possibility of a tax-based family support system.
8. Sick pay should be the responsibility of employers.
9. The social insurance fund should be responsible only for long-term illnesses.
10. Paid sick leave limited to maximum 35 days per year.
11. Shorten the period of unemployment benefits to six months.
12. Reduce payroll taxes.
13. Means-tested locally administered social assistance extended.
14. Local governments should use the nationally provided social assistance funds only or social assistance.
15. Domestic religious and other voluntary associations ought to be encouraged to set up charitable and self-help organizations; international organizations should be asked for financial help.
16. Equal treatment of private practitioners and the state health service.
17. The number of hospital beds reduced.

<sup>25</sup> I. Gy. Tóth, "A jóléti rendszer az átmenet időszakában," *Közgazdasági Szemle* 41: 4 (1994), pp. 313-340.

<sup>26</sup> R. Andorka, A. Kondratas, I. Gy. Tóth, "Hungary's Welfare State in Transition: Structure, Initial Reforms and Recommendations," *The Joint Hungarian-International Blue Ribbon Commission Policy Study* 3 (1994), p. 77.

18. Public preventive health programs in consumer education, healthy life styles, self-care.
19. Co-payments for medical care introduced, and "gratuity money" paid to the health personnel abolished.
20. Improvement of management of health institutions.
21. Cost-monitoring system in education introduced.
22. School flexibility and local autonomy in education.
23. Tuition fees in higher education. Open access to education assured.
24. Information on projections of manpower needs.
25. Price increases for rent-controlled housing. Rent support for low-income families. Construction of new housing earmarked for low-income families.
26. Support to local authorities from the state budget only if they follow the targets of government housing policy.
27. Strong eviction rights, foreclosure and complete price-setting freedom in the private housing market. Limits on these rights in the public housing market.
28. Promote a new housing credit system and mortgage instruments.
29. Permanent organization to develop and implement social policy with particular emphasis on anti-poverty measures.

I would not dare to predict whether the "realistic optimistic" scenario of slowly catching up with the Western European level of economic development, or at least returning to the "historical" level of "backwardness" (about two-thirds of the level of the Austrian economy), will be achieved, nor whether the social policy reforms will be implemented and be able to protect the losers of the transformation from durable and therefore hopeless pauperisation. The future of the social structure of Hungary therefore seems to be an open question: it might develop into a fundamentally unequal society, with a small affluent elite and a permanently poor and underprivileged mass, or into a "middle-class society," where individuals and households are ultimately able to improve their conditions even if they become temporarily poor in terms of income.

**Table 1. The main macrostatistical data on the Hungarian economy, 1989-1994**

<b>Year</b>	<b>Real wage per wage- earner 1989=100</b>	<b>GDP 1989=100</b>	<b>Employ- ment<sup>*</sup> 1989=100</b>	<b>Unemploy- ment rate, per cent</b>	<b>Real income per capita of population 1989=100</b>	<b>Real per capita consumption 1989=100</b>	<b>Consumer price index 1989=100</b>
1989	100	100	100	0.3	100	100	100
1990	96	96	99	0.4	98	97	129
1991	90	85	96	1.9	96	92	174
1992	89	81	86	7.8	94	91	214
1993	85	79	78	13.2	89	92	262
1994	91	81	74	11.0	92	-	312

<sup>\*</sup> Persons having a working place where they earn income, not including the persons on child care allowance and child care fee.



**Table 2. Decile distributions: the share of per capita income deciles of persons in total personal income, 1962-1987**

<b>Decile</b>	<b>1962</b>	<b>1967</b>	<b>1972</b>	<b>1977</b>	<b>1982</b>	<b>1987</b>
Lowest	3.9	4.0	4.0	4.5	4.5	4.5
2	5.6	6.0	5.9	6.3	6.0	6.0
3	6.5	7.1	7.0	7.3	6.9	6.9
4	7.6	8.0	7.9	8.1	7.7	7.7
5	8.6	8.9	8.8	8.8	8.5	8.5
6	9.7	9.9	9.8	9.6	9.4	9.4
7	11.0	10.9	10.8	10.7	10.5	10.5
8	12.3	12.2	12.1	11.9	11.8	11.8
9	14.6	14.0	14.0	13.7	13.7	13.8
Highest	20.2	18.9	19.7	18.6	18.6	20.9
Ratio 10/1	5.2	4.7	4.9	3.8	3.8	4.6

**Table 3. Decile distributions: the share of deciles of per capita equivalent income in total personal income, 1992-1994**

Decile	1992	1993	1994
Lowest	3.5	3.7	3.4
2	5.6	5.6	5.4
3	6.6	6.6	6.3
4	7.4	7.4	7.3
5	8.3	8.2	8.2
6	9.2	9.1	9.1
7	10.3	10.1	10.2
8	11.7	11.5	11.8
9	14.2	14.0	14.4
Highest	23.1	23.6	23.8
Ratio 10/1	6.55	6.40	7.05

**Table 4. Per capita household income of social strata, 1962-1987**

Head of Household	1962	1967	1972	1977	1982	1987
	per cent of national average per capita household income					
Manager and professional	154	140	150	142	127	125
Medium-level non-manual	128	122	115	108	107	117
Simple clerical	119	111	108	97	99	93
Skilled worker	109	103	100	99	99	102
Semi-skilled worker	95	92	89	93	92	88
Unskilled worker	82	86	86	86	84	81
Agricultural worker	87	101	105	104	95	90
Pensioner	84	81	83	91	98	94

**Table 5. Average per capita income of persons belonging to different social strata, 1993 and 1994**

Social stratum	Per capita income in per cents of the national average <sup>1/</sup>		n/1994/=
	1993	1994	
Manager	162	184	143
Professional	140	156	240
Supervisor	114	138	121
Clerical non-manual	120	118	381
Self-employed artisan, merchant	122	121	168
Skilled worker	100	96	529
Non-skilled worker	90	88	527
Peasant, agricultural worker	85	83	116
Old age pensioner	96	101	1165
Widow pensioner		78	148
Disabled pensioner	87	80	261
Mother or child care allowance	83	70	186
Unemployed	78	74	226
Housewife and other dependent adult	68	68	310
Total aged 16+	100	100	4995 <sup>2/</sup>

<sup>1/</sup> Average of persons aged 16+ .

<sup>2/</sup> The 346 students aged 16+ and some minor categories, like casual workers, whose number in the sample was lower than 100, were omitted from the table, but are included in the total, i. e. the average income of the population aged 16+ .

**Table 6. Poverty rates of persons in case of different poverty lines, 1992-1994**

<b>Year</b>	<b>Below the subsistence minimum</b>	<b>Below 50 % of the average income</b>	<b>Below the pension minimum</b>
per cent			
<b>1992</b>	21.5	10.1	5.2
<b>1993</b>	24.0	10.4	5.4
<b>1994</b>	31.8	11.6	6.7

**Table 7. Poverty rates of persons in case of different poverty lines by age groups, social strata and ethnic groups, 1994**

Age, social stratum, ethnic group	Below the subsistence minimum	In the lowest quintile	Below 50% of the average income	Below the pension minimum	n =
	per cent				
<b>Age groups:</b>					
0-2	54.5	38.1	22.8	15.0	144
3-6	41.8	29.2	11.7	6.8	312
7-14	42.3	31.4	16.4	9.5	642
15-19	41.5	29.9	15.9	10.5	447
20-29	34.5	18.8	9.5	4.7	794
30-39	36.4	24.7	13.4	8.1	796
40-49	31.3	18.4	9.3	4.4	778
50-59	28.3	13.8	11.3	7.5	668
60-69	16.1	7.6	7.4	3.7	711
70+	16.7	10.2	9.1	4.9	587
<b>Social strata:</b>					
Manager	7.4	5.7	2.8	1.9	143
Professional	10.6	2.1	1.0	1.0	240
Supervisor	5.8	2.2	0.0	0.0	121
Clerical	19.6	8.1	4.2	3.2	382
Self-employed	32.6	22.3	13.8	7.2	168
Skilled worker	24.8	11.6	4.0	1.0	529
Non-skilled worker	34.6	19.4	7.1	2.3	527
Peasant	39.5	26.0	11.7	3.6	116
Unemployed	55.5	37.6	26.6	17.9	226
Child care allowance	51.7	35.5	17.2	11.1	186
Old age pensioner	15.9	8.5	6.7	3.7	1165
Disabled pensioner	48.7	24.8	13.8	6.5	261
Widow pensioner	33.7	14.0	19.2	8.1	148
Housewife	56.4	44.6	31.8	22.8	103
Other adult dependent	53.7	37.5	28.2	16.9	207
Student	36.5	25.1	9.6	4.7	346
<b>Ethnicity:</b>					
Non-Gypsy	28.4	16.3	8.5	4.2	5743
Gypsy	86.7	73.0	56.1	43.3	277
<b>Total population</b>	<b>31.8</b>	<b>20.0</b>	<b>11.6</b>	<b>6.7</b>	<b>5877</b>

**Table 8. Poverty rates of households in case of different poverty lines by household type, number of children, residence, unemployment of household head and ethnicity, 1994**

Household type, no. of children, residence, unemployment of head, ethnicity	Below the subsistence minimum	In the lowest quintile	Below 50% of the average income	Below the pension minimum	n =
	per cent				
<b>Household type</b>					
One person	19.7	23.3	9.4	4.7	473
Couple	12.0	9.6	6.0	3.8	438
Couple with children	34.7	17.9	11.2	6.4	821
One parent with children	43.2	26.6	12.6	9.0	163
Three generations	43.9	22.5	10.3	6.4	66
Other	31.3	23.8	14.0	5.5	121
<b>Number of Children</b>					
No child	18.3	6.8	8.5	4.7	1259
1 child	37.2	17.4	10.3	6.2	347
2 children	37.0	21.6	8.4	4.6	329
3+ children	62.5	53.2	29.5	17.6	124
<b>Residence</b>					
Budapest	11.9	7.2	2.8	1.3	358
Bigger town	25.7	16.2	6.5	4.3	299
Smaller town	30.5	18.9	12.4	7.6	620
Village	31.4	24.3	12.6	6.4	816
<b>Household head</b>					
Unemployed	63.5	39.7	27.6	19.1	103
Not unemployed	25.1	17.5	9.1	4.9	1990
<b>Ethnicity</b>					
Gypsy	82.5	67.0	49.4	39.1	65
Not Gypsy	24.6	15.8	7.5	3.5	1959
<b>Total households</b>	<b>27.1</b>	<b>18.6</b>	<b>12.6</b>	<b>6.4</b>	<b>2093</b>

**Table 9. Frequency of poverty of persons during the three years of the Hungarian Household Panel Survey, 1992-1994, in case of different poverty lines**

<b>Frequency of poverty</b>	<b>Below the subsistence minimum</b>	<b>In the lowest quintile</b>	<b>Below 50 % of the average income</b>	<b>Below the pension minimum</b>
Never poor	58.0	66.6	81.6	89.3
Poor in 1 year	19.5	16.7	11.7	7.7
Poor in 2 years	12.4	9.6	3.7	2.4
Poor in 3 years	10.2	7.1	3.1	0.6
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>

**Table 11. Transition of individuals between income deciles from 1993 to 1994, percentage distribution of members of deciles in 1994 by decile position in 1993**

Decile in 1993	Decile in 1994										Total
	Lowest	2	3	4	5	6	7	8	9	Highest	
Lowest	59.4	18.3	13.9	2.6	1.1	0.5	2.4	1.1	0.5	1.6	8.9
2	13.0	35.0	23.2	10.7	5.9	3.3	0.9	1.7	2.6	0.9	9.7
3	10.3	17.9	26.1	20.3	11.2	10.3	2.6	4.4	1.3	2.6	10.6
4	4.8	9.0	11.3	23.8	25.2	8.2	7.5	4.9	4.2	0.8	10.0
5	4.6	5.8	6.6	15.7	24.0	18.2	17.6	4.7	3.9	0.7	10.2
6	7.6	4.0	5.6	10.1	10.1	21.3	17.5	16.2	3.9	4.1	10.1
7	2.2	3.3	6.7	9.1	10.9	22.6	17.6	17.3	10.2	4.2	10.5
8	3.1	3.6	3.3	4.8	5.3	8.9	17.8	23.7	18.8	11.5	10.2
9	3.1	0.7	1.2	2.9	4.6	4.8	13.3	17.2	30.6	18.5	9.8
Highest	0.9	2.4	2.1		1.6	1.8	3.3	8.7	24.0	55.2	10.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
n =	500	553	520	540	536	548	554	552	560	535	5397



**Table 12. Outflow from poverty in one year, 1992-1993 and 1993-1994, in case of the 50 per cent of the average income poverty line**

<b>Outflow rates from the income category below 50 per cent of the average</b>	<b>From 1992 to 1993</b>	<b>From 1993 to 1994</b>
Remained below 50 per cent of the average	44.3	55.2
Climbed from below 50 per cent of the average to between 50 and 60 per cent of the average	11.7	22.9
Climbed from below 50 per cent of the average to above 60 per cent of the average	41.0	21.6
<b>Total poor</b>	<b>100.0</b>	<b>100.0</b>

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**Table 13. Frequency of poverty of persons, in case of the poverty line of the lowest quintile, by age groups, social strata and ethnic groups, 1992-1994**

Age, social stratum, ethnic group in 1994	Poor in 3 years	Poor in 2 years	Poor in 1 year	Never poor	Total
<b>Age groups</b>					
0-2	17.2	20.4	11.5	51.0	100.0
3-6	12.7	15.2	25.0	47.1	100.0
7-14	13.0	15.1	16.5	55.5	100.0
15-19	11.8	12.5	19.9	55.8	100.0
20-29	7.6	10.7	19.2	62.5	100.0
30-39	8.1	10.6	18.5	62.9	100.0
40-49	6.2	9.6	16.2	68.0	100.0
50-59	4.6	6.8	11.1	77.4	100.0
60-69	2.0	3.7	12.2	82.1	100.0
70+	2.2	5.7	17.8	74.3	100.0
<b>Social strata:</b>					
Manager	2.0	2.1	6.1	89.8	100.0
Professional	0.0	0.0	9.3	90.7	100.0
Supervisor	0.0	1.1	12.9	86.0	100.0
Clerical	1.3	3.7	15.3	79.8	100.0
Self-employed	6.3	7.1	26.7	59.9	100.0
Skilled worker	2.8	6.6	15.7	74.9	100.0
Non-skilled worker	4.5	11.1	20.8	63.6	100.0
Peasant	5.5	21.0	16.7	56.7	100.0
Unemployd	18.6	14.8	19.7	46.9	100.0
Child care allowance	12.5	18.5	23.2	45.8	100.0
Old age pensioner	1.5	3.4	13.1	82.0	100.0
Disabled pensioner	11.4	16.4	14.9	57.4	100.0
Widow pensioner	5.3	9.2	25.4	60.1	100.0
Housewife	21.9	19.8	18.4	39.9	100.0
Other adult dependent	16.4	22.3	14.2	47.1	100.0
Student	9.2	8.5	20.1	62.1	100.0
<b>Ethnicity:</b>					
Non-Gypsy	4.2	7.2	16.7	71.9	100.0
Gypsy	48.3	25.3	6.8	19.6	100.0
<b>Total population</b>	<b>7.1</b>	<b>9.6</b>	<b>16.7</b>	<b>66.6</b>	<b>100.0</b>

**Table 14. Dissatisfaction with selected dimensions of personal life and of the state of the society by income quintiles, 1993**

Dimensions of satisfaction	Quintile					Total
	Lowest	2	3	4	Highest	
Respondent's life hitherto	37.0	24.1	20.0	15.0	10.2	21.2
Level of living	54.3	39.9	36.7	31.3	23.2	36.9
Income	68.7	54.1	50.1	45.9	29.9	49.0
Future perspectives	55.0	45.0	42.4	36.4	28.8	41.5
Work, job	9.6	6.3	9.6	5.4	5.6	6.9
Dwelling	22.1	9.9	10.6	6.5	8.0	11.3
Housing environment	18.2	12.5	12.9	11.3	14.2	13.8
Family	6.1	4.4	2.7	2.2	4.3	3.9
Health	28.1	28.5	26.2	18.9	14.1	23.1
Kind and friends	6.1	5.6	3.7	3.6	2.3	4.2
Colleagues	4.5	3.4	5.9	4.5	2.3	3.9
Public security in Hungary	29.4	27.2	27.7	26.4	34.3	29.0
Natural environment in Hungary	27.5	26.8	28.2	25.6	39.2	29.4
Economic situation of Hungary	77.0	71.0	74.3	74.0	73.8	74.0
Possibility of citizens to have a voice in political decisions in Hungary	50.5	45.1	47.8	41.1	42.2	45.3

**Table 15. Symptoms of psychological stress, by income quintiles, 1993**

Symptoms of stress	Income quintile					Total population aged 16+
	Lowest	2	3	4	Highest	
	per cent					
Often exhausted	67.6	65.3	61.4	58.1	53.6	61.2
Always nervous, irritable	38.6	37.2	28.7	26.9	21.5	30.5
Unable to be eased from anxieties	27.6	24.0	18.1	16.5	13.4	19.8
Often worried about health	44.7	46.8	44.1	38.0	30.4	40.8
Usually feels unlucky	73.6	62.8	60.8	51.6	37.8	57.3
Gets confused when faced by several tasks in short time	38.6	32.6	30.6	23.1	19.4	28.8
Often strong headache	36.2	33.7	31.5	26.1	22.7	30.0
Frequent tremor of members	26.1	27.1	23.2	16.7	12.6	21.1
Frequent strong heart-throb	37.3	39.9	37.3	30.2	26.0	34.2

**Table 16. Manifestations of anomie and alienation by income quintiles, 1993**

Manifestations of anomie and/or alienation	Income quintile					Total
	Lowest	2	3	4	Highest	
In order to achieve something in your life, you have to break rules	41.7	39.8	39.1	39.6	39.3	38.9
Nowadays I am hardly able to find my way in matters of everyday life	32.8	29.8	26.2	19.5	15.8	24.7
I do not have confidence in my future	21.1	13.5	10.7	9.0	7.1	12.2
I am often helpless in important issues	21.0	17.5	12.7	10.1	7.6	13.7
I am hardly able to alleviate most of my worries	29.6	19.1	13.1	9.7	7.1	15.6
My own future mostly does not depend on me	17.2	11.9	14.6	10.2	9.1	12.6
I often feel lonely	21.7	13.6	13.2	10.2	9.1	11.8
I am not able to carry out what I decided	6.8	4.7	3.3	2.2	1.5	3.7
I am hardly able to influence my own fortune	28.4	17.6	15.4	12.5	9.9	16.7
I am not able to solve my problems	21.8	11.0	8.6	4.5	3.2	9.7

ZSUZSA FERGE

**Is the World Falling Apart?  
A View from the East of Europe**

*1. The "Global" Background*

For decades talk was about convergence - for instance, between the first and the second, or the first and the third world. It was not always very clear what was converging, but, since Fukuyama's influential book on the end of history, there seemed to emerge a sort of consensus suggesting that the focal point of convergence (or the ultimate design of history) was the liberal market economy. The collapse of totalitarian state socialism<sup>1</sup> seemed to justify this view insofar as the newly liberated societies all started to move towards a liberal democracy and a market economy, or at least had a reform movement endorsing this objective.

It might have been assumed that convergence would not limit itself to the "shell" or form of the societies involved, but would affect substantive issues such as the role or the rule of law, the way of preserving freedoms, and the quality and standard of living (even if nobody was naive enough to believe that a significant improvement could be expected in human relationships or in moral matters).

What may be observed in reality is a more complex, multi-faceted movement. There are tendencies of globalization, including global issues, global movements, global organizations. This seems to be particularly true in the case of the economy, where a supranational market is developing, complete with international and supranational agents, agencies and institutions, entailing world-wide competition on a global market. The globalization process is, however, lopsided. The ideal type of a democratically organized nation-state has become, during the last century, a field of forces where the state (political power), the market, and "civil society" held each other in check in order to correct the failures of each, and especially to prevent domination of one sphere or one logic over all the others. This monolithic domination is captured by Habermas' term when he refers to the "colonization of life-world", hinting at the unbridled domination of the market over other spheres. Also, Bolshevik totalitarianism represented a system in which only political logic and interests prevailed, enslaving all other subsystems. On the global level, however, the relative equilibrium of the three large spheres (market, politics, civil society), which has some chance to prevail on the national level, is missing. The countervailing forces of the market - "international governance" and international

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<sup>1</sup> These systems are widely called communist societies, and the present stage is hence named post-communist. Since in my view those societies were not communist in any proper sense of the world, I do not follow the common practice here.

civil society - are weak, underdeveloped or non-existent. The comparison of the efficiency of the U.N. and the IMF may illustrate this point.<sup>2</sup>

Alongside the said process of globalization and the integration of the world economy, tendencies of fragmentation, polarization or disintegration are also gaining ground. As Norbert Elias put it: "Human beings are at present involved in an immense process of integration which not only goes hand in hand with many subordinate disintegrations but can at any time give way to a dominant disintegration process."<sup>3</sup> Disintegration may take different forms and may be triggered by varied causes. One of its aspects is the increasing income gap between the groups of more or less "developed" or developing countries. The scarcity of resources, in its turn, determines the chances of any given country to join the mainstream, as well as the chances of the population of that country to lead a life which is presented (by the global media, among others) as worth living.

The Social Summit of the United Nations, which met in March 1995, dealt extensively with the plight of the Third World. The reason for this preoccupation is clear, based on the most rudimentary statistics: the destitution of the majority in those countries defies the imagination of most of those who only read, write or talk about it. A relatively recent publication of two supranational agencies presented detailed data on 127 out of the some 200 countries now in existence (out of which 70 are very small or are unable to produce reliable data.)<sup>4</sup>

The Earth now has 5.4 billion inhabitants: 3.1 billion, close to 60% of mankind, live in the 40 poorest countries, with a per capita GDP of USD 350 a year (and only around USD 100 in Mozambique, Tanzania and Ethiopia); 1.4 billion, around 26%, live in the 62 middle-income countries with a per capita GDP between USD 700 and 7000; and 0.8 billion (15%) in the 22 richest countries. In the last group, the average per capita GDP is USD 21,000, with Switzerland at the top, averaging USD 33,600 per head per year.

The bottom has, thus, about 300 times less than the top.<sup>5</sup> The implications are manifold. The average life span of the poor countries is 25 to 30 years less than in the richer countries; two-thirds of their adults are illiterate; famine looms large; infant mortality is high; the children are forced to start working at a very young age; children or young girls may be sold to the more fortunate; and so forth. The country studies presented at the Social Summit make for grim reading indeed. Of course, world-wide disintegration and the growing, now apparently unbridgeable gap between the center and the peripheries need complex explanations. This

<sup>2</sup> About their relationship see Bob Deacon, "Global Social Policy Actors and the Shaping of Post-Communist Social Policy," in Abram de Swaan, ed., *Social Policy Beyond Borders, The Social Question in Transnational Perspective* (Amsterdam, 1994).

<sup>3</sup> Norbert Elias, *The Society of Individuals* (Oxford, 1991), p. 165.

<sup>4</sup> *World Development Report: Investing in Health. World Development Indicators. Crisis in Mortality, Health and Nutrition*, The International Bank for Reconstruction and Development - The World Bank (New York, 1993).

<sup>5</sup> Ivan T. Berend (in this volume) highlights this same process with figures derived from different sources. His figures show in addition that the gap referred to above has increased enormously in the last century, and particularly in the last decades.

analysis could probably gain in depth if lopsided globalization (and its causes) were taken into account.

In addition, even in very poor countries, and in many (middle income) countries of Latin America, income inequalities within the country are far higher than in the first or the former second world. In the European region, East and West alike, at around 1990, the poorest fifth (lowest quintile) of the population got about 5 to 8 per cent, and the wealthiest quintile 35 to 45 per cent of the total personal income, which means a 5 to 8-fold difference between the two extreme groups. Meanwhile in countries like Tanzania, Kenya, Honduras, Panama or Brazil, only perhaps 2 per cent of all income found its way to the poorest fifth, while the richest fifth got over 60 % - 25 to 30 times more. And these extremes are very large groups; they represent 2 million out of 10 million. More refined data referring to the lowest and highest 1 or 5 per cent show even more staggering differences between rich and poor.

From a bird's eye view, compared to the predicament of the poor countries or of the poor in very unequal countries, one should not waste one's breath on the problems (if any) of the developed countries. Nor should one be too concerned about the countries of Central and Eastern Europe, whose troubles connected with their past and the transition are much discussed. After all, the per capita GDP in the transition countries is around USD 2500; their life expectancy is shorter "only" by 8 to 10 years as compared to the top group; and illiteracy is practically absent. The problem is that one cannot always stay high enough to have merely a bird's eye view. And, as one gets closer, there are disquieting tendencies in both West and East.

## *II. Changes in the West*

There are many signs of social disintegration in the developed market economies, such as the emergence of hard-core, long-term unemployment, increased homelessness, and the like. The usual explanation is economic crisis, or economic decline. Unfortunately, the explanation is to some extent flawed. Growth in all the high-income countries, if not always smoothly continuous, was positive between 1980 and 1991. In those 11 years, their already high GDP increased by close to 30 per cent. Admittedly, this growth is slower than in the golden decades after the war, but it is not decline, not even stagnation. While the yearly average growth rate was 2.3% in the high income economies, it was only 1.2% on the world level, and negative in many poor and middle income countries as well as in the former "socialist" group. However, the "trickle-down effect," which presumes that everybody is profiting from expanding resources ("what is good for the Rockefellers is good for everybody") is not necessarily forthcoming, not even in the wealthiest countries.

In the first three decades following the Second World War, the inequalities in income and consumption have decreased at an accelerating rate, with many positive ramifications in the quality of life, from radically decreasing poverty to increasing life expectancy. It is this tendency which seems to have reverted since about the

mid-Seventies. Between 1980 and 1991, in 11 countries out of the most affluent 18, income inequalities have increased.<sup>6</sup> The slow growth in income inequalities may have dramatic repercussions at the edges. Wealth is becoming more self-assured and self-justifying, and poverty may reach extremes unprecedented in the last half century, with tendencies of fatal marginalization. Up till now, the worst outcome seems to be the "consolidation" of a so-called underclass in the United States, a group with no present and no future, representing a constant danger to society and justifying increasingly harsh feelings and punitive welfare measures against the "undeserving" poor. To emphasize again, economic growth was significant in all of these countries. *In short: the rich countries did not become poorer; only their poor did.*

One can argue in many ways about this outcome. Economists are prone to justify it in terms of slowed-down (if not negative) growth, or of the sharpening of international competition, or foreign debts which require servicing. In their view, all these factors require and justify efforts to curb central redistribution. It seems to me, though, that political and psycho-sociological reasons are more compelling than economic ones.

In my reading, the main direct reason of the turnaround is the dissolution of the postwar welfare consensus alongside the emergence and the successful breakthrough of the New Right. Of course, the victorious march of the New Right, or in other words, the metamorphosis of the dominant values of the long postwar period, also needs explaining. This issue is extremely complex, and we do not yet know which factors have contributed to the seminal change in the spirit of the time. I shall merely venture to give some hunches that may also be of relevance for countries in transition.

The postwar consensus was partly based on the solidarity forged through common suffering of people during the war, and common privation after it. Such feelings cannot be passed on to the next generations: they faded away. The values of the French revolution, especially equality and solidarity - originally those of a bourgeois society - lost their attraction because, first, they were expropriated by the Bolshevik variety of "socialism," and then corrupted and discredited by it. This development weakened the drive of postwar western democracies to reconcile by various compromises the conflict-ridden relationship between equality and freedom. With the weakening, and then the collapse, of the "socialist" block, the challenge represented by it also waned away.

These changes in the basic values fueled a backlash on behalf of the taxpayers. They increasingly revolted against levies imposed on them which, on the one hand, covered services they needed less and less, having become affluent enough to pay for them on the open market; and which, on the other hand, paid bounties to those who were unsuccessful with the market, including the idle, the scroungers, all sorts of allegedly useless and undeserving creatures. In order to justify this revolt, a set

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<sup>6</sup> A. B. Atkinson, *Seeking to Explain the Distribution of Income*, STICERD Welfare State Programme Discussion Paper No. WSP/106 (London, 1994); Joseph Rowntree Foundation, *Inquiry into Income and Wealth Vol. I. II.*, chaired by Sir Peter Barclay (York, 1995).



of criticisms could be leveled against the welfare state. Government failures - heavy and overcentralized bureaucracies, the rigidity and impersonality of the services, the self-interest of the administration - were all pointed out, and they were often justified. It could be claimed that the welfare state, which was costing so much, was a failure: for instance, after all those years of heavy spending, poverty was still rampant. And inasmuch as it had successes (for example, in the very significant reduction of the extent and depth of poverty, as well as in the improvement of health, the educational level and the housing situation of the population or of human capital), the improvements could be attributed to factors other than public intervention. They could be presented as the "natural" outcome of economic growth, the "trickle down effect" itself.

Using the arguments above, the ascending forces demanded a restoration of the unfringed role of the market, a rehabilitation of the individual's autonomy to fend for him/herself, and, in order to accomplish this, a minimization of the role of the state (and of taxation). When Mrs. Thatcher pronounced her famous statement that "there is no such thing as society,"<sup>7</sup> she expressed these feelings without making explicit their implications for public matters. These implications are, however, momentous. If there is no society, it makes no sense to talk about the common or the public good, nor about the state's responsibility in these matters.

The new ideology has prompted vast efforts to cut back the welfare state, to pluralize, to marketize, to privatize, to reactivate the family's role in caring for its members, to stop one-sided largess where people (such as the long-term unemployed) are able to get something for nothing. Meanwhile, unemployment, even long-term unemployment, has become massive; homelessness appeared on a larger scale than ever before; and other forms of need, such as those of single mothers with children, have also spread. With growing poverty, social assistance had to escalate. But this is a very costly solution.

What is more, the age-old, and traditionally unwritten, law of reciprocity, the hazy but existing equilibrium between giving and taking, between rights and responsibilities, has lost its grounding. Long-term and massive unemployment, particularly when occurring at the beginning of people's working years, means that those entrapped in this situation will practically never have any opportunity to reciprocate for the assistance they get in order to survive. (Many of the migrants and single mothers are in a similar situation.) The traditional outcry of the proletariat - bread and work - appears to have lost its meaning. The need for bread remains, but the claim to work has lost its validity. The "right to work" as an enforceable right is apparently incompatible with free Labor markets, and is therefore void of sense. The responsibility to find work has thus been fully shifted to the individual.<sup>8</sup> But responsibility is a moral category. Whether the individual proved in a satisfactory way that he/she fully endorsed this moral responsibility and did everything in his/her power to find a job is not easy to determine. It is almost

<sup>7</sup> Peter Squires, *Anti-Social Policy. Welfare, Ideology and the Disciplinary State* (New York, London, Toronto, 1990), p. ix.

<sup>8</sup> Robert Castel, *Les metamorphoses de la question social. Une chronique du salariat* (Paris, 1995).

impossible to convince those who firmly believe that one can always find a job if one "really wants to work" that the missing factor is not the willingness to work but the job itself.

As a consequence, a double movement may be observed in Western Europe. On the one hand, the European Union increasingly feels the need (partly in accordance with social democratic and Christian democratic dispositions, partly because of solid facts about poverty) to compel the Member States to recognize the basic right of a person to sufficient resources and social assistance in order to be able to live in a manner compatible with human dignity.<sup>9</sup> On the other hand, because of the (apparently) definitive "decoupling" of bread and work (the right to life and the right to work), there is an increasingly vocal opposition to the unconditional assurance to the right to survival (i.e. assistance).

The second stance often seems to overpower the first. As a consequence, there are endless efforts to lower the standards of assistance, on grounds that high assistance is an additional disincentive to look for work, and to squeeze out from the rolls those deemed undeserving of community assistance because they are not doing everything in their power to help themselves. The United States is leading the way: in its newly proposed legislation, particularly in the Personal Responsibility Act, many forms of assistance may be transformed from rights to discretionary handouts, and the time a person may spend on assistance in his/her whole life may become severely limited.<sup>10</sup> This means that legislation will legalize absolute destitution, the complete lack of rights to even the most meager livelihood.

In other words, social rights seem to be increasingly shaky. According to Marshall's optimistic view in the fifties, social rights were to become as natural a part of the fabric of a modern market economy as civil and political rights, and were to promote "social citizenship," integration and participation. The opposite of this prediction may be closer to the truth.

Up to now, however, efforts to make significant welfare cuts remained, to a large extent, unsuccessful in the developed welfare states: welfare spending in practically all these countries has slightly increased or has remained unchanged. Moreover, the "big redistributive systems," universal and social insurance schemes, have had continued support from the electorate so that only the fringes were gnawed away. But the attacks have accomplished quite a few things. Among others, they made the Left, old and new, look outdated, and put it on the defensive. By the same token, they made the New Right respectable, and its ideas influential, at least among large and vocal segments of the citizenry.

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<sup>9</sup> *Council Recommendation of 24 June 1992 on Common Criteria Concerning Sufficient Resources and Social Assistance in Social Protection Systems 92/442/EEC, Official Journal No. L 245/46, 26 August 1992.*

<sup>10</sup> F. F. Piven, "Poorhouse Politics," *The Progressive*, (February 1995), pp. 22-25.

### *III. Countries in Transition*

#### (a) Bad timing of the transition.

The collapse of state socialism came too late, and not only because it meant that those living in it had to live too long in a bad political and economic system. From the perspective discussed here it came late because at its advent the welfare consensus was over, and the ideas of the New Right were gaining ground and respectability everywhere. At the time of the revolutions of 1956 (Budapest), or even of 1968 (Prague), the "left" values of the enlightenment could still play an important role, and "existing socialism" could be denounced as a sham and criticized as such in the name of "socialism with a human face." In the new international climate of 1990, this was no longer possible: the rejection of "existing socialism" had to go all the way.

It is not too hard to understand why many groups of the former totalitarian systems espoused so promptly and without reservation the systemic change which was based on the wholesale rejection of everything "socialist," and on the adherence to the most important tenets of the New Right. In the West, better-off groups started to rebel because, for instance, progressive taxation slightly harmed their interests. But Bolshevism violated former rights and firmly embedded age-old privileges incomparably more seriously. It wanted to annihilate the basis of existence, and often the physical existence itself, of all former elites and the owners of all forms of capital, physical or symbolic.

Since physical annihilation could not fully succeed, the survivors, or their descendants, started to recapture their former position. Various analyses<sup>11</sup> show that many of those who are now arriving at the top are coming from families which owned a significant amount of (real or symbolic) capital before the war. Their ranks were swelled by large segments of the technocratic elites of late state socialism, or by the entrepreneurs of the newly emerging black economy (if it was allowed to exist), who felt increasingly frustrated with the limited opportunities for economic competition and gain. Thus, all the above (often overlapping) groups - the heirs of the prewar elite, the new technocrats and the new entrepreneurs - were ready to accept a new system of values and a new ideology (redefining the respective roles of state, individuals and market, sanctioning the legitimacy of unfettered inequalities, etc.).

It would not be accurate to say that the whole population identified with this position. At the time of the fall of the old regime, there was undoubtedly mass support for the abolition of the former economic and political system. Still, all opinion polls suggest that pure capitalism, especially in its 19th century form, was

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<sup>11</sup> Rudolf Andorka, "A magyar társadalom: a múlt öröksége, a rendszerváltás problémái és a lehetséges jövőbeni fejlődés 2005-ig," *Valóság* (Budapest, 1995), pp. 2, 3; T. Kolosi, Iván Szelényi, Szonja Szelényi, Bruce Western, "Politikai mezok a posztkommunista átmenet korszakában. A pártok és társadalmi osztályok a magyar politikában, 1989-90," *Szociológia* (Budapest, 1991); Ivan Szelényi, *The Social Conflicts of the Post-Communist Transition* (Budapest, 1992).

not what the majority of citizens expected from the Velvet Revolution.<sup>12</sup> Their expectation corresponded, rather, to a market economy "that promises affluence with low levels of social inequality and unemployment - apparently a sort of Swedish welfare state written large."<sup>13</sup> It should not be forgotten that despite all its inhuman features and tragic failures, state socialism was not unqualified evil. Unlike its political or economic system, its social (societal) policy was not an artificial construct, forced in an inorganic way on the country. It had historical roots, popular support (probably the only subsystem for which this holds true), and it was an important factor of modernizing social relationships. By developing, and assuring access on a mass scale to the health system, to education and to stable incomes, it contributed to the eradication of practically feudal social distances, the very significant reduction of utmost poverty, and the development of human capital - thereby preparing the way to a relatively painless transition. Those who refer now to a "premature welfare state" (extended social services alongside low economic development) should certainly reflect on the following problem: what would have happened in those countries without (almost) universal human and social services to deal with pre-war levels of utter poverty and huge social cleavages, as well as prepare citizens for democracy and a modern economy? It should not be forgotten that the economic gap between East and West was large, but the social and political historical gap was probably even larger.

(b) Deterioration in social matters.

However, events took a turn different from social expectations. It is now recognized by practically everyone that the transition is more painful than anybody supposed it would be. This is true even if we ignore here the toll in death and suffering of ethnic conflicts and civil wars, the results of repressed hatred; of the driving force related to newly found identities; of reviving nationalism, or other, even more obscure causes. All countries are undergoing a period of deterioration of living standards and conditions. Data about the fall of production, the rate of inflation or of unemployment are widely known, and sometimes staggering. (The exception is the Czech Republic, which had the advantage of not having inherited foreign debts, and where, despite all the neo-liberal rhetoric, state involvement with the economy has remained significant up to the present, preventing wage liberalization, mass bankruptcies and large-scale unemployment.)

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<sup>12</sup> John Myles and Robert J. Brym, "Markets and Welfare States: What East and West Can Learn from Each Other," and Tatiana Zaslavskaja, "Prospects of Social Policy after Perestroika," in Zs. Ferge and J. E. Kolberg, eds., *Social Policy in a Changing Europe* (Boulder, 1992); J. Heinen, "Employment Policy and the Female Workforce in Poland: Yesterday and Today," in Stein Ringen and Claire Wallace, eds., *Societies in Transition: East-Central Europe Today*, Prague Papers on Social Responses to Transformation, Vol. 1 (Prague, 1993); Matild Sági, "Dismantling the Welfare State. (How the State Discards its Responsibilities)," paper prepared for the European Research Conference on "From European Societies to European Society: the National Welfare States and European Integration," St. Martin, Germany, November 22-26, 1993.

<sup>13</sup> Myles and Brym, "Markets and Welfare States," p. 29.

Studies about the human or social dimension of the aftermath of the transition are slowly becoming available. In one of them, it is stated that "The mortality and health crisis burdening most Eastern European countries since 1989 is without precedent in the European peacetime history of this century. It signals a societal crisis of unexpected proportions, unknown implications and uncertain solutions."<sup>14</sup> One tragic sign is the excess mortality of nearly 800,000 people, with the highest increase in mortality having been recorded for male adults in the 20-59 age group. The causes are manifold, but widespread impoverishment and social stresses are both of the utmost importance.

Unlike in the West, poverty did not evolve incrementally, but escalated rapidly. According to UNICEF, until 1991 the Czech Republic and Hungary experienced a relatively slow deterioration, while the rise was explosive in the other countries, particularly in the case of children. (Romania is also an exception in the sense that the situation was already very bad in 1989.) The relative advantage of Hungary has probably diminished from 1993 on. Since then, the downward shift of the middle strata has accelerated; and the poor, having exhausted their physical and mental reserves, have become poorer.

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<sup>14</sup> Cornia in UNICEF, *Central and Eastern Europe in Transition: Public policy and Social Conditions: Crisis in Mortality, Health and Nutrition, Economies in Transition Studies, Regional Monitoring Report No.2 (August 1994)*, p. v.

**Table 1. Estimates of poverty in the countries of Central and Eastern Europe  
(in % of the relevant population) 1989-1992**

	1989 (Bulgaria=1990)	1992 (Hungary=1991)
<b>Bulgaria (Poverty line = 45 % of 1989 average wage)</b>		
Total population	13.8	53.6
Adults	11.0	53.7
Children	17.7	59.9
<b>Czech Rep. (Poverty line = 35 % of 1989 average wage)</b>		
Total population	4.2	25.3
Adults	4.4	22.6
Children	4.2	38.3
<b>Hungary (Poverty line = 40 % of 1989 average wage)</b>		
Total population	14.5	19.4
Adults	12.3	18.5
Children	20.6	27.0
<b>Poland (Poverty line = 40 % of 1989 average wage)</b>		
Total population	24.7	43.7
Adults	19.7	40.1
Children	32.3	61.8
<b>Romania (Poverty line = 45 % of 1989 average wage)</b>		
Total population	33.9	51.5
Adults	29.8	47.2
Children	41.2	62.8
<b>Slovakia (Poverty line = 40 % of 1989 average wage)</b>		
Total population	5.8	34.1
Adults	4.2	27.0
Children	8.8	51.1

(Source: UNICEF, 1994, p.2)

The basic gain of the transition is freedom in many meanings of the term. It seems, though, that the gain in freedom does not counterbalance the losses - at least for some time and for a significant proportion of citizens. One of the first losses was the wholesale delegitimation of the past practiced by most first governments. The social and psychological consequences of the "social amnesia" forced on people are complex and diverse. The loss of individual and collective historical roots creates a cultural vacuum undermining people's sense of continuity. (This was all the more so because it happened for the second time in the life-spans of many. The Bolshevik regime conducted precisely the same practice in relation to the system it overthrew.) And if the history of one or two generations is wiped out, the identity of those affected, the meaning of their lives, is called into question. The delegitimation of all professed values of the former system leads to a psychological vacuum

and creates grave anxieties. In the former Soviet Union, the loss of empire, and the national pride connected with it, adds to this turmoil.<sup>15</sup>

On top of the unexpected psychological trauma came the loss of basic, existential securities. Whether there was a so-called shock therapy or not in a given country, practically all of them have gone through the shock of the collapse, or of the fundamental change, of various institutions including health, education, or the ownership structure (hitting closely, for instance, former members of agricultural cooperatives); that of suddenly high unemployment; of two or three digit inflation; of the weakening or loss of the calculability of the future of children; or the increasing inability of maintaining one's current residence or making ends meet. The erosion of all these securities, combined with the rapid deterioration of public safety, aggravated stress to a significant degree.

UNICEF has collected in 9 countries 29 indicators on the quality of life, ranging from school enrollment to mortality rates. Out of these, only two indicators show consistent improvement (maternal and 1-4 year olds' mortality rate). By contrast, 72 per cent of all collected indicators reflect a usually significant deterioration. In some cases, the downturn may be seen as a "normal" and direct consequence of impoverishment (which may occur everywhere with economic decline), such as the decrease in calorie intake, or even the spread of tuberculosis. But in most cases poverty alone cannot explain the new troubles, and certainly not in such a short time span. Indirect consequences, such as the rapid drop in nuptiality and fertility, and the equally rapid rise in mortality in general and in violent deaths (suicide and murder) in particular, point to a tragic weakening of the joy of, or interest in, life, of the value attached to life in general, both of self and of others. In Cornia's words, there is a "social adaptation crisis." Out of its many components, I would emphasize the sense of loss, fear of the future, and a lack of hope about a not-too-distant better future among a sizable minority.

### (c) Responses to increasing needs

The remark that the transition came too late implies also that new troubles are not being addressed at the proper time, in the proper way, and with adequate instruments - mostly because of the world-wide change in the ideological tide. As already stated, the reality of social policy has changed far less in the vast majority of the Western countries than what has been called for by the New Right. But the voice of the advocates of the new trends reverberates much more strongly than that of the majority trying to defend its solidaristic institutions. The divergence between mass aspirations and practical politics in a democratic society is a well-known problem even in the West, but it cannot be treated here in detail.<sup>16</sup>

Over and above the West, whose support was strongly hoped for, and is largely missing, two actors could offer significant help in the transition countries: the state

<sup>15</sup> Ian Crawford and Alan Thompson, "Driving Change: Politics and Administration," in Nicholas Barr, ed., *Labor Markets and Social Policy in Central and Eastern Europe, The Transition and Beyond* (London, 1994).

<sup>16</sup> See, for instance, Elias, *The Society of Individuals*.

and the community or civil society. But because of the pervasive new ideology, the state is trying to withdraw from its former responsibilities, or those responsibilities that have been endorsed by Western welfare states. The slogan of the "minimal state," strongly advocated by the strongest supranational agencies, implies that citizens should cope on their own as much as possible, turning to the state only "as a last resort." In practical terms this means, on the one hand, that former universal benefits (such as the family allowance) are increasingly abolished and transformed into means-tested benefits and "last resort" assistance. On the other hand, social insurance - essentially pensions and health care - is being scaled down both in coverage and standards. Those who fall out of its coverage should also turn to assistance or help from the community (family, the NGO sector). Those who are dissatisfied with the low standards should turn to the market.

Indeed, one of the alternatives offered is the market. The switch from asphyxiated central planning to a market economy has been a prime objective of the transition. In case of many needs, the market is in fact the adequate tool of need satisfaction, and indeed "delivers the goods" in real as well as figurative terms. It is also a good solution for the 10 to 20 per cent minority who have been the real beneficiaries of the transition, and who are now able to pay extravagant prices for services which used to be public, such as private health care, private schools, or private pension insurance. A growing number of the remaining 80 per cent are unable to pay even decent market prices. This problem is exacerbated because price subsidies have been abolished, so that, with liberalized foreign trade, the consumer price level is almost on par with that of the West, while wages and pensions have remained almost at their former, very low level. Thus, with escalating fees (for instance in child care institutions) and prices (in the case, for instance, of school books or drugs), and the closing down of institutions (in Hungary, for instance, close to 50 per cent of available places in the creches have disappeared), the number of those losing access to these goods and services is swelling.

The other alternative is the community or civil society. The new approach suggests that if people cannot help themselves, and if the state is not available, they should help each other on a much larger scale than they currently do. This help can take many forms, from individual alms-giving to organized self-help. Unfortunately, support on the scale required (even if sufficient goodwill was there) would be out of the reach of not only the (all too often invoked) family, but the entire informal, non-profit voluntary sector as well. The voluntary sector would be able to effectively pick up the functions discarded by the state if the state withdrew only as a service deliverer, but continued to finance the services that have thus been "farmed out." (Subsidiarity in Germany or the "quasi-markets" in Britain<sup>17</sup> are examples of this type.) Otherwise the voluntary sector would have to rely on private donations which are usually insufficient, and unevenly spread regionally or otherwise. This holds true even for the United States, a rich society with long traditions of civil movements. The countries in transition are not only poor and lacking many

<sup>17</sup> Julian Le Grand and Will Bartlett, eds., *Quasi-Markets and Social Policy* (Basingstoke and London, 1994).



of the virtues of an established democratic society, but also lack across-the-board solidarity which could be the basis of massive and non-demeaning help.

The paradox involved here is remarkable. The function of state social policy as it emerged, by and large, since the rise of capitalism has been to solve problems generated by the weakening of traditional communities (*Gemeinschaften* such as the family or the local community); by new risks related to an altered organization of production; and market failures including those of the insurance market.<sup>18</sup> These causes did not disappear. Still, *the state is now offering, as functional alternatives to itself, pre-social policy arrangements patently impotent to handle current difficulties.* The simple-minded explanations of this setback might be that the protagonists simply do not know the history of social policy. Less benevolent interpretations may suggest either that they have illusions about the potentials of alternatives offered, or they condone the social consequences that former social policy sought to avoid.

The sociological explanation of this paradox in the new democracies may be found, partly at least, in the social background of the new propertied class (already briefly described); in their ideological inclinations explained by this background; and in the long suppression of their interests. The new conditions allowed them to gratify their unfulfilled aspirations at last. Reliable data regarding the new distribution of wealth is missing, but privatization and new opportunities have already created both possessors of significant wealth and a mass of "have-nots." Income distribution data (albeit also rather unreliable because of the unusual proliferation of the non-legal economy) provides some tangible proof of the growing income differentiation. In Hungary, for example, the multiplier between the lowest and the highest income decile was 4.6 in 1988; the same indicator (derived from similar, but not fully comparable, data) amounted to 6.7 in 1992, and to 7.4 in 1994. The last figure is high even according to Western standards. Income inequality is not smoothly gradual. The gap between the poorest and the poor (the 1st and 2nd income decile) and that between the well-to-do and the rich (9th and 10th decile) have disproportionately contributed to the increase of income inequality, meaning that the distance between the two extremes and the rest of society is growing.<sup>19</sup>

The same tendency is illuminated by the increasing dispersion of salaries and wages, which also shows who may be winners and losers in more detail. The hierarchy of occupations did not change with the transition (an interesting fact in itself), but the difference between the averages of highest and lowest paid professional groups has grown from 2.5 in 1988 to over 4 in 1994. Again, the distance between the top and the average, and between the bottom and the average, have both increased. (See Table 2.)

<sup>18</sup> Nicholas Barr, *The Economics of the Welfare State* (London, 1987).

<sup>19</sup> Central Statistical Office, *Income Distribution in Hungary, 1988* (Budapest, 1990), p. 113; R. Andorka, T. Kolosi, Gy. Vukovich, eds., *Social Report, 1993* (Budapest, 1994), p. 58.

**Table 2. Personal income or salary of selected occupational groups**

	1988	1992	1994
	(CSO)	(T A R K I)	
<b>All wage earners</b>	<b>1.00</b>	<b>1.00</b>	<b>1.00</b>
<b>Top managers</b>	1.92	2.38	2.66
<b>Middle management</b>	1.36	1.74	1.71
<b>Professionals</b>	1.22	1.25	1.33
<b>Skilled workers</b>	1.00	0.86	0.85
<b>Unskilled workers</b>	0.76	0.74	0.66
<b>Top/bottom group</b>	<b>2.51</b>	<b>3.22</b>	<b>4.06</b>

(Source: Central Statistical Office, 1991, p. 24.; Andorka et. al., 1994. p. 60.)

The facts presented above point, then, to overall social deterioration and increasing inequality. The inequality is generated partly by old, partly by new structuring forces.<sup>20</sup> Out of these, power is more pluralistic, more democratic, and therefore less unequal than it used to be. Meanwhile, opportunities to accede to two other resource-generating structural relationships, namely ownership and knowledge, are becoming increasingly unequal. Access to relevant, marketable and convertible knowledge is likely to be more and more conditioned by the already available resources of the family. Chances of the acquisition of important private holdings are rapidly diminishing, because the third "original capital accumulation" is more or less over. This time it implies the expropriation of former state ownership, a large part of which was originally private. The new owners, as already suggested, come for the most part from the upper strata of the previous two regimes.

The new structuring forces, ideology and social policy do not offer much of a chance to those who are not heirs to any form of capital. Whether impoverishment and hopelessness will remain part of the landscape and ultimately lead to the formation of an "underclass,"<sup>21</sup> or whether the gap will be smoothed over and result in a "normal" unequal structure, is by now an open question. The way the question is formulated leaves some doors ajar for deliberate societal action to counteract the spontaneous social forces. But whether or not these opportunities will be used by the powers-that-be is also uncertain. (Deliberate state intervention seeking to curtail an expansion of market forces or the unbridled lust for gain of the new entrepreneurs is difficult because of two reasons: it goes against the new ideology and recalls the totalitarian system, which endeavored not only to restrain, but also smother, all spontaneous movements and the pursuit of individual interests.)

All in all, current trends are not reassuring in this respect. The danger of a fragmented society, and even of the formation of a marginalized underclass, looms large at least in some countries. The danger is sizable if there are ethnic minorities who are easily scapegoated (like the Gypsies in Hungary or Slovakia). An additional aggravating factor is the residualization of social policy, which, by "helping" only the poor, will increase the gap between rich and poor, strengthen intolerance

<sup>20</sup> See Zs. Ferge, "A Society in Transition," paper prepared for the forthcoming volume of the Active Society Foundation, Budapest, 1995.

<sup>21</sup> Michael B. Katz, ed., *The "Underclass" Debate, Views from History* (Princeton, 1993).

against the latter, and thereby gradually erode the levels of assistance. This scenario conducive to social tensions and ultimately to social disintegration is based, unfortunately, on historical precedents and sociological truisms, and therefore cannot be dismissed as a figment of one's imagination.

**(d) Popular feelings**

Without putting in doubt the necessity or the potential long-term advantages of the transition, the present outcome is not exactly what the majority in countries undergoing transition have bargained for. Of course, the worse the former system was, the greater the satisfaction is with the new one, but the current difficulties also have an obvious influence on opinions. According to preliminary, as yet unpublished, survey data, the degree of satisfaction, in declining order, is the following: former East Germany - Czech Republic - Poland - Slovak Republic - Hungary. The ratio of those assessing the new system as being better than the former one is between 50 and 60 per cent in the two most satisfied countries, but much lower in the other three. (See Table 3)

**Table 3. Percentage distribution of the opinions about comparing the past and the present regime (February, 1994)**

The present	Czech. Rep.	Poland	Hungary	Germany (East)	Slovak. Rep.
Much worse	9.4	18.4	25.8	5.4	23.3
Slightly worse	14.0	20.6	25.2	13.9	27.9
Same	18.9	17.1	22.6	24.1	16.4
Slightly better	34.3	32.8	21.2	41.1	27.4
Much better	23.4	11.1	5.2	15.5	5.1
<b>Total</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
n=	979	1011	939	1038	976

(Source: Survey on Social Consequences of the Transition (SOCO), carried out under the auspices of the Institute of Human Studies (IWM) in Vienna, directed by the present author and Endre Sik.)

Incidentally, it is repeatedly confirmed by survey data that Hungary, after having been the "most cheery barrack in the camp," has now become the most gloomy one. The easiest but probably not entirely false explanation is that the Hungarians might have been the best prepared for the economic and political transition, expected the most from it within a short time, and were deeply deceived on all accounts.

The gloom does not envelop everybody equally, however. A Hungarian survey shows that the majority of the best qualified, and among them the entrepreneurs, do feel that they have gained from the transition, and are optimistic about the future. Without going into a thorough analysis of the detailed data, it may be interesting to point out that, first, evaluations made in 1993 are very close to those gathered in Hungary in the early eighties. In both instances the "Fifties" (the high point of Stalinism in Hungary) were judged as the worst period in the past, worse - in case of workers, too - than the pre-war system. In both cases the "Eighties" were

assessed as the golden age. The difference between the former and the present survey is that the future is now seen with more pessimism. Significantly, both unskilled and skilled workers think that their lot will be worse in the future than it was during the dark Fifties. (See Table 4)

**Table 4. The evaluation of the situation of the family in different historical periods, according to the head of household's socio-economic group (Mean of self-placement on a 7-point "ladder")**

	<b>Unskilled worker</b>	<b>Skilled worker</b>	<b>Lower white collar</b>	<b>Professional, manager</b>	<b>Total</b>
<b>Before the war</b>	2.75	2.97	3.48	3.29	3.09
<b>In the „Fifties“</b>	2.66	2.81	2.83	2.83	2.79
<b>Late Seventies/ Early Eighties</b>	3.56	3.81	3.91	3.87	3.79
<b>At present</b>	2.74	3.01	3.17	3.53	3.11
<b>In 3 years</b>	2.15	2.47	2.94	3.54	2.76
<b>n=</b>	130	217	93	156*	596

\* The group of self-employed or entrepreneurs was under 20, and therefore too small to be presented separately. However, all relevant data show consistently that they are more satisfied and more optimistic than the salaried professionals or managers. (Source: Panel survey 1991-1994, funded as Research 2140/90 by OTKA, carried out at the Department of Social Policy of Eötvös University, directed by the author.)

While Hungarians may be more pessimistic than others, such uneasy feelings or dissatisfactions are widespread in most countries, even in those that are at the spearhead of reform, where there is already a tangible positive outcome, and where social peace does not seem precarious. On the basis of the unpublished data of the ongoing IWM survey, some hunches may be offered as food for thought. The dismantling of the social security system is clearly unpopular: a vast majority in all the countries still firmly believes in state responsibility in many fields, not only in primary education, but also in health services, in guaranteeing decent pensions, or even in making jobs available for all. The between-country differences are rarely significant (albeit the Czech Republic gives almost consistently lower scores than the others). The rank-order of the responsibilities is practically identical in all the countries, with significant differences between domains. But even when the citizens endorse a high level of responsibility (as in case of the care and maintenance of small children, and with first homes), the share of the state still remains important. (The grading goes from 1 to 5. An equal sharing of responsibilities would yield an average of 2.5. All the means presented are significantly higher than 2.5.)

**Table 5. To what extent should the state endorse responsibility for some services**  
(Means of responses on a scale of 5 grades, 1=low, 5=high responsibility.)

Country	Health care	Child care	Primary educ.	Second. educ.	Higher educ.
Czech R	4.49	3.29	4.52	3.70	3.04
Poland	4.38	3.34	4.67	4.24	3.70
Hungary	4.41	3.55	4.30	4.15	4.03
Germany	4.61	3.65	4.50	4.41	4.22
Slovakia	4.58	3.57	4.50	3.89	3.27
All countries	4.50	3.48	4.50	4.09	3.66

Country	Costs of children	Decent pension	First home	Available jobs	Handicapped people
Czech R.	3.16	4.52	3.68	3.85	4.71
Poland	2.82	4.59	3.53	4.34	4.69
Hungary	3.68	4.64	4.21	4.49	4.43
Germany	3.81	4.72	3.24	4.57	4.55
Slovakia	3.33	4.70	4.03	4.37	4.65
All countries	3.36	4.63	3.72	4.33	4.61

The "overshoot" of the reforms is clearly observed in the case of income differentials, for instance. While only a small minority (10 to 20 per cent) think that income differentials were too high at the end of the Eighties, this is an opinion shared at present by 70 to almost 90 per cent of the interviewees, and the Czechs are no exception.

One set of data compares the importance attributed to various freedoms, and the extent to which they are assured. Another set does the same with various types of security. Some elements of the results are worth mentioning. While (according to some survey evidence) freedom was valued more than, or as highly as, security at around the time of the transition, by now the importance of all types of security is significantly higher than the various types of freedom. Regarding most kinds of security (especially income security, job security, the security of one's children's future), people feel that they are both of utmost importance and extremely threatened, and this feeling is shared by all countries involved. But, contrary to our expectation, they feel that the freedoms, particularly political ones such as freedom of the press or freedom of opinion, are not too secure either - even though freedoms are thought to be much less threatened than is security. The message is that it is not only the economy (or the market) which is not offering a solution to people's basic problems. Many feel that democracy, or the rule of law, is also somewhat shaky.

Finally, in all countries only a small minority expects an improvement of their income or social situation in the next three years, and a somewhat larger minority expects further deterioration. The underlying feeling of a significant part of the citizens may very well be that the new society is geared neither towards the improvement of conditions of the majority, nor towards an altogether more just and free society, but towards promoting the unfettered freedom and self-interest of those

who accept, adjust to, and are able to make use of the new opportunities, and who can use democratic freedoms to make the market operate to their advantage.

Of course, subjective feelings and conjectures about the future are not facts. They reflect moods, expectations or apprehensions. In some cases they may become self-fulfilling prophecies; in others they may increase tensions, or may represent a warning to the government that it must become more responsive to people's aspirations. There is much cause for concern about the future, though, even if we ignore the worst eventualities such as the escalation of civil wars, or the realization of threats of armed intervention to protect the rights of Russians living outside Russia.

One cause for concern is the current approach to economic and social policy. All the governments in power assume, and conduct their policies according to this assumption, that the restriction of internal consumption (and especially the scaling down of welfare redistribution) offers the only road to economic development. Central redistribution is a major target, because it is judged to be too high (percentage-wise, not in absolute terms) if compared to the developed countries with more secure economic growth. According to this tenet, economic development needs investment, and funds to invest can only be secured if consumption is curtailed.

The weakening and dismantling of welfare arrangements and social security are proceeding rather successfully despite popular discontent. Whether the funds thus released will promote economic growth and propel these countries in the direction of "Europe" is, to say the least, less sure. But one set of facts should not be neglected. There are in the world a few countries with high economic standards and a relatively good social welfare system. And there are, by far, many more which have neither economic growth, nor a social policy worth mentioning, and where, therefore, deep social cleavages, poverty and social disintegration loom large. The question is, what are the odds that with restrictive monetarism we'll manage to join the group of the happy few as opposed to joining the unfortunate many?

The second concern stems from the discrepancy between popular expectations and actual developments. In quite a few countries with already two elections, Poland and Hungary included, the citizens voted the second time for (more or less) reformed socialists in the hope of gaining back some of their lost security. The socialists - by themselves or in coalition with others - do not seem to be delivering the goods. The question is what will the citizenry's reaction be if their hopes are again deceived? There are few alternatives left. Out of them, right-wing (if not extreme) populism, is a possible answer - representing a genuine threat to the newly-won democracy, to many improvements that have been, or perhaps will be, gained from the collapse of totalitarianism socialism. These trends (possibly even with some economic growth) may produce a scenario that is usually called "Latin-Americanization".

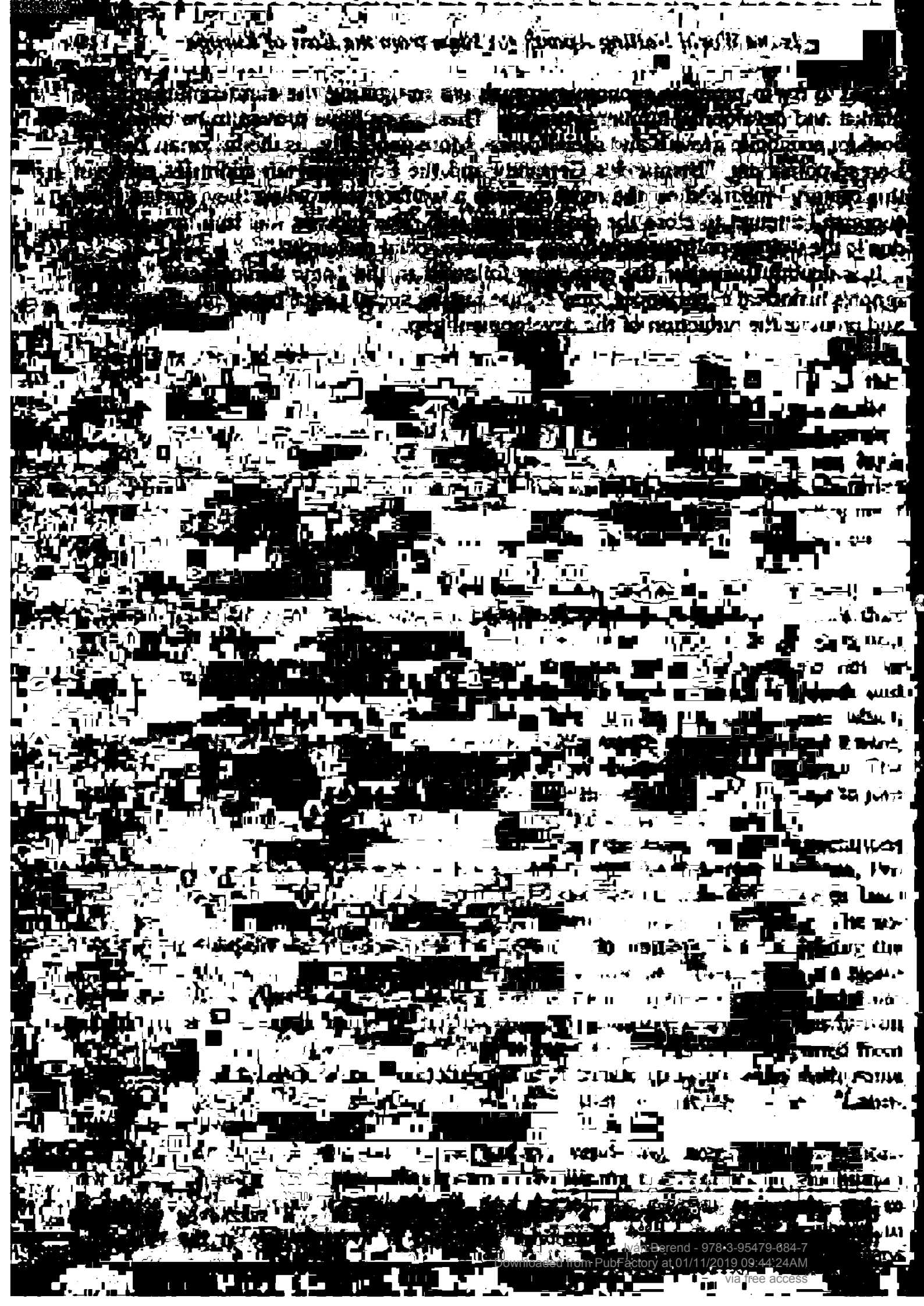
Also, with such a divisive social policy, rendering access to institutions developing human resources difficult and undermining social cohesion, the human factor underpinning economic growth and democratic politics is thereby put in jeopardy. Politics of this sort is in marked contrast with the efforts deployed in Western Europe after the Second World War, when governments and citizens

agreed to try to promote economic growth *via* mitigating the shortcomings of the market and developing human resources. These steps have proved to be beneficial both for economic growth and social peace. More generally, as the historian Ivan T. Berend points out, "Bismarck's Germany and the Scandinavian countries early in this century embarked on the road towards a welfare state when they started their successful attempt to close the development gap. The success was to a large extent due to the welfare politics mobilizing immense social resources."<sup>22</sup>

It is doubtful whether the path now followed in the "new democracies," which ignores historical experiences, may secure lasting social peace based on democracy, and promote the reduction of the development gap.

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<sup>22</sup> Ivan T. Berend, "Átalakulás a világgazdaság perifériáin - a századvég gazdasága történelmi perspektívában," manuscript presented at a conference at the Hungarian Academy of Sciences, April 1995.





PAUL MARER

## Comparative Privatization and Restructuring in Hungary, Poland, and the Czech Republic, 1989-1995

### *1. Legacies and Initial Conditions*

This chapter investigates one of the most difficult common problems of economic transformation: that of restructuring the three Central European (CE-3) countries, Hungary, Poland, and the Czech Republic. Occasional references are made to developments in the other Central and East European (CEE) transforming economies, as well as in Russia and China. Special attention is paid to the restructuring of state-owned enterprises (SOEs) because that large sector used to represent - and to a considerable extent, still does - the "core" of the economies of these countries.<sup>1</sup> Although many differences existed among these countries when fundamental systemic transformation began - differences rooted in their cultures, levels of development, historical experiences, and varied other initial conditions - state enterprises in all of these countries have been facing many similar problems.

One general common legacy of a centrally planned system was that of a *misdeveloped* economy. To be sure, all the countries on the periphery of developed Western Europe were both less developed and, to some extent, misdeveloped even before communism and central planning were introduced or imposed, as is discussed in the introductory essay by Berend. But central planning added new kinds of misdevelopment, with both structural and institutional dimensions.

To a large extent, these economies were insulated (i.e., protected) from the world market. Heavy industry was overdeveloped, both because of high rates of investment and military expenditures in final demand and because little effort was made to minimize inputs of fuels, raw materials and intermediate products. They typically used obsolete technologies, relying on imports from the West only in narrow areas and using old equipment until it fell apart. Consumer goods production was of low quality, unable to compete on world markets. To facilitate planning and to pursue often illusory economies of scale, production was concentrated in a small number of large, often monopolistic, firms, while the broad base of small, flexible, entrepreneurial firms generally found in Western countries did not exist. Foreign trade was oriented mainly among the Communist countries themselves, often for the convenience of the planning system, and trade with the West was driven by the need to fill shortages rather than occurring in response to comparative advantage. Prices, as well as production and distribution, were planned, and reflected neither world market valuation nor domestic opportunity costs.

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<sup>1</sup> This essay relies in part on the findings and conclusions of *Transforming the Core: Restructuring Industrial Enterprises in Russia and Central Europe* (Boulder, 1996), which I have co-authored.

The basic cause of misdevelopment at the macro-, mezzo-, and micro-levels was that economic strategies and enterprise decisions were largely driven not by market forces but by historical, ideological, political, and military considerations, as well as by the practices of central planning. (The term "misdeveloped" is not meant to suggest that central planning had only undesirable outcomes. Educational attainments, certain aspects of health care, and full employment were, from the point of view of welfare, some of the more positive features of central planning.) The main historical factor was the centuries-old desire of all of the CEE countries, as well as that of Russia, to catch up with the more developed West.<sup>2</sup> This was coupled with the transitory belief, or hope, of their rulers that Communism and central planning were the way to reach that goal.

State-owned industrial enterprises embodied certain basic features of misdevelopment. They typically had an inappropriately large size, wrong production profile and managerial incentives, excessive vertical integration (to reduce reliance on outside suppliers), skewed technological development and labor force skills, inadequate market orientation, and "soft" financing. Under the dramatically changed political and economic circumstances in which these countries found themselves at the end of the 1980s and early 1990s, restructuring their misdeveloped economies and enterprises could not be avoided. The only question was - and to some extent, still is - when and how restructuring would take place.

Restructuring policies are a function of country-specific initial economic, political and social conditions, which in turn shape the transformation strategies that the countries pursue. Generally, an economy will be more constrained and its transition more difficult, the more severe its misdevelopment, the less developed its market mechanism, and the greater its macroeconomic imbalances.

A rather impressionistic characterization of how these three groups of factors affected the degree of preparation for and the difficulty of the transition can be presented in simple, ordinal diagrams, which show the approximate relative position of the five countries for each group of factors.<sup>3</sup> Chart 1 plots the estimated relative position of the countries with regard to the degree of structural misdevelopment (i.e., how excessive the development was of the heavy industries relative to the economy's other sectors), which is shown on the vertical axis, and institutional preparedness for a market economy (i.e., whether, what type, and for how long reforms of the traditional central planning system had been introduced), which is shown on the horizontal axis. Not surprisingly, we find that these two sets of factors are highly correlated. Russia (the dominant unit in what was then the Soviet Union) was the most ill-prepared for the transition with respect to both structural and institutional factors. Next was the Czech Republic, while Hungary and Poland were in a much better position. China was structurally better off in 1979 than Russia was in 1989, though its institutional development was at least as

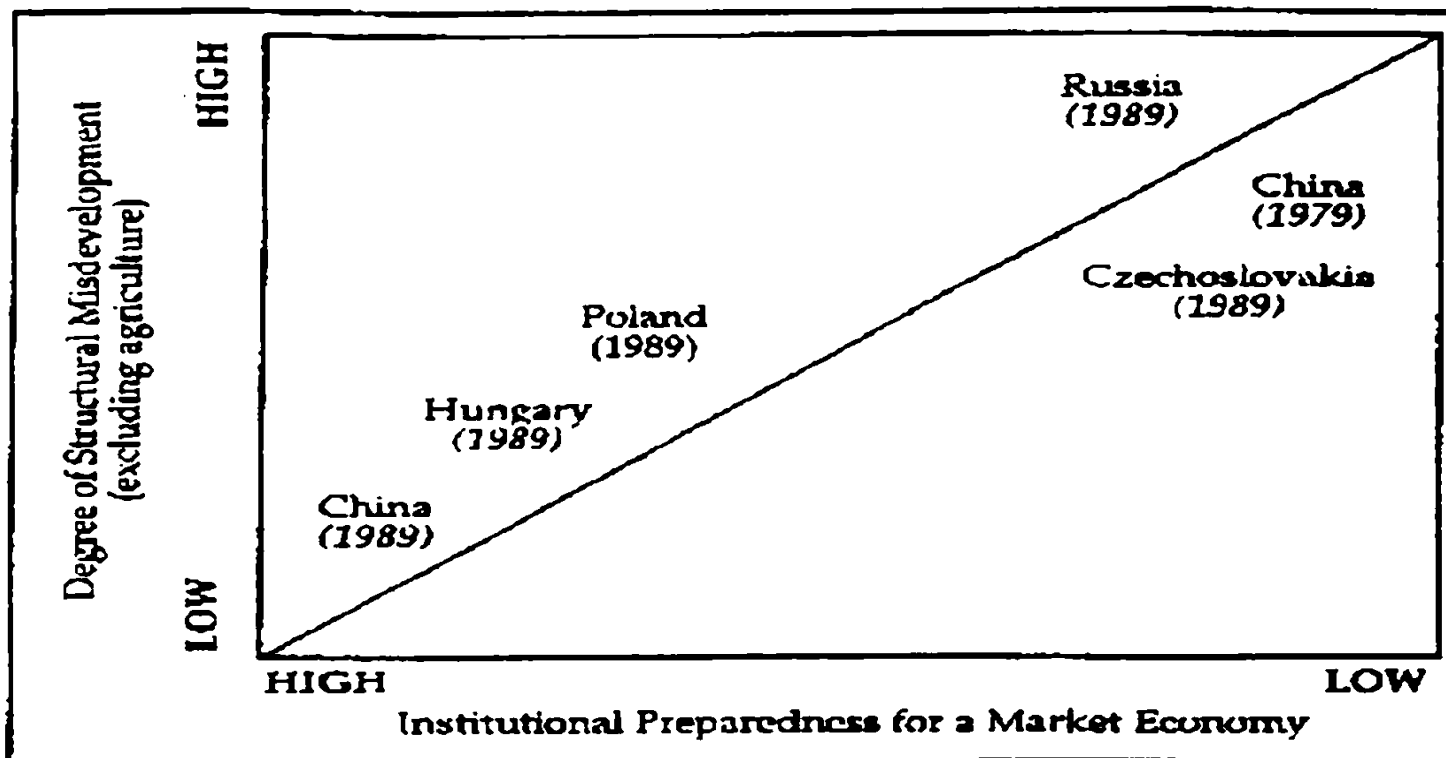
<sup>2</sup> Iván T. Berend and György Ránki, *The European Periphery and Industrialization, 1780-1914* (Cambridge, 1982).

<sup>3</sup> These charts and the accompanying text were developed in discussions with Michael Alexeev and Maurice Ernst.

weak. But by 1989, owing to a decade of successful systemic reforms, China was in the best relative position with respect to both structure and institutions.

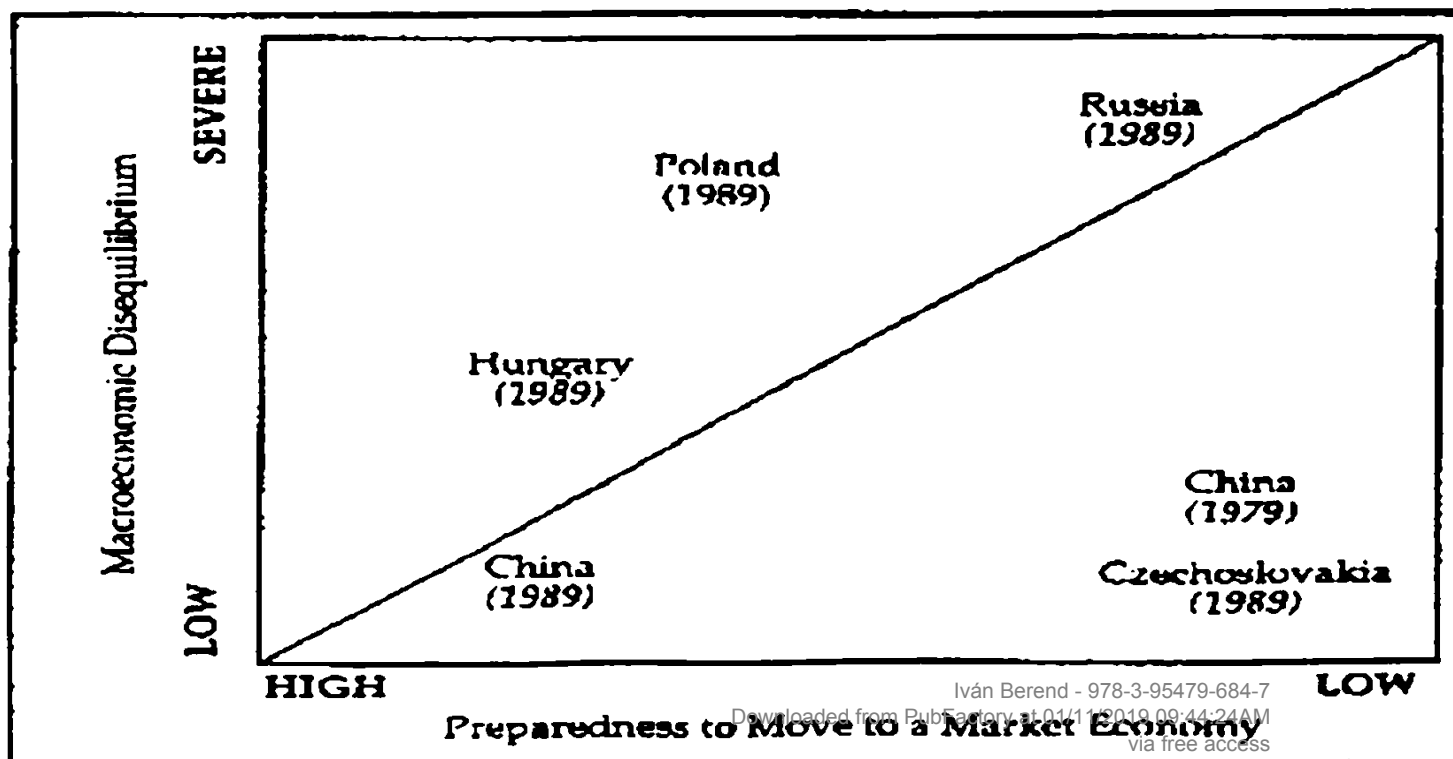
**CHART 1**

**Initial Conditions: Country Preparedness to Move to a Market Economy**



**CHART 2**

**Initial Conditions: Country Preparedness to Move to a Market Economy and Macroeconomic Disequilibrium**



The fact that structural and institutional preconditions are closely correlated (that is, all countries lie near the 45° line in Chart 1) makes it possible to qualitatively combine them so that they can be jointly compared with the third condition, the degree of macroeconomic imbalance (Chart 2). The best combination is low macrodisequilibrium and high preparedness to move to a market economy. Here again, Russia was in the worst shape for both of these synthetic variables, whereas China and Hungary in 1989 were in the best shape. In Poland and the Czech Republic, the following factors tended to be offsetting: Poland had good preconditions but high macroeconomic imbalances, whereas the Czech Republic had relatively poor preconditions but low macroeconomic imbalances.

## II. Economic Features and Restructuring

The five countries compared in Charts 1 and 2 have very different economic features (Table 1). Two of them, Russia and China, have continent-sized territories, large, diversified economies, and a low dependence on foreign trade. China, however, is still underdeveloped whereas Russia is highly industrialized. Among the three Central European countries, Poland is the largest and least dependent on foreign trade.

**TABLE 1. Economic Features of the Five Countries in 1992**

	<b>Russia</b>	<b>China</b>	<b>Poland</b>	<b>Hungary</b>	<b>Czech Rep</b>
<b>Population (millions)</b>	149	1,166	38	10	10
<b>GDP (billion \$)</b>	400	442	75	31	25
<b>GDP per cap. (dollars)</b>	2,700	400	2,000	2,750	2,700
<b>Share of Export/GDP (%)</b>	6	19	19	33	58

*Note on GDP Estimates:* GDP estimates in U.S. dollars are obtained by converting GDP in local currency to dollars using average exchange rates over several years (usually three). The results of this 1992 calculation understate the purchasing power of U.S. dollars over domestic goods and services in these countries by factors of the following approximate magnitude: 2/1 in Russia, Poland and Hungary; 2.5/1 in the Czech Republic; 3/1 in China. Use of purchasing power parity estimates for GDP would thus increase total and per capita output figures by the multiples above and correspondingly reduce the share of exports in GDP. Accordingly, the share of exports in GDP would be reduced from 19% to 6% for China, from 19% to about 10% for Poland, and so on.

*Source:* Population and GDP: *The World Bank Atlas 1994*; exports: official country data.

Economic size and dependence on foreign trade are closely related. The larger the economy, the greater the scope for economic specialization within the domestic market, at an acceptable cost, even if little import competition is allowed. A strong endowment in natural resources, which is generally also found in continental-sized economies such as Russia and China, is another factor tending to reduce foreign trade dependence.

The impact of large economic size, good natural resource endowment, and low foreign trade dependence on transformation policies tends to be double-edged. Such a country is under less pressure than smaller countries to integrate into the world economy. There is more flexibility in the allocation of resources and less sacrifice of efficiency if domestic producers continue to be heavily protected from import competition and are unable to export at a profit. This is particularly true where large economic rents can be obtained by exporting oil, natural gas, or other low-cost natural resources, as is the case in Russia. By the same token, such conditions make it easier to sustain policies that fail to improve industrial efficiency. By contrast, a high dependence on foreign trade and weak natural resource endowment mean that Hungary and the Czech Republic cannot achieve an effective transition without making their firms internationally competitive.

The degree and nature of industrialization also matter. Earlier policies had emphasized the rapid development of heavy industry, generally leaving a legacy of gross overcapacity in such industries as fuels, metallurgy, heavy chemicals, heavy machinery, and military hardware - coupled with gross underdevelopment of infrastructure, business services, finance, sophisticated consumer goods, and modern electronics, as well as a misallocation of resources in agriculture.

Although this structural legacy is common to all transition economies, its scope varies among the countries. Russia has the most serious structural problems, owing to having been under central planning longer as well as to its massive military programs. Among the CE-3 countries, the Czech Republic's economy was the most distorted by the policies of central planning because its pre-communist lead in industrialization led to the assignment in the Council for Mutual Economic Assistance (CMEA) of a very important role as a supplier of heavy industrial goods. The economic structures of Poland and Hungary were somewhat less distorted. In China, the heavy industry that was developed under central planning was generally inefficient, but made up a smaller part of a relatively undeveloped and still rural-based economy.

Focusing on the CE-3 countries, Hungary and Poland were in a relatively good position to restructure their economies, although the Czech Republic also had certain economic advantages. Furthermore, political-social conditions in a country can moderate or reinforce its economic "readiness" (or "unreadiness") to move to a market economy. For example, the almost complete discrediting of all aspects of communism and central planning made the Czech Republic more "ready" to transform than, say, Hungary, where economic and political reforms since the mid-1960s had created a degree of legitimacy for the "liberal" Communist political system. Although we seem to be saying that "good" legacies are "bad" for transformation and vice versa, the conclusion to be drawn is that the country best able to harness its legacies - whatever they are - to support the politics and economics of transformation will succeed most quickly in that difficult task.

### III. Transformation Strategy Models

The basic strategy of restructuring SOEs is partly determined by, and partly influences, the broad strategy of economic transformation that the authorities in each country pursue, purposefully or as the unplanned or unforeseen outcome of forces over which they have little control. The approach in this essay is not to begin with some preconceived notion of what *the* appropriate general model of transformation and restructuring might be, but to proceed empirically, to observe what each country has done, and then try to draw certain broadly generalizable conclusions and lessons. Nevertheless, it is useful to sketch three greatly simplified transformation models, to serve as benchmarks: *shock therapy* (broadly defined), the *order will emerge out of chaos* approach, and *gradualism*.

**Shock Therapy.** This model assigns a key role to the post-Communist governments in transforming the economy quickly and decisively. The authorities have a dual responsibility. One is to implement rapid economic liberalization by freeing most factor and product prices, including imports, and making the currency convertible. The other is to quickly put in place the new rules and institutions of a market economy, including effective bankruptcy procedures. This model typically includes macroeconomic stabilization via responsible monetary and fiscal policies, as well as the rapid but orderly privatization of the means of production. The advocates of shock therapy see a tradeoff between concentrating the pain over a short period to cure the patient quickly, which they prefer, versus lesser immediate pain, which will last much longer, with the eventual cure being less certain.

**Order Will Emerge Out of Chaos.** The advocates of this approach have a fundamental distrust of governments, especially those that are likely to emerge in the immediate post-Communist era. For radically transforming a centrally planned economy, "chaos is not all that bad," argues, for example, Nobel-prize-winning University of Chicago economist, Gary Becker.<sup>4</sup>

In this view, unbridled market forces will do a better job than politicians in shaping the norms of a newly capitalist society. Under particularly onerous governments, even corruption and organized crime may be providing a valuable service of facilitating market development by disregarding state rules that often hamper what should be routine market activities, such as importing and exporting. The best chance for successful transformation is for governments to stand back and let market institutions evolve from the ground up. Such a process cannot be forced onto a society by insisting that it try quickly to duplicate the institutional arrangements of developed market economies. At the same time, this approach shares with the shock therapy model the basic prescription of speedy price liberalization and macro-stabilization.

**Proceed Gradually.** This model is advocated by those who believe that it takes a long time to learn and practice the principles of a market economy because

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<sup>4</sup> "Free-Market Group is Divided on How to Bring Capitalism to Ex-Soviet Bloc," *Wall Street Journal*, September 30, 1994, p. 12.

“knowledge travels with great difficulty.”<sup>5</sup> The market mechanisms we find today in the developed countries have taken a long time to evolve. The advocates of the gradual approach cite with approval the example of China. That country first allowed the build-up of millions of family- and village-based ventures before tackling the more complex problems of creating modern financial institutions and reforming the governance and operation of SOEs. Many advocates of the gradual model do not believe that a quick and radical political transformation to democracy can always be successful or that it would promote a market-oriented economic transformation. The quick attainment of sustainable democracy and an efficient market system is especially problematic in less developed, predominantly agricultural societies, with no strong pre-Communist tradition of democracy and markets. Some proponents of this model also hold the view that - in poor countries, with no democratic tradition - gradual marketization should occur first, political transformation later.<sup>6</sup> The rapid economic growth of South Korea, initially under a single-party and highly authoritarian system, is an oft-mentioned example.

#### *IV. Observed Transformation Strategies*

There is no single best transformation strategy for *all* transforming economies. The best strategy will depend on each country's legacies, initial conditions, and current circumstances. And no country can be expected to follow any of the pure models. The actual strategy of transformation is likely to combine elements from each, although circumstances in a given country may make it more receptive to one of the approaches than to another. For example, China is, in many ways, *sui generis* because of its low level of development, population size and density, and cultural traditions, as well as because the communist political system did not collapse, its economy was never fully centralized, and much of its output is highly labor-intensive.

Whatever one might think about the virtues of the Chinese model - namely, of letting the non-state sector gradually “grow around” and overtake the centrally planned core - the fact is that it was not a feasible approach in the Soviet Union and in CEE. The reason is the rather sudden and unexpected collapse of the communist political system, owing to a combination of domestic and external circumstances. The collapse of the absolute rule of a single political party had also swept with it just enough (but not all) of the generally discredited system features of central planning. Thus, a gradual reform of central planning was not a feasible option, although the scope and the speed with which central planning's legacies should be eliminated can be debated.

The CE-3 countries had to combine elements from each of the three models and there are many possible combinations. One example is the Czech approach, most

<sup>5</sup> Ronald Coase, another Nobel prize economist, cited in the above *Wall Street Journal* article, p. 12.

<sup>6</sup> Lee Kuan Yew, the former Prime Minister of Singapore, is one strong advocate of this model, at least for China. See his interview in *The Economist*, June 29, 1991.

closely associated with Finance Minister turned Prime Minister, Vaclav Klaus. He summed up his country's experiences by the end of 1994 as "a mixture of intentions and spontaneity." In his view, neither democracy nor price liberalization or privatization could wait. Furthermore, once an "institutional vacuum" had been created by the collapse of the communist system, "the government had to react and implement a coherent set of system-changing measures" as well as responsible monetary and fiscal policies.<sup>7</sup> In these respects, the Czechs followed *shock therapy*. At the same time, in Klaus' view, the government should not try to over-regulate how the market should function, but let certain institutions, such as who will control enterprises after voucher privatization, emerge from the bottom up. This aspect of the Czech strategy is consistent with the *order will emerge out of chaos* model. Coincidentally, political prudence has justified that certain painful steps - such as allowing bankruptcies to be widespread or large layoffs to occur before new jobs can be created - be managed by the government cautiously and gradually, so as not to tear apart the social fabric and thereby run the danger of losing political support for otherwise rapid economic transformation. In these areas, the Czech approach has been much more *gradual* than either Hungary's or Poland's.

Poland and Hungary have employed a different mix of approaches. Poland's first post-Communist government applied shock therapy successfully by quickly freeing prices and bringing hyperinflation under control. To be sure, one may argue, as does Kowalik in his chapter, that the speed - and thus the cost - in terms of unemployment and growing inequality of income distribution were excessive. Be that as it may, it is a fact that successive governments had only limited success, over five years, in privatizing and restructuring the large SOEs. The fact that the private sector has grown rapidly - in spite of several policy failures or inaction by successive governments - while the state sector has eroded steadily indicates that market forces have become strong enough to shape the economy.

If shock therapy is defined, more narrowly, as rapid price liberalization and quickly bringing inflationary pressures under control (which is how economists usually define the term), then Hungary did not need such medicine because earlier reforms had already freed most of its prices, without high inflation. To be sure, given Hungary's large foreign debt-service obligations and the low share of investment in GDP, the level of consumption had to be kept in check by tight monetary and fiscal policies, not unlike those under shock therapy in the other two countries. The authorities did just that until about mid-1992, when the monetary and fiscal reins were loosened (too early, as it turned out). At the same time, in many other areas, including the restructuring of SOEs, Hungary repeatedly followed stop-and-go policies that yielded impressive achievements but also spawned many inconsistencies and problems. So although Hungary had an early lead over Poland and the Czech Republic at the beginning of the transformation, its lead has narrowed and might even have disappeared by the mid-1990s.

<sup>7</sup> "Free-Market Group."



## V. Comparative Assessment of Progress, 1989-1995

It is difficult to be precise in defining and measuring transformation's progress. Nevertheless, the question is often asked: "How much progress has a particular country made, as compared to others, to create institutions and policies resembling those of a well-functioning market economy?" Most would agree that well-functioning market economies have certain basic common features, such as ownership that is predominantly private; factor and product prices that are mostly free from administrative control; adequate competition; and an efficient and well-supervised banking system.<sup>8</sup>

At the end of 1994, the European Bank for Reconstruction and Development (EBRD) prepared a comparative progress report on 25 transition economies, not including China, focusing on five aspects: changes in ownership, price determination, extent of competition, banking reform, and enterprise restructuring. This is how the Bank ranked the five countries that, in its view, had made the most progress by 1994. We also show the position of Russia in this group of 25 countries. (The maximum point score in this computation is 24. Countries with identical scores are presented here in alphabetical order.<sup>9</sup>)

Rank	Country	Point Score
1	Czech Republic	21
2-5	Estonia	20
2-5	Hungary	20
2-5	Poland	20
12-13	Russia	16

A few brief comments on these rankings and on the developments and perceptions they reflect are in order here. One can agree that Russia should be ranked approximately in the middle of the group of 25 transition economies.<sup>10</sup> Russia (where transformation began a year or two after those in the countries of CEE) initially seemed to model its transformation on Poland's approach, combining extensive price liberalization with macro-stabilization policies. In addition, Russia undertook an ambitious privatization program, basically similar to that of the Czech Republic, on which it has made impressive progress in just a few years. However, the government quickly abandoned its stabilization efforts, mostly

<sup>8</sup> For essential similarities and differences among some of the main successful capitalist models, see Paul Marer, "Models of Successful Market Economies," in Paul Marer and Salvatore Zecchini, eds., *The Transition to a Market Economy: Vol. 1-The Broad Issues* (Paris, 1991).

<sup>9</sup> As cited in *Transition* (Newsletter of the Transition Economics Division of the World Bank), Vol. 6, No. 4 (April 1995), p. 3. There is less agreement on how important are other institutional and policy aspects, such as reform of the legal system. To be sure, everyone acknowledges that many supportive reform steps are needed if transformation is to be successful.

<sup>10</sup> The contribution of Michael Alexeev in interpreting developments in Russia is gratefully acknowledged.

under pressure from enterprises. The decentralization of political as well as economic power to the regions has also complicated the ability of the center to implement its economic policies. For these and other reasons, after the initial push, economic liberalization has proceeded slowly in most regions. Low credibility of the government and persisting distortions in the economy stimulated rent-seeking efforts by various interest groups. To a large extent, the "order out of chaos" approach has characterized reforms in Russia ever since. At the same time, the implementation of bankruptcy procedures, the privatization of land and commercial real estate, and the rise of unemployment have been permitted to occur only gradually.

I am not fully certain that, as of 1994, the Czech Republic was clearly in the lead over Poland, and especially Hungary, in transforming its economy, impressive as the Czechs' progress has been since 1989. Two of the Czech Republic's great advantages over the other two countries have been a decisive and articulate government pursuing a steady course in economic policy and the apparently greater degree of domestic political consensus behind those policies. In public pronouncements, Prime Minister Klaus has been stressing mainly the positive features of the Czech transformation, and insisting that the members of his government do likewise. These features contrast sharply with frequent governmental changes in Poland, with the stop-and-go policies in Hungary, and with the sharp *public* disagreements over economic policy in both countries, both within the ranks of successive governments as well as among the political parties. Even so, in Poland, successive governments have followed quite similar economic policies. And the output of Poland's "true" private sector has grown at least as rapidly as in the Czech Republic.

The nub of the issue of how much comparative progress has been made in systemic transformation is the pace of privatization. If one interprets the Czech Republic's voucher distribution of state assets as completed privatization, then the country has indeed made impressive progress. But if one assesses voucher distribution as quasi-privatization and sale for cash as real privatization - an interpretation that I prefer (see below) - then it is not so clear that the Czech Republic clearly leads the other two countries in economic transformation and restructuring. During *each* of the first five years (1990-1994), foreign investors had clearly shown their greatest confidence in Hungary's progress. To be sure, Hungary's large initial advantages over the other two countries have been eroding, as was noted.

## VI. Restructuring Defined

Restructuring is a process that enables firms - originally created to serve the goals of a planned economic system - to operate successfully in a market economy. Restructuring includes processes that redeploy more efficiently the assets initially controlled by SOEs. Comprehensive restructuring of the inherited production units, especially the large ones, is necessary because most firms are not well prepared to compete in a market-driven economic system. (While the need to restructure firms

also occurs with some frequency in a market economy, the scope, the extent, and the difficulty of restructuring are much less than in a transition economy.) Although, in a broad sense, the entire transformation process in a transition economy may be regarded as restructuring, here we are focusing on those actions by the authorities, and by the owners and managers of SOEs and of privatized firms, where the cause and effect relationships can be traced quite clearly, making restructuring outcomes more predictable.

Enterprise restructuring involves significant changes in one or more aspects of basic strategy, such as products, markets, and marketing; production technology; finance; substantial reductions in unit costs; and organization and management. Restructuring tasks are quite different in large SOEs in, say, the energy sector than in modern electronics or in a large service organization, such as a financial institution. Even within a given industry, individual firms may require quite different restructuring programs, depending on the nature of their technology, markets, and management, to mention just some of the factors.

The results of restructuring can be observed at the macro level, from changes in the sectoral composition of GDP (price effects should be separated from output effects); at the mezzo level, through changes in the branch and product composition of an industry; and at the micro level, through enterprise case studies. At the enterprise level, four kinds of restructuring may be distinguished, none mutually exclusive.<sup>11</sup>

*Strategic restructuring* takes place when an enterprise develops and implements a comprehensive, long-term business strategy in response to a profound necessity or opportunity. Strategic restructuring may involve the introduction of new product lines, new processes, new technologies, the development of new markets, and substantial downsizing. If successful, restructuring will significantly enhance the enterprise's net present value.

*Defensive restructuring* involves measures whose primary goal is the enterprise's survival. The measures taken, such as neglecting investment to pay wages, or selling real estate and other assets for the same purpose, often decreases the firm's value, in the long run. The key point is that the motive is short-term survival, not the enhancing of the enterprise's value.

*Passive restructuring* takes place when an enterprise's assets (which could include real estate, buildings, machinery, tools, employees, suppliers, markets, and receivables) erode - whether legally or illegally, by design or by happenstance - for personal gain. Enterprise insiders often have excellent and low-risk opportunities for "asset stripping." Restructuring is passive in the sense that its benefits do not, as a rule, accrue to the enterprise itself, as a going concern, but to its managers or workers and their "networks" in the private sector. The passive restructuring process is typically not visible to the public eye. Its contributions are embedded in statistics showing that a rapidly growing share of GDP originates in the private sector.

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<sup>11</sup> Two of the four distinctions are also made in Irena Grosfeld and Gerard Roland, "Defensive and Strategic Restructuring in Central European Enterprises," Discussion Paper No. 1135 of the Center for Economic Policy Research (London), March 1995.

*Restructuring through liquidation* is one typical outcome of bankruptcy procedures. It usually occurs when the assets of an enterprise are not worth more as a going concern than if the assets were sold separately. It may also happen if the creditors cannot agree on a reorganization plan.

### VII. Restructuring: Summary of Findings

In all of the countries, considerable restructuring has taken place during the first five years of transformation, 1990-1994. But contrary to what was expected, *strategic restructuring* of SOEs has not taken place on any substantial scale, except in the Eastern part of Germany (a special case, where restructuring has occurred both before and after privatization) and, elsewhere, in those industry pockets where the SOEs were acquired by foreign investors (mainly in Hungary and mainly after privatization). Strategic restructuring has been under way for only a year or so in Poland, since about 1994; is just beginning in the Czech Republic, as of 1995; and has barely begun in Russia. So far, much more common has been *defensive restructuring* and *passive restructuring*, which have occurred rather widely in all of the countries. Thus, over time, "autonomous" forces, not government programs, have tended to accomplish a great deal of restructuring, though not as efficiently, perhaps, as it might have been done under different circumstances.

The scope, the speed, and the efficiency of the restructuring depend mainly on the following four sets of interdependent policy variables: (1) a country's privatization strategy; (2) the nature of the budget constraint facing enterprises, policies concerning enterprise bad debts, and the efficiency of financial intermediation (all three aspects are closely inter-related); (3) corporate governance arrangements; and (4) a country's macroeconomic policies and institutional framework. For each variable, the findings are summarized below.

### VIII. Privatization and Restructuring

There is a large and growing literature on privatization in transition economies.<sup>12</sup> The focus here is to summarize the impacts of alternative privatization strategies on restructuring.

**Criteria for Assessing Privatization.** From the point of view of restructuring, the privatization strategy a country pursues should be assessed by the extent to which it results in (1) harder budget constraints for the privatized firms and (2) the

<sup>12</sup> For example, *Mass Privatization: An Initial Assessment* (Paris, 1995); John S. Earle, et al., *Small Privatization: The Transformation of Retail Trade and Consumer Services in the Czech Republic, Hungary and Poland* (Budapest, 1994); *Privatization: The Lessons of Experience* (Washington, no date, circa 1992); Stipon Nestor and Scott Thomas, "Systemic Privatization and Restructuring in East Central Europe," in *East Central European Economies in Transition* (Washington, 1994); *Compendium of Invited Papers by the Joint Economic Committee, U.S. Congress.*

acquisition of shares by new owners who are interested in, and capable of, maximizing the long-term market value of the businesses they acquire, and (3) the speed with which one or both of these key objectives are achieved.

The two main alternative privatization methods are to sell assets or to give them away through a voucher program. (Also important, but less pervasive, is the privatization of assets through liquidation or leasing.) With either sales or distribution, preference may be given to inside stakeholders: labor or management.

**Voucher Privatization.** Giving away assets is apt to hasten the onset of a hard budget constraint for most privatized firms, which exerts pressure for restructuring. The budget constraint is likely to become harder because privatization tends to reduce the control of labor unions and like bodies, as well as that of the state bureaucracy that exercises ownership functions over the enterprises to be privatized. This reduces the pressure on the authorities to bail out enterprises the state no longer owns or controls. To be sure, if the creditor banks remain state-owned, and control (directly or indirectly) the distributed enterprise shares - as is the case in the Czech Republic - then the budget constraint may not harden immediately.

Privatization by distribution is advantageous because of its speed. It does not require large amounts of capital at a time when accumulated domestic savings are tiny relative to the market value of the assets being privatized. Furthermore, distribution is perceived by the public to be the more equitable of the two approaches. Distribution also forces decisions by both the government and the new owners that might otherwise have been delayed or avoided. For example, the government must decide on the mode of distribution. And the new owners must choose whether, and to whom and under what terms, they are willing to sell their shares.

Distribution's main drawback is that most of the initial new owners are likely to be "passive." This means that they are not able or interested in effectively exercising such key ownership functions as deciding on the property's best use, selecting managers and holding them accountable for performance, and providing capital, if needed, to restructure the enterprise. Thus, the distribution of shares in large enterprises should be considered semi-privatization. It is an interim step, as is emphasized, for example, by the Czech authorities. The initial owners - whether the enterprise's workers, other individuals, or small investment funds - are generally passive investors. Over time, however, they tend to sell their shares to *active investors*, who are more likely to have the interest and the capital to restructure the firms. Voucher privatization thus sets in motion a process of ownership change that will continue for years. In the meantime, however, the business value of the "semi-privatized" property may continue to decline. And whether the ultimate owners will be those who would want to, and would be able to, restructure the enterprises they control is an open question.

**Conclusion:** Voucher privatization may facilitate restructuring by hardening the budget constraint of enterprises, which may or may not happen immediately. It also promotes restructuring by improving corporate governance arrangements, although only some time in the future.

**Privatization by Sale.** This approach is recommended mainly from a market point of view: those who put up money to acquire state property are the most likely

to know, and care about, the best use and operation of the property, including its quick restructuring. These same buyers are also the most likely to be able to afford, or borrow, the investment funds necessary for this purpose. The approach also provides revenue to the government.

The main drawback of privatization by sale is its slowness, due to the difficulties of valuing the property and selecting the right buyer (if there is an interest in buying it, which is not uniformly the case). The latter is especially problematic and politically sensitive because price should not be (and generally is not) the only consideration. But this means giving discretionary power to the privatizers, which is likely to tempt political interference and corruption, or at least give the appearance of such, which politically damages the government and the privatization process. In any case, the government has to stand ready to justify the specifics of each transaction to an often suspicious, and envious, public.

The slowness of privatization has further serious drawbacks. One is that the business value of much of the property to be privatized tends to decline, often substantially, with each passing day. (To the extent that this happens owing to *passive restructuring*, that may be bad for the enterprise, and for generating privatization revenues for the government, but it may be good for the economy.) The other drawback is that since *any* type of privatization is politically always controversial, the longer the procedure drags on and the more protracted is the domestic political debate about it, the more that undermines political support for privatization, leaving less time, attention and support for the authorities to address other vital transformation issues.

Sale to insiders, generally involving leases, can be quite efficient for restructuring in small or medium-sized firms whose output is labor-intensive and thus require little capital for restructuring. Even in a large enterprise, leasing out certain units or activities to those insiders who make good business proposals and have the know-how and the commitment to implement them can be a good approach to privatization. Otherwise, insider control is likely to be counterproductive for large enterprises because typically the main concern of the insiders is the preservation of jobs and the enhancement of current incomes, and because they are not likely to have access to capital for restructuring.

Conclusion: Privatization by sale hardens the budget constraint *and* improves corporate governance arrangements. Its disadvantage is its likely slow pace - more so in larger countries than in small ones because small countries, such as the Baltic states, that have only a few hundred SOEs, will find it easier to mobilize the expertise and the capital needed.

### ***IX. Budget Constraint, Financial Intermediation, and Restructuring***

Another set of variables that influences the scope, speed, and efficiency of restructuring is the nature of the budget constraint facing enterprises, together with the quality of financial intermediation. One of the most acute problems in all transition economies is the bad financial condition of a large number of SOEs. Many were heavily indebted to begin with, often because the authorities established

firms with relatively little equity. Under the old system, the mode of enterprise finance was not important because the enterprises as well as the banks were state-owned and the authorities did not, as a rule, permit enterprises and financial institutions to go bankrupt. When market pricing and competition were introduced and markets in the former CMEA countries were lost, many firms began to sustain large losses and thus could not service their debts.

Initially, the “new” commercial banks (that had remained mostly state-owned) continued to supply unsecured credits. When a degree of financial discipline was imposed on the banks through tighter monetary and bank supervision policies, and they transmitted those pressures to enterprises by hardening their budget constraints, many businesses responded by accumulating large inter-enterprise debts.

Thus, in every transforming economy, the early period of transformation coincided with a banking and financing crisis. (The main difference between these crises and those that market economies have also been experiencing is that, in the former, most of the bad loans had been made to public firms, not private borrowers, although this changes as transformation proceeds.) The overhang of large debts greatly complicates privatization and restructuring.

Financial restructuring, which is designed to deal with a large volume of non-performing loans, involves two main tasks. One is to recapitalize the creditor financial institutions because otherwise they could not function well. The other task is deciding whether, and how, to provide debt relief to the debtor enterprise and to liquidate those judged to be not viable as business entities even after debt relief would be granted. Such procedures, focusing on the debtor, are called “workouts.”

For several reasons, it is advisable to link bank recapitalization and enterprise workout procedures and, if possible, to tie the workout to privatization. Although the recapitalization of the banks is the responsibility of the state, the restructuring (workout) of the bad debts of individual enterprises is best done by private interests, in order to depoliticize (as much as possible) such procedures. But some kind of linkage between bank recapitalization and enterprise debt restructuring is important because a bank’s recapitalization needs are largely a function of the kind of debt relief that its debtors are to be granted. Furthermore, the creditor bank should have knowledge about the debtor’s operations and management that would be useful to bring to bear during the workout negotiations. The creditor bank should also have a stake in the terms of the workout. Without coupling bank recapitalization and the painful workout process, the banks are more likely to get used to the idea of being bailed out. It is also useful to link workout to privatization. How a potential buyer proposes to handle the target acquisition’s outstanding financial obligations should be part of the negotiations over privatization’s terms.

Although scattered examples of such a simultaneous approach can be found in each CE-3 country (much less so in Russia or China), only Germany could afford to implement this approach economy-wide, and relatively quickly. This was because the German government was in a position to mobilize, on the one hand, the large number of credible experts required to manage the workouts and, on the other, the immense financing needed to foot the bank recapitalization *and* initial enterprise restructuring bills. In all of the other transition economies, bank

recapitalization had been largely accomplished, typically, at substantial costs to current and future taxpayers, but only modest progress has been made to date on the financial workout of enterprises. The most important reason for this is the continued full or partial state ownership and control of most of the large banks. That, in turn, can be traced to the reluctance of the authorities to sell controlling interests in large banks to foreign strategic investors, as well as to the scant interest on the part of foreign strategic investors, given the poor financial health of most state-owned banks and the legal, economic, and political uncertainties in the prospective host countries.

Conclusion: Until many of the large banks are privatized, competition among them is enhanced, prudential supervision is strengthened, and the legal-regulatory system becomes more “creditor-friendly,” bank recapitalization, *by itself*, is not likely to bring about the efficient restructuring of enterprises or to improve financial intermediation.

### *X. Corporate Governance and Restructuring*

“Corporate governance” refers to a wide range of issues that concern the power of, and the relationships between, different stakeholders in a firm - namely, its owners, managers, employees, creditors, customers, suppliers, and the authorities - who jointly determine a firm’s goals and operations. An efficient corporate governance structure is a prerequisite of effective restructuring. Apart from the financial discipline issues just discussed, the most important set of incentives relevant for restructuring is related to the governance of firms.<sup>13</sup>

In most cases, the owners are the most important stakeholder group. In principle, five types of institutions can perform, alone or jointly, such essential ownership functions as setting strategic objectives for the enterprises they control; appointing, holding accountable, rewarding, and dismissing managers; and helping to secure finance for the firms. The five institutions are: the state, “real” private owners, public equity markets, investment funds, and banks. How each institution works, in the abstract, is sketched, and the relevance of each for the transition economies is discussed briefly.

The *state* and its bureaucracy are generally not well suited to effectively perform the functions of ownership because politics and bureaucratic considerations are apt to interfere too much. However, this generally correct blanket statement must be qualified: State ownership is no impediment to efficiency if managerial incentives are set appropriately. Politics aside, the feasibility of setting appropriate incentives for managers is much greater if SOEs are islands in a sea of private firms (because only then can the market mechanism function well) than if private firms are islands in a sea of SOEs. This is why comprehensive and speedy privatization is a *sine qua non* of effective corporate governance.

*Real private owners* have the best prospects for doing the job well, provided the environment in which they find themselves is conducive to long-term planning and

<sup>13</sup> Nestor and Thomas, *Systemic Privatization*.



business operations generally. To be sure, many privately owned businesses fail because entrepreneurs or managers make poor decisions or cannot adapt to changes in the business environment. Although business failures may hurt the stakeholders of a particular business, “creative destruction” (to use Schumpeter’s phrase) is essential if an economy is to function well. That process ensures that productive resources will, in most cases, be controlled by those who can make good use of them. Business failures allow well-functioning enterprises to prosper. From the point of view of economic efficiency and growth, permitting no business failures - as was the case under central planning - clearly hurts an economy’s long-term performance. Even in a market economy, private firms whose ownership is diffuse are more likely to fail than those with concentrated ownership. This is because managerial incentives tend to be poorer in the former. In the transition economies, the unusually large proportion of private ventures that fail mirror not a fundamental flaw of the capitalist system but weaknesses in the institutional and policy environments, especially in the early stages of transformation.

*Public equity markets* are of significant importance in a well-functioning modern economy because they facilitate the creation of “real” owners, by placing individuals and groups of investors in a position to acquire controlling equity in firms. Public equity markets also help to “control” the managers of listed companies because the (absolute or relative) rise or fall of the value of the shares is a vote of confidence (or no confidence) in the company’s management. A well-functioning equity market facilitates the take-over of companies by new owners (presumably, in order to improve management). Both the threat of take-over and actual take-overs are essential tools of corporate governance. Furthermore, by making equity liquid, stock markets promote saving, investing, entrepreneurship, and thus restructuring. Each of the five target countries has (re)established a functioning stock market, but they are as yet in infant stages of development.

*Investment funds* are of considerable importance in countries that have implemented voucher privatization. The problem with investment funds exercising effective corporate governance is that they face a fundamental conflict of interest. On the one hand, they serve as holding companies that are expected to be involved in helping to restructure enterprises. On the other hand, they are mutual investment institutions, with responsibility to the “small investors” (who have entrusted them with what may be a large part of their savings) not to take imprudent risks with their savings. Furthermore, if the shares in such funds can be redeemed by the investors on demand, then the funds have to maintain a highly liquid asset structure, which would not be conducive to financing enterprise restructuring. This potential conflict of interest can be mitigated if investment funds are owned or controlled by healthy *commercial banks*. To be sure, in such cases the potential conflict appears at the bank, whose commercial banking and investment banking functions must be well separated and supervised by the authorities, to protect the general public.

Investment funds are beginning to play significant roles in the Czech Republic and Russia, and are slated for a major role in Poland as well. Foreign venture funds, which have begun to be established to invest in the transition economies (as “emerging markets”) are perhaps under fewer constraints than domestic investment

funds to assist with restructuring. If these economies do well, the expansion potential of foreign and domestic venture capital funds is vast, and they could play an active role in corporate governance.

### *XI. Macroeconomic Policies, Institution Building, and Restructuring*

The fourth set of variables influencing restructuring procedures and outcomes is macroeconomic policies and institutions. The main policy lessons with regard to macro policies and institution building that would facilitate the restructuring of large firms are the following:

- Price liberalization and economic decontrol should be prompt, and the building of market institutions as rapid as possible. The more efficient the markets, the more rapid and efficient enterprise restructuring is likely to be. In the absence of reasonably free markets, it is impossible to determine which firms should be restructured, and how.
- Governments do have vital direct as well as indirect roles in restructuring. The most important direct role of the authorities is to establish clear strategies and procedures for privatization and to eliminate such obstacles to privatization as lack of clear titles to assets (in this respect, corporatization is helpful). The authorities should also work closely with the private sector to help relieve potentially viable enterprises of their non-performing debts to banks and other government agencies. The indirect but no less important role of the government includes macro-stabilization, banking reform, and establishing a stable and enforceable tax and legal-regulatory framework.
- For large, important firms, governments have little choice but to remain involved, probably for several years. This is especially justified in the case of firms that have faced the collapse of the major markets for their products. Continued involvement is often politically necessary, in part because for some of them there will be no buyers or “takers,” or because keeping them in temporary or permanent state ownership will be considered politically or economically prudent - as is also often the case in market economies. Although central governments might play a useful role in restructuring such firms to prepare them for eventual privatization, it is desirable for the restructuring process to be implemented in as decentralized a way as possible, without political interference, beyond preparing and monitoring the implementation of the broad restructuring guidelines set by the government.
- With regard to the economic policies of governments, *policy credibility* is of overriding importance. None of the key actors whose cooperation is vital for successful restructuring - the owners and managers of enterprises, the work force, the creditors, and prospective investors - are likely to respond to government policies as the authorities expect them to do if the actors do not

believe that the government has sound economic and social policies and is willing to persevere in their implementation.

## *XII. Structural Changes in the Economies of the CE-3 Countries*

**Output of GDP.** For Hungary, Poland, and the Czech Republic, the peak year for GDP was 1989. In all three countries, measured GDP declined by roughly one-fifth during the next two to three years:

	Maximum Cumulative GDP Decline
Hungary	18%
Czech Republic	21%
Poland	18%

The only significant difference is in the timing of the decline. In Poland the largest decline occurred in 1990, there was a further smaller decline in 1991, and since 1992 good growth rates have been registered. In Hungary and the Czech Republic, the largest declines came in 1991, there were further declines in 1992, and a modest turnaround began only in 1993 in the Czech Republic and in 1994 in Hungary.

The approximately one-fifth decline in GDP has been dubbed by János Kornai as the "transformation depression." This is perhaps not the most fortunate of terms, because it implies that the cause of the output drop was the transformation itself, rather than the sudden revelation of the economic problems of "misdevelopment" that have been accumulating for a long time, combined with such large external shocks as the collapse of the markets of the former CMEA countries. Be that as it may, the order of magnitude of the output drop appears to rival that of the Great Depression of the 1930s. To be sure, a significant part of the output fall reflects the elimination of production for which demand could exist only as long as the economy was highly protected and planners, not final and intermediate consumers, decided what is to be produced. Moreover, official output data tends to underestimate the contribution of the "unrecorded" private sector. Even so, substantial and prolonged economic pain, as well as increased economic uncertainty, had to be faced by a large segment of the populations in all of the transforming economies.

Because the three countries had significant differences in initial conditions as well as in policies, the comparable magnitude of the output declines suggests that the "transformation depression" was caused primarily by the sudden revelation of misdevelopment and by strong external shocks affecting domestic economies that were unsuited to easily absorb them, and not mainly by the economic policies that the countries had pursued during the early years of the transformation. Poland's shock therapy affected mainly the timing of its decline and recovery, and not the magnitude of the decline, relative to those of the other two countries which, in different ways, followed more gradualist economic policies.

**Industrial Output.** While exceeding those of GDP, declines in industrial production were also about the same in the three countries:

Hungary	31%
Czech Republic	33%
Poland	31%

**TABLE 2. Share of Major Sectors in the Total Output of the CE-3 Countries, 1990-1994 (Percent of GDP)**

	1990	1991	1992	1993	1994*
<b>Czech Republic</b>					
Industry	50	55	45	40	36
Agriculture	7	6	6	6	6
Construction	8	6	4	5	6
Services	32	31	45	50	52
<b>Hungary</b>					
Industry	27	29	28	26	23
Agriculture	13	9	7	6	7
Construction	6	6	6	6	7
Services	55	54	59	62	63
<b>Poland</b>					
Industry	45	40	34	33	30
Agriculture	8	7	7	7	7
Construction	9	10	7	6	7
Services	36	41	48	53	56

\*Author's projections.

Source: UN Economic Survey of Europe in 1994-1995, p. 79.

**TABLE 3. Official Estimates of the Contribution of the Private Sector to GDP and Employment in the CE-3 Countries, 1990-1994 (Percentages)**

	GDP					EMPLOYMENT	
	1990	1991	1992	1993	1994	1992	1993
<b>Czechoslovakia</b>	5	9	--	--	--	--	--
<b>Czech. Republic</b>	--	--	28	45	62	31	47
<b>Slovakia</b>	--	--	22	26	58	17	28
<b>Hungary</b>	16	18	25	65	70	48	53
<b>Poland</b>	31	42	45	48	n.a.	56	59

Source: UN Economic Survey of Europe in 1994-1995.

**TABLE 4. Annual Inflation Rates in the CE-3 Countries, 1989-1994 (Percent)**

	Hungary	Czech Rep.	Poland
1989	17	1	251
1990	29	10	600
1991	35	57	70
1992	23	11	43
1993	22	21	35
1994	19	10	32

Source: PlanEcon Reports, various issues, based on official data.

**TABLE 5. Unemployment Rates in CE-3 Countries, 1989-1994 (Percent)**

	Hungary	Czech Rep.	Poland
1990	2	1	6
1991	8	4	12
1992	12	3	14
1993	13	4	16
1994	10	3	16

Source: PlanEcon Reports, various issues, based on official data.

**Unemployment.** Comparative trends in unemployment rates (Table 5) show further important similarities as well as differences in economic policies. One similarity is that declines in employment have been considerably smaller than declines in GDP. One difference is that while policy makers in the Czech Republic have been emphasizing limiting unemployment, for social and political reasons (for example, by going easy on bankruptcies), policy makers in Hungary allowed unemployment to rise, with their tough policies on bankruptcy probably contributing to it. Poland's situation is probably explained in part by the rapid increase in new entrants into the labor force.

**Foreign Trade.**<sup>14</sup> Between 1989 and 1991, the CEE countries' share of world trade dropped for exports from 2.4 percent to 1.8 percent, and for imports from 2.1 percent to 1.8 percent. The drop was particularly large for Bulgaria (in both exports and imports) and for Romania (mainly exports). CEE's relatively limited participation in world trade is indicated also by the value of its per capita trade. The highest value for exports and imports combined was in Hungary (around \$1,000), followed by Czechoslovakia (\$700), Poland and Bulgaria (\$300-\$400), and Romania (\$200).

<sup>14</sup> Trade figures originating in the customs declarations of the transition economies often diverge to an unusually large extent from the "mirror statistics" of the partner countries, and are also often inconsistent with such other series of national data as balance of payments statistics and national income accounts collected on a different basis. Whether the mirror data compiled by the individual OECD countries and published by the OECD have also been affected is less clear. The elimination of customs borders among the EU members probably did have such an impact.

All these values are lower than for market economies of comparable size and level of development. For example, Greece's per capita exports plus imports are around \$2,000.

Trade developments during 1989-1994 between the OECD and the CEE countries, based on OECD data sources, can be divided into two sharply contrasting periods: from 1989 through mid-1992, and from mid-1992 to the end of 1994. The first period is one of unexpected trade successes for CEE, dominated by reorientation from the markets of the CMEA countries to those of the OECD, especially the EU. The EU's share of the total trade of the Visegrad countries (the CE-3 and Slovakia) jumped from less than 25 percent in 1989 to about 50 percent in 1992, and was especially strong in exports. Although better market access to the West did not - and could not - offset fully the market loss suffered in the East, it did limit the damage. (The main reason it could not is that many products sold on the protected markets of the CMEA countries were too outdated to be marketed in the OECD countries at any price.) The increase in exports was across the board, in sensitive and non-sensitive sectors.

The most important factors explaining this initial export success were:<sup>15</sup>

- the Visegrad countries having inherited established industrial structures;
- strong pressure to find new markets to replace those lost in the CMEA countries and to compensate for declining domestic demand during the "transformation depression";
- reductions of the often large inventories held by producing and trading enterprises;
- the solid cost competitiveness of the Visegrad countries, caused by (a) the large wage gaps between the two parts of Europe, which is greater than average for the more highly skilled workers, and (b) the CEE countries' substantially undervalued initial exchange rates, especially during the first part of the period; and
- increased demand by - and improved access to - some of the EU markets.

During this period, German imports from CEE grew much faster than Germany's total imports, while for the rest of the EU, the differential in favor of CEE was smaller. Table 6 shows the product categories in which the Visegrad countries had significant market shares in the EU in 1991, many representing "sensitive" sectors. Sectors are sensitive for a combination of partly overlapping reasons. They are particularly vulnerable to import surges caused by trade liberalization or other factors. And the representatives of those industries have the political clout to influence their government's trade policies in those sectors.<sup>16</sup> Depending on industry and product, generally between 1 to 4 percent of the OECD area's total imports of sensitive products have come from the Visegrad countries. Yet for some of the latter, sales to OECD countries represent over half of their total exports of these products, with the EU being their most important market.

<sup>15</sup> András Inotai, "Central and Eastern Europe," in C. Randall Henning, et al, eds., *Reviving the European Union* (Washington, 1994).

<sup>16</sup> D. Nevin, "Trade Liberalization with Eastern Nations: How Sensitive?" Discussion Paper No. 1,000 of the Center for Economic Policy Research (London, 1994).

**TABLE 6. EU Imports of Main Commodity Groups from the Visegrad Countries, as Percent of Total EU Imports in 1991**

<b>Commodity Group</b>	<b>Visegrad Countries</b>
All commodities	1.20
Food and live animals	1.88
Meat	3.48
Vegetables and fruits	2.54
Raw materials	1.97
Mineral fuels	0.83
Chemicals	1.18
Organic chemicals	1.61
Medicines	0.35
Fertilizers	5.91
Explosives	1.57
Manufactured goods	1.73
Textiles	1.22
Iron and steel	2.33
Manufactures of metal	1.84
Machinery and transport equipment	0.54
Power generators	0.79
Specialized machinery	0.99
Metalworking machinery	1.58
Electrical machinery	0.87
Automobiles	0.41
Other manufactures	1.79
Sanitary, plumbing, etc.	1.84
Furniture	3.70
Luggage and handbags	2.47
Apparel	3.23
Footwear	3.13

*Source: OECD Trade by Commodities, Series C, Paris 1993.*

During 1992-1994, there was a reversal of fortunes for CEE. Its exports to the EU began to weaken in the second half of 1992 and declined further in 1993, while imports continued to rise. There are important differences among the countries in what combination of domestic factors (such as exchange rate appreciation) and external factors (such as demand and access to particular markets for particular products) explain the developments. Nevertheless, for all or most of the countries, the reversal of the earlier pattern is probably explained by several factors:

- The EU was in a prolonged recession in 1992-1993—though this could not be the full explanation, in view of the fact that CEE exports to the EU fell faster than overall EU imports from all sources. To be sure, Germany's particularly deep recession especially hurt the exports of CEE.

- Most of the OECD and EU trade liberalization measures had positive, once-and-for-all effects; once the new ceilings for trade expansion had been reached, no additional impact could be expected from the concessions.
- The exchange rates of most of the CEE countries had appreciated substantially in real terms.
- Protectionism in some of the OECD countries had increased, selectively, in some of the sensitive sectors. For example, imports of steel products were restricted by the EU shortly after the Europe Agreements had been concluded.
- Over the course of the last several years, enterprises in the CEE countries have invested very little to modernize, given that they faced poor market conditions and too many uncertainties, and had insufficient retained earnings or capability to tap external funds (partly because government budget deficits to finance transfer payments preempted savings and prompted central banks to pursue anti-inflationary monetary policies). The inherited production structure, not highly modern to begin with, became less and less capable of generating new exports for Western markets. To be sure, there were notable exceptions, often where foreign investors had acquired domestic capacity, made large investments, and undertook a successful restructuring program. A case in point is General Electric's acquisition of Hungary's largest manufacturing firm, the light-source manufacturer TUNGSRAM. During 1990-1994, GE made a \$600 million investment in the acquisition, modernized production, introduced several new products, and doubled exports, mostly to the West. Other similar examples can also be found, especially in Hungary, where the inflow of foreign investment has been the largest.

### *XIII. Prospects*

The following paragraphs project some plausible scenarios for political and economic developments in each of the CE-3 countries by the early years of the twenty-first century. This is a medium-term projection since at the time of writing (mid-1995), the turn of the century is less than five years away. The projections focus on those aspects of their economies and societies that are especially important for establishing a base for effective corporate governance and restructuring.

An optimistic but plausible scenario for the Czech Republic, Hungary, and Poland to the year 2000 is shaped by the powerful drive of all three countries to be accepted into the EU and, at least indirectly, into NATO. This drive severely constrains their economic policies because it will be necessary for new members to meet certain economic criteria (e.g., the size of the budget deficit relative to GDP)—although what exactly the economic criteria will be, and whether they will differ for various groups of countries, is still to be decided by the EU, a task that it plans to accomplish in 1996. Consequently, changes in government in any of the CE-3 countries, even from one side to the other of the mainstream political spectrum, are unlikely to basically change the direction of policy. The essential continuity of economic, social, and foreign policies in Poland and Hungary under their current governments - prominently including former communists - supports



this thesis. For example, financial and political pressure by the international community, in addition to domestic pressures, had forced Hungary's socialist government in March 1995 to announce a drastic and domestically unpopular economic stabilization program.

It is assumed that around the year 2000, the CE-3 countries will all be on the verge of becoming members of the EU. To be sure, the EU will likely have become a multi-tier integration unit, in which some member countries will be given a longer period to achieve the strict economic conditions laid down by the Maastricht Treaty. Some of those conditions may be eased for some or all members. Thus, with the kind of economic policies necessary to strengthen their pending EU memberships, it is reasonable to expect that in each CE-3 country:

- Inflation will probably be in the single digits;
- The share of the private sector in GDP will have increased from the current 50–70 percent to 80–90 percent, as a result of both private sector growth and the steady shrinking of the state sector;
- The institutional, legal, and regulatory frameworks of a well-functioning market economy will have developed considerably further;
- Financial constraints will have forced some real reforms in the government budget, especially in the large social expenditures component, such as pensions and health care;
- Labor costs will remain far below West European levels, with corresponding implications for comparative living standards, as well as production sharing (specialization),<sup>17</sup>
- Foreign direct and portfolio investment, mainly from Western Europe, will increase, driven both by better growth prospects than in the home countries and by the competitive pressures with North America and Japan (whose integration with low-cost Latin America and South-east Asia, respectively, will continue), as well as directly with the newly industrialized countries.

Under these circumstances, domestic investment can be expected to increase considerably as well, as a result of which a reasonable projection for economic growth would be on the order of 3 to 6 percent a year during the intervening five years. Accompanying this healthy growth will be a steady upgrading of production and exports, as all three countries expand their competitive niches in heavy industry, high-tech industries, food processing, and certain services. Indeed, this upgrading process must be viewed as part of continued “normalization,” following the necessary but transitional concentration on labor-intensive production during the first few years of the transformation.

With regard to large industry, their size, as well as the share of state ownership, will shrink considerably, as a result partly of privatization but mostly of continued asset erosion. Private ownership will become more concentrated, with a much larger role for foreign investors and domestic capitalists and a smaller one for financial intermediaries, like domestic investment funds.

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<sup>17</sup> In certain countries, such as the Czech Republic, real labor costs may increase as a result of real currency appreciation, since the Czech crown was notably under-valued during 1991–1994.

In the Czech Republic, investment funds may sell a considerable part of their shares to foreign and domestic investors, while concentrating the remainder on a smaller number of firms. The government's share will probably fall to about 10 percent and the foreign share will increase greatly, perhaps approaching the levels (about one-third of the total) found in most of the smaller West European countries, such as Austria, Belgium, and The Netherlands.

In sum, the economic prospects of the CE-3 countries is judged to be cautiously optimistic. Sustained economic recovery in the countries to the east and to the south of them would significantly boost prospects for the CE-3 as well.

## TADEUSZ KOWALIK

## Towards a Free Market or a New Mixed Market Economy - Comments on Professor Paul Marer's Paper\*

### *I. Two Schools of Thought*

The systemic transformation of an economic system in the post-state-socialist countries has few precedents, and is thus, quite naturally, a subject of many controversies. Different theoretical views are presented and programs recommended. It is interesting to note that main lines of differences are, so to say, geographically conditioned. The mainstream economists of Anglo-Saxon countries are seeing systemic changes in Central and Eastern Europe as a transition from the one well defined system (a pure command economy) to another pure system - a free market economy. On the other hand, the economists of the continental Europe, especially French, German and Scandinavian ones, are seeing these changes through the concept of the great transformation. For them the end of this transformation is still unknown, but they expect a creation of a new mix, rather than just a copy of the Anglo-Saxon model of a market economy, as it is usually presented in the standard textbooks.<sup>1</sup>

For the first school of thinking the year 1989 is a clear-cut *caesura*, something like a zero hour, or - as in case of Fukuyama and his followers - an end of history. As opposed to the second school which stresses an accelerated continuation of earlier changes, the first school sees the political collapse of the communist system and the formation of a new political power as a precondition for a "jump in a

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\* In the previous chapter of this volume.

<sup>1</sup> For this school, the advanced capitalist economies are also now transforming "from one mixed economy regime to another mixed constellation." The authors of this statement, Bernard Chavance and Eric Magnin, quote the following opinion of R. Boyer, accomplished with a rather extreme prognosis: "In fact, the last two decades have exhibited a chaotic and rather myopic transition out of one mixed economy regime, that the regulation approach uses to call fordist, Beveridgian and Keyensian. This label characterizes respectively the capital-labor compromise, inherited from the interwar Great Depression and finally the countercyclical use of monetary and fiscal instruments for smoothing economic fluctuations. The rather likely outcome will be another configuration of mixed economies. Tentatively, these regimes have been labeled toyotist for Japan, uddevalist for Sveden, or nostalgic and fordist for US and France. If true such a diagnosis strongly contradicts any institutional convergence, be it among the western world, or for Eastern European countries". Bernard Chavance and Eric Magnin, "The Emergence of Various Path-Development Mixed Economies in Post-Socialist Central Europe," Working paper of CEMI EHESS (Montrouge, 1995), mimeo, p. 2; R. Boyer, "Market Within Alternative Coordinating Mechanism," CEPREMAP (1991), mimeo.

market economy," as Jeffrey Sachs has aptly put it.<sup>2</sup> For to the second school, however, there is not, nor can there be, such a thing, as a jump from one system to another. The new system must be an outcome of an evolution independent of government activity. Moreover, a collapse of a political system is seen (if we ignore the result of the rivalry of the two super powers, which was, most probably, the decisive factor) rather as a result of an earlier socio-economic transformation.

The second school also pays much more attention to the problems of inequalities. The adherents of this school recall that this is not only a matter of justice, but (within certain limits, of course) a precondition of rapid development. They point out that, in the second half of the twentieth century, it was the most egalitarian economies, such as the Scandinavian, Japanese, Korean and Taiwanese, that have managed to catch up economically with the most developed Western countries. In contrast, the first school considers growing disparities as the inevitable cost of transition to a more efficient system, a historic stage of the well-known process of primitive accumulation of capital, which inevitably precedes the mature market economy. For the first school, competition and rivalry is the essence of development; for the second school, competition should be reconciled with cooperation. The latter argues, for example, that the Japanese firms "coordinate rather than compete, and the government supports rather than regulates and deregulates."<sup>3</sup> It also distinguishes (following Marx, Schumpeter and Lange) between a market economy and a capitalist economy as its special stage.

In a sense, this division of approaches has even some emotional color. Namely, the first school sees the emergence of a new system as the result of conscious government policy, of a great undertaking of the state. If changes are not rapid enough, or not implemented within a short time, this is a fault of the famous *Homo Sovieticus*, which has deeply infected a society as well as its political elites.

There are, of course, many exceptions: Professor Anders Aslund, the well-known adviser of Gajdar, is an exception among the Scandinavians (he recently moved to the USA). P. Murrell is another exception amongst the Americans. The geographical differences, however, are only one dimension; another would be occupational. The economists are mainly the big bangers, or shock therapists, whereas the sociologists, politologists, historians, or, more generally, the non-economic social scientists, are rather evolutionists, gradualists and institutionalists. The title of a book by Jeffrey Sachs, *Poland's Jump in a Market Economy*,<sup>4</sup> represents the essence of this approach. It should be stressed that the model of a free market economy is very far from reality even in the United States, the economy of which is most probably the closest to this model. This has been argued not only by J.K. Galbraith, but also, albeit in a rather perverted way, even by Milton Freedman, who has proposed that the Polish political elite follow not the present-day US economic system, which is highly infected by socialism, but the system that existed a hundred years ago. In

<sup>2</sup> Jeffrey Sachs, *Poland's Jump in a Market Economy: based on the Lionel Robbins Memorial Lectures delivered at the London School of Economics, January 1991* (Cambridge, Mass., 1993).

<sup>3</sup> Lin Nan, "Local Market Socialism: Local Corporatism in Action in Rural China," *Theory and Society* 24 (1995), p. 303.

<sup>4</sup> Sachs, *Poland's Jump*.

reality, at least since the Great Depression, a mixed and not a pure market economy is a dominant feature of the contemporary world.

## II. Which School Does Professor Marer Belong to?

Professor Paul Marer's paper, as well as his other publications, is much more sophisticated than the typical approach of the American mainstream economists. After all, he is an outstanding specialist not only of the Hungarian, but also of other command economies.<sup>5</sup> While being an active member of the reformist "Blue Ribbon" Committee, he was one of the best known experts of its stabilization and transformation program, which was preceded by a comprehensive research project on the so-called "reform economics." By and large, however, his paper would have to be placed in the second school. As I read it, its main methodological framework is the so-called (propagated by the World Bank) market friendly policy, if not a paradigm. I have a feeling that this paradigm is too narrow for his knowledge. That is why I decided to discuss his general, explicit or tacit assumptions.

In this short note I choose the following ones:

1. Roots of a recession 1990-1992,
2. The rationale of privatization and efficiency of privatized enterprises, and the private sector as a whole,
3. Prospects for, and the gains and costs of, integration.

**"Recession."** In Marer's opinion, the well-known J. Kornai's term "transformational recession" is "not the most fortunate" one because "it implies that the cause of the output drop was the transformation itself, rather than the *sudden revelation* of the economic problems of 'misdevelopment,' that have been accumulating for a long time, combined with such large external shocks as the collapse of the market of the former Council for Mutual Economic Assistance (CMEA, often called in the West COMECON countries)."<sup>6</sup>

I think that such an explanation of the phenomenon is much, much too hasty. I also think that Kornai's term is highly inadequate both as far as the magnitude of a drop of production as well as its causes are concerned. Since the World War II we used to mean by recession a slow down of economic activity or a relatively small drop of production. Central and Eastern Europe have experienced, however, not a slow down, but a real catastrophe, which also for Marer himself is comparable to the Great Depression of the thirties! Also, the causes of this slump are multiple, and are not only systemic changes. Kornai may be right in saying that *in Hungary* "the transformational recession has characteristics that are far more Schumpeterian than Keynesian."<sup>7</sup> But it is also the case, however, that such a far-reaching generalization of the Hungarian experience may be misleading. It is a pity that he

<sup>5</sup> Paul Marer, *Dollar GNPs of the USSR and Eastern Europe* (Baltimore and London, 1985).

<sup>6</sup> Paul Marer, in this volume (emphasis added).

<sup>7</sup> Janos Kornai, *Highways and Byways, Studies on Reform and Post-Communist Transition* (Cambridge, Mass. and London, 1995), p. 176.

did not consider differences between those countries that implemented shock therapy (Poland and Czechoslovakia), on the one hand, and countries such as Hungary, with more gradualist type of reforms, on the other. In Poland, particularly in the first months of 1990, the most evident consequence of this shock treatment was a drastic cut of demand.<sup>8</sup> In this respect both explanations, Marer's and Kornai's,<sup>9</sup> are, in my opinion, insufficient.

Marer's explanation of a recession by "sudden revelation" seems to be too hasty a generalization for Romania, and perhaps even for Czechoslovakia, where a semi-Stalinist system had lasted to the very end of the existence of a command economy. But Hungarian and Polish people were fully aware of the real state of their economies. In Poland the main wave of criticism took place in 1980-81. Poland's official statistic notes that a drop of industrial production in January 1990 was only about 30%. This is almost the exact same drop of industrial production that took place in the USA within two to three years of the Great Depression! January 1990 was the month of introducing the Balcerowicz Plan. No new, shocking facts had been brought to the public at that time. Thus, it would be more persuading to connect this sudden drop of production with a sudden cut of aggregate demand, a sudden increase of the interest rate and a devaluation of the zloty. Poland's drop of production was deeper but otherwise quite similar in kind to that of other countries that had implemented the IMF (and World Bank) sponsored stabilization programs.

Of course, there was a lot of "misdevelopment" in the structure of command economies. Heavy industry (also armaments) was overdeveloped, and consumer goods were outdated. But we must be careful to properly analyze these phenomena as well. First, there was already a relative contraction of heavy industry branches in the 1980s;<sup>10</sup> second, in the first period of the recession, it was the production of consumer goods and the precise industry which suffered the most; and third, the character of recovery in Poland demonstrates that the production apparatus was not as obsolete as one might have thought at the beginning of the recession. For the last four years of the present recovery, Poland has had quite a high rate of economic growth, which has been achieved in spite of a very low level of investment. This clearly indicates that recovery was mainly due to a better use of (idle) production capacity. Thus, "the elimination of production," for which there was no demand, has been conditioned by some temporary phenomena connected with the stabilization program. One of them, which was not even mentioned by Marer, was an external shock: namely, the liberalization of foreign trade to such an extent that

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<sup>8</sup> The Polish stabilization program was outlined on the assumption that there was an excessive money overhang, whereas it was absorbed in the second half of 1989. Branko Milanovic, "Poland's Quest for Economic Stabilization 1988-1991, Interaction of Political Economy and Economics," *Soviet Studies* 3 (1991); Stanislaw Gomulka, "Polish Economic Reform 1990-1991: Principles, Policies and Outcomes," *Cambridge Journal of Economics* 16 (September 1993).

<sup>9</sup> It is interesting, however, that in his anti-recessional recipe Kornai recommended mostly typical Keynesian measures.

<sup>10</sup> This was emphasized in Evá Ehrlich and Gábor Révész, *Hungary and its Prospects, 1985-2005* (Budapest, 1995).

Poland (and Hungary too) became one of the most free-trading countries in the world, probably just behind Hong Kong. From the perspective of such a radical free-trade policy, Poland's economy was indeed "misdeveloped." But how many moderately developed economies in the world would have been able to meet such a sudden openness without experiencing a recession? Moreover, in Poland, Hungary and other Central and Eastern European countries, this external shock took place in conditions of very expensive credits (a prohibitive high rate of interest) and an underdeveloped banking system! Thus, even with a thesis of "misdevelopment," we should not exaggerate.

Now about a dissolution of CMEA. It is unquestionably true that the collapse of trade with the Soviet Block countries created a lot of difficulties for many enterprises and branches. Still, this external shock was a factor not entirely independent of the economic policy of the Polish government. For one, the Polish government was very active in dismantling the CMEA structure, but did so without offering any proposals for substituting the former organization. Moreover, according to many observers, even after the dissolution of CMEA, the fall of trade with the East need not have been so dramatic had the Government undertaken certain countervailing steps, like encouraging barter and clearing agreements arrangements.

According to some observers, the radical change of the direction of trade from the East to the West was being imposed upon the Polish enterprises as a result of a political reorientation to the West. There is some evidence that a drastic reduction of trade with the Soviet Union was deliberately planned already in January 1990: a conference of 200 top managers of state enterprises was then held, at which the Ministers of Industry and Foreign Economic Cooperation announced that "the government has decided to reduce exports to the USSR this year [1990] by 50% in relation to 1989 figures."<sup>11</sup> Bearing this information, given by one of the participants, in mind, Professor K. Bolesta-Kukulka writes that "this was most probably part of the political strategy of the West. At the time the West wanted Poland to repay its debt not to the East but to the West." She concludes: "the dictate of the East began to be replaced by the dictate of the West. The new protectors also expected that Poland show evidence of its creditability."<sup>12</sup> If this assertion seems not entirely convincing, this is because of the mood of Polish rulers, which was then so uncritically pro-Western that they would have complied to the creditors' demands even without any external dictates.

We also should not forget that changes in external opportunities were not only negative ones. The sudden opening to the Western markets had facilitated the export expansion to the West. The statistical data shows that, in the years 1990-1992, Poland and Hungary managed to redirect their exports from East to West so successfully that the total exports (as expressed in USD) exceeded the export level

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<sup>11</sup> J. Z. Salamon, "Ograniczac czy stymulowac (To constrain or to stimulate)," *Trybuna*, March 16, 1990; cited by Krystyna Bolesta-Kukulka, *Gra o wladze a gospodarka (A play for power and the economy), 1944-1991* (Warsaw, 1992), p. 159.

<sup>12</sup> Bolesta-Kukulka, *Gra o wladze a gospodarka*, pp. 159-160.

of 1989. Only Czechoslovakia (probably because of a radical drop of armaments exports) did not cover the eastern losses fully (98%).<sup>13</sup>

This was an unquestionable success and an unexpected manifestation of considerable flexibility of the state firms, which had a substantial role in foreign trade during the first years of transformation. This success was remarkable when we remember how strongly the structure of the satellite economies had been shaped by specific bonds with the Soviet Union. Indeed, these bonds only partially resembled the relationship between the center and periphery, since the USSR provided raw materials while receiving manufactured goods from the peripheries in return. Manufactured electrical machines had a considerable share of the peripheries' exports to the USSR, but were uncompetitive in the Western markets. It is also true that initially the Visegrad economies took advantage of the Soviet Union's raw materials bought at prices far below the world market. Many enterprises exported these raw materials bought in the USSR just prior to the transition from ruble to hard currency in trade relations. It was one of the sources of the rapid rise in exports to the West in 1990.

By and large, then, the collapse of the CMEA trade did not create particular difficulties in compensating the amount of exports, but instead was a problem of a deterioration of the structure of trade. These branches which have increased their share in total exports are characterized by the extensive use of materials, and energy. To this group belong the metallurgical, chemical and timber industries. On the other hand, we notice a considerable fall in the share of products of machine tools, electrical engineering, and particularly high-tech goods (automation, information systems, etc.) and precision engineering. The collapse of these exports was particularly great and clearly significant, for such high-tech industries are known to comprise a rapidly growing share of exports in highly developed countries, and are usually considered a sign of industrial progress. It is important to note that there was also no improvement of the foreign trade structure even in time of recovery. For example, in 1994 Poland's exports showed a negligible increase in the share of industrial products containing little value added (from 26.4 % in 1993 to 27.5 %), and a drop in the share of machinery and equipment (from 20.9 to 19.6%).<sup>14</sup> The specialists consider this to be "an expression of the new pattern of Poland's export specialization."<sup>15</sup>

The above mentioned changes in exports caused a regression in the structure of domestic production. Similar changes caused the rapid rise in imports (a composition of which was rather unfavorable to the development of home manufacturing).

**Privatization.** Marer's approach to privatization and also to restructuring is based on the assumption that the private sector is evidently much more dynamic than the state one, because private firms are much more efficient than public firms not only *per se* or in a developed market environment, but also in present-day Central and Eastern European realities. Perhaps the most visible demonstration of this approach

<sup>13</sup> Thus, I do not understand why Marer thinks that "better access to the West did not and could not offset fully the market loss suffered in the East." Marer, *Dollar GNPs*, p. 22.

<sup>14</sup> World Economic Research Institute, *Poland, International Economic Report 1994-1995* (Warsaw, 1995), p. 123.

<sup>15</sup> Instytut Rozwoju i Studiów Strategicznych, *Gospodarka Polski w procesie transformacji, 1994* (Warsaw, 1995), p. 87.



can be seen in the following sentence: "The fact that the private sector has grown rapidly - in spite of several policy failures or inaction by successive governments - while the state sector has eroded steadily indicates that market forces have become strong enough to shape the economy."<sup>16</sup> This assertion is addressed to the Polish "Shock therapy."

Let's distinguish two separate questions in the expressed opinion: 1) Did market forces act so forcefully *in spite of* policy failures and inaction or *because of* the economic policy of the government? 2) What were the special conditions favoring the rapid growth of the private sector? Can we expect that these or new special conditions of similar character will promote a continuation of the rapid development of private sector?

There were, of course, failures and periods of inaction in the subsequent government policy. Some of them made the expansion of viable private enterprises difficult. On the whole, however, the private sector expanded first of all due to its ability to exploit a lack of government control, the existence of many loopholes in legislation, the ease in which it could bribe customs officers, bank clerks, policemen, etc. Quite a substantial part of state capital assets have been transferred into private hands not because state enterprises were unable to use them efficiently, but simply because of a lack of state control on the one hand, and an explosion of vested interests of the old (and new of course) *nomenklatura*, on the other. Thousands of companies and individual enterprises have emerged in this highly pathological, corruptive manner.

This is, however, only a part of the very favorable, and thus rather exceptional initial environment for private entrepreneurial activity. The other part is connected with deliberate government economic policy oriented towards a "steady erosion" - as Professor Marer put it - of the state sector, and the promoting of a private one. Not only a general attitude, but the whole economic policy, was subordinated to this goal. Even recently, after a couple of years of "normalization", private firms pay on average three times, and the largest ones (mainly international corporations or joint ventures) about fifteen times, lower tax than do state firms.<sup>17</sup> Lower tax payment is not only a result of frequent tax evasion (and tax vacation for the multinationals). Private and state firms are treated differently in the very tax system. Only state firms were obliged to pay the special tax on excess wage increases and the so-called dividend (a tax on capital assets). Private firms also proportionally contribute very little to the insurance fund.

There is no doubt that private firms have been more flexible than the state ones from the point of view of market adaptation. This is, however, the result not only of their nature, but also because the majority of private firms have emerged into a new situation. Thus, their production equipment was from the very beginning adapted to market requirements. This was not the case with state firms suffering from an autarchic past. In the new conditions they became overburdened with much unneeded equipment, or they have had limited access to credits necessary for

<sup>16</sup> Marer, in this volume.

<sup>17</sup> Anna Krajewska, "Opodatkowanie sektora prywatnego i publicznego w Polsce (The tax burden of the private and public sector in Poland)," *Gospodarka Narodowa* 78 (1994).

adapting to the demands of the open market. Economists, as well as many state firms' top managers, for years demanded in vain the creation of a special agency to handle equipment and buildings no longer needed by state firms.

There are, however, very few signs that private firms by themselves can restructure the whole economy. So far the private sector was most dynamic only in such spheres as trade and services, which were highly neglected by the communist authorities. It has not acted as forcefully in industry, which badly needs reconstruction. The private sector has invested a much smaller proportion of its assets in this sphere, which is still the most important part of the national economy. Figures for Poland given by a researcher<sup>18</sup> are revealing. In 1993 the share of private firms in total turnover capital in industry was almost 12 %, but their share in total investment outlays was only less than 7%. The figures for the traditional state firms are 56% and 54 % respectively, and 26% and 26% for the so-called state treasury companies.

One may agree that "a significant part of the output fall reflects the elimination of production for which demand could exist only as long as the economy was highly protected and planners, not final and intermediate consumers, decided what is to be produced."<sup>19</sup> But how significant? Specialists say that in Poland even now, in the fourth year of recovery, about half of production capacity in industry remains idle. Was a third or fourth part of this unused capacity and lost production unneeded? It could not be more than that, because otherwise the present high rate of economic growth, which took place with minimal investment, would be impossible. One may be sure, then, that much of this could have been easily exploited if enterprises had normal access to credits.

*Integration.* Professor Marer's medium-term projection for Central European countries is quite optimistic. He writes: "An optimistic but plausible scenario for the Czech Republic, Hungary, and Poland to the year 2000 is shaped by the powerful drive of all three countries to be accepted into the EU and, at least indirectly, into NATO. This drive severely constrains their economic policies. Consequently, changes in the government in any of the CE-3 countries, even from one side to the other of the mainstream political spectrum, are unlikely to change the direction of policy."<sup>20</sup> Thus Marer's optimism is based not as much on internal sources of development, as it is on international pressure.

It is quite likely that these countries will continue the well-known IMF and World Bank- supported "market friendly" policies. The question arises, however, whether this scenario is simply optimistic and quite precarious. As we have written above, the reorientation of these countries' trade from East to West has been done at the price of the deterioration of its structure. All three countries are now exporting relatively more raw materials and material and energy intensive products than they were five or six years ago. A similarly negative phenomenon can be observed with imports as well. The impact of both exports and imports on the production structure

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<sup>18</sup> Ryszard Domanski, "The State and Private Sector Performance in Poland: Slightly Uncommon Glimpses," working paper, (Cambridge, July 1995), p. 7.

<sup>19</sup> Marer, in this volume.

<sup>20</sup> *ibid.*

has brought changes that we can safely describe as negative restructuring. Furthermore, preliminary research demonstrates that direct foreign investments do not contribute much to the modernization of production technology.<sup>21</sup> All this leads one to ask whether the persistence of present day policy does not mean the preservation of the peripheral character of Central European economies. A weak spot of Marer's paper, which was apparently a result of empirical research, is a total lack of analysis of these new symptoms of "misedevelopment" of the Visegrad countries' economies. While acknowledging that the structure of these economies' production "became less and less capable of generating new exports for Western markets,"<sup>22</sup> Marer attributes this only to past backwardness and a lack of credits for modernization. The very logic of the present East-West trade relations is not even mentioned. The recent crisis of the Mexican economy reveals an acute vulnerability of a less developed economy integrated with a much more advanced partner. True, the example of Spain and Portugal (but not of Greece) is more promising. But it is unclear whether the Central European countries can expect such gracious assistance as was accorded to these two countries; indeed, many authors doubt it.<sup>23</sup> It may be not enough to counteract the quite natural tendency of a free market to increase disparities between the richer and poorer regions.

### III. Conclusions

Hans van Zon drew five alternative scenarios for the Central Europe's future: *the laissez-faire path to capitalism, the leaning-upon-the-West, a populist-authoritarian, muddling on, and the sustainable development scenario*.<sup>24</sup> If I understand Marer's paper correctly, he tends to rely upon the first two scenarios, assuming that a free-market path *cum* leaning-upon-the-West is the best option for sustainable economic development in these countries. That is why his paper is so scanty in its postulative part. A recovery from the last recession, particularly in Poland and the Czech Republic, seems to support his reasoning, though the current Hungarian practice of "muddling on" is less promising. It seems to illustrate that the path of a free market, as promoted by the West, may lead to the least favorable prospects for development. Needless to say, such a model that isolates political power from a society creates particularly fertile soil for a populist-authoritarian

<sup>21</sup> Urszula Plowiec, *Strategia otwierania polskiej gospodarki (A strategy for opening the Polish economy)*, (Warsaw, 1995), mimeo.

<sup>22</sup> Marer, in this volume.

<sup>23</sup> Richard E. Baldwin, *Towards Integrated Europe* (London, 1994); Richard Jackman, "Regional Policy in an Enlarged Europe," *Oxford Review of Economic Policy* 11:2 (1995); Bob Jesop, "Regional Economic Development Strategies in Post-Socialist Societies: Contents, Constraints and Conjectures," in Margaret Mendell and Klaus Nielson, *Europe Central and East, Critical Perspectives on Historical Issues* (Montreal, New York and London, 1995).

<sup>24</sup> Hans van Zon, "Alternative Scenarios for Central Europe," in Jezy Hausner, Bob Jesop, Klaus Nielson, eds., *Strategic Choice and Path-Dependency in Post-Socialism, Institutional Dynamics in the Transformation Process* (Aldershot, 1995).

outcome. But even with regard to Poland and the Czech Republic, we have to remember that so far their recovery is still within a business cycle level, and they have not reached the level of economic activity they attained at the beginning of the last recession. It remains to be seen whether this recovery will lead to long-term economic growth.

ÉVA EHRLICH AND GÁBOR RÉVÉSZ

## Structural Change in the Hungarian Economy during the First Phase of Transition, 1989-1993

### 1. Facts Regarding the Structural Change of the Economy

It is well-known that a strong decline occurred in the Hungarian economy during the period under review. It is not our task here<sup>1</sup> to characterize this decline and its causes, but we shall certainly deal with its structural repercussions.

(1) Table 1/a presents the quantity indices of two performance indicators (gross output and value added), as well as employment in industry breakdown, and does so separately for the 1989-1991 and 1991-1993 periods. The movement of these indicators is in one direction. Among the differences in movement, one should single out, because of their structural impact, the following:

- The decline of performance indicators in the material sphere was much stronger in the first phase than it was in the second. In the non-material sphere the indicators signal stagnation in the first phase and growth in the second. (Table 1/a columns a and b)
- Employment decreases with a lag (column c): the decrease is larger for almost every industry in the second phase than in the first. Considering the whole period, the decrease of employment is significantly larger than that of performance, which may be, perhaps erroneously, termed as an increase in "macro level productivity."
- Decline is largest in agriculture<sup>2</sup> and in branches of construction where performance indicators (with the exception of one) degenerated by one third.
- Growth is characteristic for the non-material sphere particularly in phase two. The spread of real estate<sup>3</sup> and the prominent other services<sup>4</sup> is due to the character of transformation. The "growth" of the output of public administration<sup>5</sup> as registered by national accounts may be the result of the building up and operating of democracy's institutional system.
- A strange case is trade,<sup>6</sup> which increased in the first phase, stagnated in its gross output during the whole period, decreased in value added and increased considerably in employment. The difference between the quantity indices of value added and employment amounts to 30%-point. We think the "anomaly" is due to the reorganization of industry, since the predominance of large state firms was replaced by that of small individual and family ventures.

<sup>1</sup> A more detailed analysis of these problems is found in Éva Ehrlich and Gábor Révész, *Hungary and its Prospects 1985-2005* (Budapest, 1995), p. 168.

<sup>2</sup> Agriculture, hunting, forestry and fishing.

<sup>3</sup> Real estate, renting and business activities.

<sup>4</sup> Other community, social and personal service activities.

<sup>5</sup> Public administration, defense and compulsory social security

<sup>6</sup> Wholesale and retail trade, repair of motor vehicles and household goods.

Table 1/b, which presents part of the above-mentioned performance indicators for the various branches of industry, indicates the winners and losers among them. The data in this table differ somewhat from those in Table 1/a. This is due to the fact that the data of Tables 1/a and 1/b come from different assessments. The differences are nevertheless small and not significant; hence Table 1/b might be considered as a supplement to Table 1/a.

- This table also corroborates our previous statement: within individual branches of industry, the decrease of performance indicators was larger in the first than in the second phase.
- The visible losers are mining,<sup>7</sup> textiles,<sup>8</sup> metals<sup>9</sup> and machinery.<sup>10</sup> Relative winners, i.e., those who lost the least, are food,<sup>11</sup> wood<sup>12</sup> and electricity<sup>13</sup> industries.

The endeavor to maintain the large, loss-sustaining, autarchic mining and metal industries, and the failure of their modernization, has been an acute problem of Hungarian industrial and economic policy for decades. Old traditions and experiences made Hungarian textile, wearing-apparel and leather products quite renown. Several branches of machinery, however, comprised high-level Hungarian industrial culture and intellectual capital. Their decline brought with it the loss of a large part of a historically-developed Hungarian work culture. For instance, between 1989 and 1993 employment declined by 72% in the radio industry<sup>14</sup> and by 67% in the medical instruments industry.<sup>15</sup> The "winners" in this branch-level breakdown belong to less prestigious branches producing less sophisticated products with high energy or raw material content.

(2) Tables 2/a and 2/b present the branch structure of gross output and GDP: Table 2/a for the first and last years of the period, and Table 2/b (in more detailed breakdown) for the middle and last years of the period. Temporal shifts in breakdowns of the table reflect differences in volume indices of former tables: under unchanged conditions (in our case relative prices), a lower than average volume index brings with it a decrease of the breakdown; a higher than average volume index brings an increase. At the same time these breakdown indices react to differences in changes in relative prices: higher than average price indices add to, and lower than average indices reduce, the value of the breakdown. Tables 2/a and 2/b thus turn our attention to differences in value and quantity effects.<sup>16</sup>

- The data shows a strong devaluation of industries of the material sphere: a large part of the decrease in their share of total output is due to value (price)

<sup>7</sup> Mining and quarrying.

<sup>8</sup> Textiles, wearing-apparel, leather and fur products.

<sup>9</sup> Basic metals and fabricated metal products.

<sup>10</sup> Machinery and equipments.

<sup>11</sup> Food, beverages and tobacco products.

<sup>12</sup> Wood, paper and printing products.

<sup>13</sup> Electricity, gas, steam and water products.

<sup>14</sup> Radio, TV and communication equipment and apparatus.

<sup>15</sup> Medical, precision, and optical instruments, watches and clocks.

<sup>16</sup> We have to note that in the present phase of our work we did not analyse directly the structure of price changes.

effects. Price effects for the whole period surpass volume effects in almost every position of agriculture and industry. The loss of position of agriculture and industry is largely due to a restructuring of value relations. Value effects are strong in the first phase for agriculture and in the second phase for industry.

- Price effects are positive in other branches, and they raise the respective breakdown indicator. Particularly strong is this effect on transport,<sup>17</sup> but also on trade: despite the negative volume effect, the share of these branches in the current price value added increases.

(3) We already mentioned changes in employment as they are related to changes in volume of gross output and gross value added. Now, reviewing tables 3, we examine changes in activity and employment.

- Table 3/a reflects dramatic changes in employment and the activity structure of the population. Between 1990 and early 1994, with an almost 1% loss of total population and a 1% gain - due to demographic factors - in active age, the population's employment declined by 1.3 million (26%), from 5.2 million to 3.9 million. As a result, (row 6) the number of dependents per 100 employees grew from 98 to 165. In another context, the working age population's employment decreased from 88% to 64%.
- While the unemployment rate grew from 0.4% to 13.3%, the number of the registered unemployed increased from 24,000 to 632,000. Beyond this there is a drastic drop in the employment of non-active age workers, and an increase of family members - due first of all to demographic changes - of active age students.
- As it appears from Table 3/b, most of employment reduction (more than 80%) fell on agriculture and industry. The huge (61%) loss of employment of agriculture requires an explanation. Back in 1989-90 extensive "profile alien" (industrial, construction and service) big units could be found within agricultural firms (agricultural cooperatives and state farms). A large part of them gained independence in the process of transformation (or went bankrupt). They appear in statistics as non-agricultural activity even if they are doing the same job in the same place. Unemployment is the most serious in agriculture, where it has risen to above 30%, and is around 50% in some Gypsy-inhabited districts.

(4) Transformation includes changes in the size structure of business units. This is revealed by Table 4.

- All categories of legal business units have been decentralized: the number of larger units decreased, and smaller units increased gradually. (see Table 4/a) Besides a strong reduction of their total number, the share of big state-owned enterprises declined by half, and by one fourth in the co-operative sector. Joint stock companies gained ground in the economy (with their size decreasing somewhat). A large sector of limited liability companies dominated by small organizations did arise. Overall figures on the size structure of business units by the number of employees and the value of output

<sup>17</sup> Transport, storage and communication.

are not yet available, but one can already determine a change in the size structure. The previously characteristic "reversed pyramid,"<sup>18</sup> with few small and medium-sized and many large units, is increasingly reversed. The number of small (though less so with that of mid-size) units grew rapidly, essentially erasing the "pyramid." Today its shape is rather that of a vase, with the multitude of recently formed small ventures at the bottom, the weak sector of mid-size (300-500 people) firms in the middle, and the large, preponderantly state-owned firms, which still carry considerable weight in employment, at the top.

- In the process of transformation the number of those employed in small individual ventures without legal entity, the so-called self-employed, grew rapidly. Data on this process is found in Table 4/b. Also because of the decrease of total employment, their share grew from 7.2% in 1989 to 21.8% by 1994. This is an extremely high share even compared to the South-European market economies. The spread of individual ventures and small units without legal entity is a progressive element of the transformation and the enfolding of market forces. At the same time, some of these self-employing small ventures are undeniably fronting for the black market and other illegal activities. According to some researchers, a large number of these small units are hopeless ventures established "for want of something better" by those fleeing unemployment.

(5) We called attention above to some structure-constituting peculiarities of the transformation related to production and producers (employment, business organizations). We now turn to the problems of usage. Table 5 presents data about the most important macro-categories of GDP use.

- The volume of total domestic use decreased between 1989 and 1991 by almost 12%, but it increased between 1991 and 1993 by 3%. Considering the whole period, the decrease of domestic use did not reach 10%. It is particularly striking that, in the period of a strong shrinking of the economy, the volume of public consumption grew by 6.5%. According to data of Table 1/a, the GDP declined by 14% in the first phase, by a further 4% in the second phase, and by 18% during the entire period. According to preliminary data in 1994, both GDP and domestic use grew by 2%.
- A comparison of volume indices shows the serious discrepancy of production and use. It shows up in actual form in the last row, column 4 and 5 of Table 5, where the 3.4% export surplus of the year 1989 (most of it to the Soviet Union and other CMEA countries, a surplus which is difficult to mobilize) turned

<sup>18</sup> See I. Schweitzer, *Vállalatméret (Size of Firm) Közgazdasági és Jogi Könyvkiadó* (Budapest, 1982), p. 147; É. Ehrlich, et al., "Establishment and Enterprise Size in Manufacturing: An East-West International Comparison," *WIIW Forschungsberichte* 80 (June 1982), p. 139; É. Ehrlich, "The Size Structure of Manufacturing Establishments and Enterprises: An International Comparison," *Journal of Comparative Economics* 9 (1985), pp. 267-295; É. Ehrlich, "Shift in the Size Structure of Manufacturing Establishments and Enterprises: An International Comparison," working paper, Institute for World Economics, Hungarian Academy of Sciences, (Budapest, 1993), p. 18.



into a 5.3% deficit by 1993, and remained so in 1994. The discrepancy relative to the year 1989 measured by the balance of foreign trade is therefore almost 10 %-point ( $3.4 + 5.3 = 8.7$ ), which is much the same as the difference between the volume indices of GDP creation and use for the period 1989-1993. As can be seen from the data presented, discrepancy sharpened in the second phase: the renewed growth of indebtedness, threatening the solvency of the firms, began in the second part of 1992 and continued well into 1994.

- Ratios in current prices (columns 4 and 5 of Table 5) indicate that the internal breakdown of GDP use changed radically for the sake of consumption and at the expense of accumulation (by 16 [8+8] percentage points in the whole period). The shift in volumes was much smaller. As a result of price changes (as is shown by the last two columns of Table 5), individual consumption statistically appeared to increase and accumulation decrease. The scissors between the two categories opened wide, with a large part of the opening due, as the data indicates, to value effects. Nevertheless, aside from breakdowns, volume indices also demonstrate that a healthy development of the economy requires a sizable growth of accumulation.

(6) We investigated two dimensions to the changes in foreign trade, as is customary: changes based on the directions of trade and those based on commodity structure.

- Investigating the directions of trade (Table 6/a) quantifies the well-known fact that trade with the former socialist countries (herein referred to as Eastern trade) declined and trade with market economies (herein referred to as Western trade) expanded. As a result of this shift, the share of Eastern trade declined to 25%, and the share of Western trade grew to 75% (the 5-7% share of developing countries included), of Hungarian foreign trade.
- There are interesting features in the evolution of this change in time. The big turning point occurred already in 1991: volume indices relative to 1989 were 50% less in Eastern trade, and over 130% more in Western trade. The year 1992 shows some slowing down of this trend: the shares of individual directions no longer change very much; and Hungarian imports from the West decreased somewhat but exports grew further. 1992 indices for the whole turnover (92.5 in imports and 92.1 in exports) show that, overall, the shares that produced in 1989 a surplus (3.4% of GDP used) of exports (to be sure, to the East) had been restored. In 1993 this equilibrium was turned up again: exports to the West decreased by 15%, while imports grew by 15%. Thus a gap had arisen between the production and use of GDP: more than 5% of the use of GDP is accounted for by import surplus.
- The largest change in commodity structure (Table 6/b) is a strong decrease in machinery exports: in volume in 1993 it was only 44% of the year's total in 1989. The fall is explained by the severing of CMEA relations. Only a small part of the machinery-producing capabilities serving primarily Eastern markets could be converted to the Western market. There were many bankruptcies and liquidations. What is striking is the decrease in export volume of the food industry. This shows that despite associate membership in the European Union - the main potential market for Hungary - the sales

position for Hungarian exports is deteriorating. However, it cannot be denied that, due to the decrease of domestic production, a large part of agricultural quotas offered by the European Union could not be used. In our view, not only insurmountable objective factors, but also subjective errors and political causes, had a role in this.

On the import side, the 20% growth of food and the 66% (!) growth of industrial consumer goods may indeed be striking. It should be emphasized that such consumption-oriented imports increased to such a extent in a period when the domestic market was shrinking and the deficit of foreign trade and the current account had been one of the most acute problems of the country, which had had macroeconomic management for decades.

## *II. Comments*

The first results of our macroeconomy-based investigation allow the formulation of the following comments:

Generally speaking the structure of Hungarian economic changes are in line with the requirements of a market economy, or are at least not contrary to them. Among them are the following structural changes:

- 1) The non-material sphere gained ground relative to the material sphere, in what reflected changes both in volume and price. This tendency undeniably reflects an adjustment to the requirements of market economy. Nevertheless, the question arises: does a 30% decrease of output in the material sphere and a 5-7% growth in the non-material sphere not suggest a huge and abrupt change that leads to disequilibrium both in the economy and society?
- 2) The economy and the entire country irreversibly shed units of oversized, loss-sustaining mining and metallurgy industries, which are anachronistic under the given natural endowments of the country. This is a positive development even if, in the short run, it causes serious social and human hardships (unemployment, slums, etc.) that are difficult to alleviate.
- 3) Market and business-oriented service sectors grow rapidly.
- 4) A strong decentralization took place in the size structure (based on the number of employees) of firms.
- 5) A large sector of previously-suppressed small (individual and family) ventures did emerge. This is a positive element of transition and development, even if (as we already mentioned) many of them have been established for fraudulent activities or merely to escape from unemployment.
- 6) The reorientation of Hungarian foreign trade "from East to West" is an unavoidable element of long-term development, though it caused serious losses that in part could and should have been avoided.

The negative elements of the changes mentioned above are in our estimation the following:

- 1) At the beginning of the period, 88% employment of the working age population indicated an overheatedness of the labor market. The 26% drop in employment within four years, and the 12-13% unemployment rate (with real wages shrinking), necessarily spells a shock for a large number of families that might result in social discontent, endangering political stability so necessary for the transition.
- 2) The loss of ground of industries intensive in work culture and intellectual capital, both among production organizations and in exports, seems to be greater than that of those that are less intensive in this regard. This tendency is due to the nature of the reshuffle. In our view the extent of the losses is much greater than what would be unavoidable.
- 3) The growth of imports particularly with consumer goods seems to be exaggerated. In this respect, an abrupt, indiscriminate import liberalization seems to be a hasty measure, and a selective protection of domestic producers on the home market should be stronger.
- 4) The balance of production and consumption could not be established. An acute problem of imbalance is the strong growth of public consumption coming about in a period of high indebtedness and a shrinking of the economy. The lack of equilibrium and its necessary reflection in the growth of domestic and foreign debt and accelerated inflation bears the danger of halting the transformation process. We should add that the imbalance became critical by the end of the period reviewed, and made implementation of some strong restrictive measures unavoidable at the time of writing.

### *III. Supplementary Remarks*

As revealed in what has been said above, we are not finished with our research. Our investigation should be continued. Some problems basic to the structural aspect of transition have not even been touched. The reason is the lack of necessary, consistent statistical data, as well as the time constraints on research.

One of the most important aspects left out is the shift in property relations during the process of transformation. Estimates that 55% (60% with independent cooperatives) of GDP have come from private property (including foreign property) in 1994<sup>19</sup> seems to be acceptable. Important branch level details of national accounting have not yet been explained by official Hungarian statistics (and research).

The participation of import capital in the creation of the Hungarian market economy (the building up of Hungarian capitalism) and in transforming property

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<sup>19</sup> For the period of 1980-92, we have at our disposal the structure of GDP according to property form, but its industry breakdown is still unknown. See J. Árvay and A. Vértés, *The Share of the Private Sector and the Hidden Economy in Hungary, 1980-1992, Summary*, (Budapest, 1994), p. 36.

relations is an extremely important factor. Such capital investment led to the creation of new industries that were non-existent during the last 5-6 decades, such as car manufacturing. Others, such as electric bulb production or pharmaceutical firms, were modernized after being sold in full to foreign investors. The cumulated value of foreign direct investments in Hungary amounted by the end of 1994 to US\$ 6.9 billion.<sup>20</sup> We still do not know the breakdown of foreign investment by industry, but we do know by country of origin.

The breakdown of foreign direct investment in Hungary by country of origin was the following between 1988-93:<sup>21</sup>

USA	29
Germany	20
Austria	14
France	7
Italy	6
Japan	5
The Netherlands	4
United Kingdom	4
Other countries	11
<b>Total FDI</b>	<b>100</b>

According to some estimates, one third of this foreign capital was spent on the purchase of state firms, and on their restructuring, development and modernization. 23% of direct foreign investment spent for the purchasing of state firms in 1988-93 came from Austria, 19% from Germany, 10% from both the USA and the Netherlands, 8% from the United Kingdom, 5% from both Sweden and Switzerland, 3% from Belgium and the CIS countries, 2% from Italy and 12% from other countries.<sup>22</sup>

Between 1990 and 1993, income from the sale of state assets to foreigners amounted to US\$ 1.8 million, 56% of which was cash (60% in foreign currency and 40% in HUF).

Three factors had a main role in the fact that 50% of foreign capital flowing into Central-Eastern-Europe since the systemic changes landed in Hungary:

1. at the moment of the collapse of the old system, Hungary was foremost in reform processes aiming at a market economy;
2. here the legal framework and infrastructure (financial, banking, telecommunication, business) network and services necessary for the creation of the market were relatively the most developed;
3. material, cultural and intellectual preconditions of everyday life (including a friendly attitude towards foreigners) could be found in Budapest and in the

<sup>20</sup> *Economic Survey of Europe in 1994-1995*, United Nations Economic Commission for Europe, (New York and Geneva, 1995), p.151.

<sup>21</sup> Gy. Csáki, *Foreign Direct Investments and Joint Ventures in Hungary: A Basic Issue of Transformation Towards Market Economy*, Study prepared for JETRO-Budapest, Institute for World Economics, Hungarian Academy of Sciences, December 17, 1993, p. 20.

<sup>22</sup> *State Property Agency - Privatization Monitor* (March 1994).

Western part of the country, making them perhaps the most favorable place to stay for foreigners in the whole of Central-Eastern-Europe (with the possible exception of Prague).

The plan of our present work on structural changes includes the comparison with the other Central East European countries. The subsequent task of our research is to characterize the most important structural shifts of the four Visegrad countries (Bohemia, Hungary, Poland and Slovakia) by comparing their basic macro-economic indicators in order to show their similarities and differences. The compilation of the necessary comparable data for the past 4-5 years was met with difficulties.

Finally we have to speak about difficulties in handling data contained in the tables. The Statistical Yearbook of 1993 was published by the Hungarian Statistical Office in November of 1994. The data published in it was revised on several counts. We obtained through personal contacts in April 1995 the data of the National Accounts chapter in manuscript form. Changes in the data are substantial. Tables attached to the paper are based on the data of the April 1995 manuscript. The data of this paper therefore are not those of the official publications in 1994.<sup>23</sup>

In 1993 Hungary "bought" at the expense of outstanding Hungarian liabilities military airplanes from Russia. The value of the purchases figures as imports and as collective consumption in the National Account and in foreign trade and financial accounts. Since this single item has a very large value, its inclusion would "distort" to a large extent the data on the composition of structural changes, and force both analyst and reader to seek "explanations." Therefore we left out this single item from all our data and calculations.

Hungarian statistics switched in 1993 from a previous indigenous system to that of the International Standard Industrial Classification. The data assembled in this way for 1991, 1992 and for 1993 was first published in the 1993 statistical yearbook. The above-mentioned manuscript also gives the corrected data in this system. For the period 1989-91 we have at our disposal only data assembled and processed with the previous system. Under such circumstances we had to work in this study by chain indices, i.e. 1993/89 indices were obtained through multiplication of the 1991/89 index with the 1993/92 index. We were often forced to make such approximations.

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<sup>23</sup> The Central Statistical Office (CSO) published its *National Account in Hungary, 1991/1993* (Budapest, 1995) with corrected data after closing this manuscript. Its data differs somewhat from those we worked with. The differences are not large, however, and do not alter our conclusions.

**Table 1/a. Volume indices of macroeconomic performance (%)**

	1991/1989			1993/1991			1993/1989		
	a	b	c	a	b	c	a	b	c
<b>Material sphere</b>	77.9	81.7	84.4	89.5	91.0	83.7	69.7	74.3	70.3
of which:									
<b>Agriculture and forestry</b>	79.1	87.5	67.9	80.2	77.8	56.2	63.4	68.1	38.8
<b>Industry</b>	74.1	75.7	84.5	91.4	97.5	83.7	67.7	73.8	70.7
<b>Construction</b>	65.4	66.4	82.2	98.7	95.4	87.8	64.5	63.3	72.2
<b>Trade and repair</b>	109.9	102.4	105.0	91.3	79.5	106.5	100.3	81.4	111.8
<b>Transport, storage and communication</b>				98.3	90.8			74.5	
	78.8	82.1	90.1			85.5	77.5		77.0
<b>Non material sphere</b>	100.0	101.0	97.6	105.4	106.6	94.2	105.4	108.1	92.0
of which									
<b>Financial intermediation</b>				94.8	98.0				
<b>Real estate, renting and business activities</b>				103.4	107.8				
<b>Public adm. and defense, compulsory soc. security</b>				106.1	105.1				
<b>Education</b>			}94.6	100.2	103.9	}97.3			}92.0
<b>Health and social work</b>				99.0	106.2				
<b>Other community, social and personal service activities</b>				139.6	126.1				
<b>Total (excl. net taxes on products)</b>	81.3	85.8	87.6	93.1	96.1	86.2	75.7	82.4	75.5

Notes: a) Gross output  
b) Gross value added  
c) Employment at 1. January of the next year

Source: Statistical Yearbook of Economy 1992. Central Statistical Office (CSO)  
- Statistical Yearbook of Hungary 1993. CSO. its corrected tables in manuscript - Nemzetgazdasági munkaerőmérleg (Balance of labor force) 1994. január 1. CSO.

**Table 1/b. Volume indices of production and workforce of industrial firms (%)**

	1991/89	1993/91	1993/89	
	a	a	a	b
<b>Mining and quarrying</b>	79.1	80.9	64.0	36.4
<b>Food, beverages and tobacco</b>	92.4	91.9	84.9	76.7
<b>Textiles, wearing apparel, leather and fur</b>	63.9	86.9	55.5	65.9
<b>Wood, paper, printing and publishing</b>	83.2	114.8	95.5	96.4
<b>Chemicals</b>	74.9	94.1	70.5	80.4
<b>Non-metallic mineral products</b>	67.7	108.1	73.2	64.8
<b>Basic metals and fabricated metal products</b>	59.1	92.6	54.7	56.7
<b>Machinery and equipment</b>	59.6	98.3	58.6	53.0
<b>Other manufacturing industries, recycling</b>	71.2	95.2	67.8	66.6
<b>Manufacturing</b>	70.8	94.6	67.0	65.9
<b>Electricity, gas, steam and water supply</b>	98.2	83.3	81.8	92.6
<b>Industry total</b>	74.1	93.9	69.6	65.0

Notes: a) Gross output

b) Average number of employees

Source: Statistical Yearbook of Economy 1990, 1991 and 1992, CSO

- Statistical Yearbook of Hungary 1993, CSO

**Table 2/a. Performance according to industry**

	Gross Output				Gross Value Added			
	Breakdown		from the difference		Breakdown		from the difference	
	in %		Volume	price	in %		Volume	price
	1989	1993	effect		1989	1993	effect	
<b>Material sphere</b>	81.4	72.2	-6.4	-2.8	71.4	60.8	-7.0	-3.6
of which:								
Agriculture	12.9	8.3	-2.1	-2.5	12.8	6.7	-2.2	-3.9
Industry	47.9	37.9	-4.8	-5.2	32.9	26.5	-3.4	-3.0
Construction	6.9	5.5	-1.0	-0.4	7.8	5.3	-1.8	-0.7
Trade	7.9	13.0	+2.6	+2.5	9.9	13.3	-0.2	+3.6
Transport	5.8	7.5	+0.1	+1.6	8.2	9.0	-0.8	+1.6
<b>Non material sphere</b>	18.6	27.8	+7.3	+1.9	28.6	39.2	+8.9	+1.7
<b>Total (excluding net taxes on products)</b>	100.0	100.0			100.0	100.0		

Source: Statistical Yearbook of Economy 1992, CSO - Statistical Yearbook of Hungary 1993, CSO, its corrected tables in manuscript

Table 2/b. Performance according to industry

	Gross Output				Gross Value Added			
	Breakdown		from the difference		Breakdown		from the difference	
	in %		Volume	price	in %		Volume	price
	1991	1993	effect		1991	1993	effect	
<b>Material sphere</b>	78.1	72.2	-3.0	-2.9	67.5	60.8	-3.6	-3.1
of which:								
Agriculture	10.3	8.3	-1.4	-0.6	8.5	6.7	-1.6	-0.2
Industry	43.5	37.9	-0.8	-4.8	29.0	26.5	+0.4	-2.9
Construction	5.2	5.5	+0.3	0.0	5.4	5.3	0.0	-0.1
Trade	12.6	13.0	-0.2	+0.6	15.5	13.3	-2.7	-0.5
Transport	6.5	7.5	+0.4	+0.6	9.1	9.0	-0.5	+0.4
<b>Non material sphere</b>	21.9	27.8	+2.9	+3.0	32.5	39.2	+3.5	+3.2
of which:								
Finance	2.9	3.1	+0.1	+0.1	4.4	4.6	+0.1	+0.1
Real estate	7.2	9.3	+0.8	+1.3	10.2	13.2	+1.1	+1.9
Public adm.	4.2	5.2	+0.6	+0.4	6.4	7.5	+0.6	+0.5
Education	2.7	3.3	+0.2	+0.4	4.8	5.5	+0.4	+0.3
Health	2.7	3.3	+0.2	+0.4	4.2	4.7	+0.4	+0.1
Other services	2.2	3.6	+1.1	+0.3	2.5	3.7	+0.8	+0.4
<b>Total (excluding net taxes on products)</b>	100.0	100.0			100.0	100.0		

Source: Statistical Yearbook of Hungary 1993. CSO. its corrected tables in manuscript

Table 3/a. Employment activity (on 1. of January in thousand)

		1990	1991	1992	1993	1994
1.	Population	10375	10355	10337	10310	10277
2.	Population in working age <sup>1</sup>	5957	5997	6031	6056	6072
3.	Employed in working age	4739	4617	4200	3837	3682
4.	Employed over working age	488	435	334	253	200
5.	Employed total <sup>2</sup>	5227	5054	4534	4090	3882
6.	Unemployed/100 employed (1-5)/5x100	98	105	128	152	165
7.	Registered unemployed	24	101	406	663	632
8.	Rate of activity (5+7)/1x100	50.6	49.8	47.8	46.1	43.9
9.	Rate of activity in working age 3/2x100	79.6	77.0	69.6	63.4	60.6
10.	Registered unemployment rate 7/(5+7)5x100	0.4	1.9	7.8	13.2	13.3

Notes: <sup>1</sup> Males aged 15-59, females aged 15-54.

<sup>2</sup> Including employed pensioners and excluding persons taking advantage of child care allowance or fee.

Source: Statistical Yearbook of Hungary 1993. CSO - Nemzetgazdasági munkaerőmérleg (Balance of labor force) 1994. január 1. CSO.



Table 3/b. Employment according to industry (1. of January)<sup>1</sup>

	1990		1994		change	
	in thousand	breakdown %	in thousand	breakdown %	in thousand	in percentage point
Material sphere	4134	75.6	2905	70.2	-1229	-29.7
of which:						
Agriculture	955	17.5	371	9.0	-584	-61.2
Industry	1708	31.2	1207	29.1	-501	-29.3
Construction	353	6.5	255	6.2	-98	-27.8
Trade	618	11.3	691	16.7	+73	+11.8
Transport	443	8.1	346	8.4	-97	21.9
Others	57	1.0	35	0.8	-22	
Non material sphere	1338	24.4	1231	29.8	-107	-8.0
of which:						
Health, social and cultural services	811	14.8	746	18.1	-65	-8.0
Public, community and other services	281	5.1	290	7.0	+9	+3.2
<b>Total</b>	<b>5472</b>	<b>100.0</b>	<b>4136</b>	<b>100.0</b>	<b>-1336</b>	<b>-24.4</b>

Note: <sup>1</sup> Including persons taking advantage of child care allowance or fee (in 1990 244 thousand, in 1994 252 thousands)

Source: Nemzetgazdasági munkaerőmérleg (Balance of labor force) 1994. január 1. CSO.

Table 4/a. Size structure of economic units by staff number categories

	1989		1990		1991		1992		1993	
	a	b	a	b	a	b	a	b	a	b
<b>State-owned enterprises</b>										
Less than 21 persons	98	4.1	103	4.4	112	5.1	172	9.9	235	
21 to 50 persons	141	5.9	154	6.6	185	8.4	191	11.1	156	20.8
51 to 300 persons	715	29.6	720	30.7	769	35.0	618	35.7	412	13.8
More than 300 persons	1456	60.4	1366	58.3	1132	51.5	749	43.3	327	36.5
<b>Total</b>	<b>2410</b>		<b>2343</b>		<b>2198</b>		<b>1730</b>		<b>1130</b>	<b>28.9</b>
<b>Joint stock companies</b>										
Less than 21 persons	66	21.5	152	23.6	282	26.3	483	28.6	717	30.3
21 to 50 persons	51	16.7	118	18.3	175	16.3	245	14.5	311	13.2
51 to 300 persons	90	29.4	192	29.8	322	30.1	492	29.1	671	28.4
More than 300 persons	99	32.4	183	28.3	292	27.3	468	27.8	665	28.1
<b>Total</b>	<b>306</b>		<b>645</b>		<b>1071</b>		<b>1688</b>		<b>2364</b>	
<b>Limited liability companies</b>										
Less than 21 persons	3266	73.2	14336	78.4	34488	83.8	49478	86.7	63624	87.6
21 to 50 persons	799	17.9	2596	14.2	4498	10.9	5014	8.8	5731	7.9
51 to 300 persons	366	8.2	1237	6.8	1968	4.8	2343	4.1	2897	4.0
More than 300 persons	33	0.7	125	0.6	208	0.5	262	0.5	334	0.5
<b>Total</b>	<b>4464</b>		<b>18294</b>		<b>41162</b>		<b>57097</b>		<b>72586</b>	
<b>Co-operatives</b>										
Less than 21 persons	1155	21.3	1250	23.2	1235	23.7	1966	32.7	2873	44.2
21 to 50 persons	1261	23.2	1128	21.0	1185	22.7	1394	23.2	1349	20.7
51 to 300 persons	2043	37.6	2115	39.3	2156	41.3	2203	36.7	1990	30.6
More than 300 persons	970	17.9	891	16.5	746	14.3	446	7.4	293	4.5
<b>Total</b>	<b>5429</b>		<b>5384</b>		<b>5222</b>		<b>6009</b>		<b>6505</b>	

Notes: a) Number of units

b) % total = 100

Source: Statistical Yearbooks of Hungary 1989-1993. CSO

**Table 4/b. Active wage earners as individual entrepreneurs and working in units without legal status**

Year	Number in thousand	in percentage <sup>1</sup>	from this: according to character of activity					
			industry	construction	agriculture	transportation	trade	services
1989	347	7.2						
1990	483	10.1						
1991	677	14.5	155	91	117	81	162	43
1992	707	16.7	163	85	122	68	221	43
1993	780	20.2	185	95	126	69	245	52
1994	805	21.8	128	70	134	53	320	89

Note: <sup>1</sup> Number of employed in working age = 100

Source: Statistical Yearbooks of Hungary 1989-1993. CSO.

Nemzetgazdasági munkaerőmérleg (Balance of labor force)

1994. január 1. CSO.

**Table 5. Use of GDP**

	Volumen indices			Breakdown in		From the difference	
				current prices in %		volume	price
	1991/89	1993/91	1993/89	1989	1993	effect %	
Individual consumption	91.0	100.8	91.7	63.7	70.2	0.7	5.8
Public consumption <sup>1</sup>	99.8	106.7	106.5	9.4	11.0	1.6	0.0
Final consumption	92.4	101.8	93.8	73.1	81.2	2.2	5.9
Gross fixed capital formation	83.2	99.0	82.4	24.3	17.7	-2.2	-4.4
Changes in stocks				2.6	1.1		
Gross capital formation	75.6	108.2	81.8	26.9	18.8	-2.6	-5.5
Domestic use	88.1	103.0	90.7	100.0	100.0		
Surplus of exports (+)				+3.4			
Surplus of imports (-)					-5.3		

Note: <sup>1</sup> Excluded the imports of military equipment from Russia in 1993.

Source: Statistical Yearbook of Economy 1992. CSO - Statistical Yearbook of Hungary 1993. CSO. its corrected tables in manuscript

Table 6/a. Breakdown and volume indices of foreign trade according to its direction

Main commodity groups	Countries in transition and without free market economy	Free market countries	Of which:		Total
			developed countries	developing countries	
<b>Structure according to direction in % and in current prices (Ft)</b>					
1989 imports	44.4	55.6	49.6	6.0	100.0
1989 exports	47.3	52.7	44.3	8.4	100.0
1991 imports	24.4	75.6	67.6	8.0	100.0
1991 exports	23.6	76.4	68.0	8.4	100.0
1993 imports	23.4 <sup>1</sup>	76.6	71.8	4.8	100.0
1993 exports	26.5	73.5	68.0	5.5	100.0
<b>Volume indices; 1989 = 100</b>					
1990 imports	86.1	101.5	96.5	141.8	94.8
1990 exports	79.3	109.2	112.0	94.8	95.9
1991 imports	48.7	132.3	127.9	154.1	100.1
1991 exports	44.1	130.5	136.3	100.1	91.1
1992 imports	48.2	120.6	119.7	105.0	92.5
1992 exports	47.5	132.7	143.8	68.9	92.1
1993 imports	50.7 <sup>1</sup>	134.9	140.8	117.7	102.0
1993 exports	44.6	111.5	121.2	87.2	80.0

Note: <sup>1</sup> Excluded the imports of military equipment from Russia

Source: Statistical Yearbook of External Trade 1993. CSO

Table 6/b. Commodity structure and volume indices of foreign trade

Year	Fuels. electric energy	Raw materials. semi-finished products. spare parts	Machinery. transport equipment. other capital goods	Industrial consumer goods	Raw materials for the food processing industry. livestock. processed products	Total
Commodity structure in % in current prices (Ft)						
<b>1989</b>			17.9	13.2	7.3	100.0
imports	11.1	50.5	24.0	15.8	21.5	100.0
exports	2.3	36.4				
<b>1991</b>			20.3	21.7	5.7	100.0
imports	15.0	37.3	12.6	22.6	25.1	100.0
exports	1.7	38.0				
<b>1993</b>			19.9	23.2	6.5	100.0
imports	13.9	36.5	13.9 <sup>1</sup>	25.3	21.3	100.0
exports	3.4	36.1				
Volume indices; 1989 = 100						
<b>1990</b>						
imports	117.2	86.7	91.3	103.4	110.2	94.8
exports	81.4	103.8	82.6	101.0	95.3	95.9
<b>1991</b>						
imports	101.1	80.7	111.8	149.6	104.5	100.1
exports	63.8	110.4	47.3	99.1	103.9	91.2
<b>1992</b>						
imports	95.9	72.6	101.3	143.2	102.1	92.5
exports	114.8	108.0	42.8	116.0	95.6	92.1
<b>1993</b>						
imports	110.0	79.1	104.1 <sup>1</sup>	165.7	120.1	102.0
exports	125.6	98.8	44.2	97.7	69.6	80.0

Note: <sup>1</sup> Excluded the imports of military equipment from Russia

Source: Statistical Yearbook of External Trade 1993. CSO

## NIKOLAJ ORDUNUNG

**Structural Changes in a Transforming Economy: the Case of the Czech Republic***1. Summary of the Main Achievements in Five Years of Economic Transformation*

The concept of transition from a centrally planned to market economy in Czechoslovakia was worked out in the course of 1990. Out of the competing approaches a radical concept of systemic transformation was chosen over a rather gradualist, reformist strategy.

When assessing the progress made, one cannot escape the conclusion that, in regard to the systemic changes, the strategy adopted in Czechoslovakia in 1991-1992 and later in the Czech Republic has been very successful.

In the area of liberalization and deregulation, a far-reaching price liberalization was effected starting in January 1991. As a result, prices of about 95 per cent of goods and services entering the market are set through the free interplay of market forces. The government controls virtually only the prices of energy and rents (housing), which are gradually being brought to market-determined levels. The only major exception to price liberalization trends was the price of labor, with continued control of wages applied in the state sector until mid-1995. The price of labor since that time on can be thus taken as being market-determined.

However, even these controls have been gradually relaxed, becoming more and more a psychological factor; and today with the drastic shrinkage of the state sector due to rapid progress in privatization, they are losing much of their relevance. Simultaneous with price liberalization, a general liberalization of foreign trade was carried out which resulted in creating a competitive environment for domestic producers. It eliminated price distortions by bringing prices relatively close to international ones, and substantially improved the range of goods and services available in the domestic market. Together with the liberalization of the foreign trade regime, an internal convertibility of the national currency was introduced. Convertibility related to practically all operations on current account, and full convertibility of the Czech crown was introduced in late-1995, thereby meeting all requirements of Article VIII of the IMF. Though some controls were still maintained on capital account transactions, they were considerably relaxed as well, allowing, for instance, Czech firms and citizens to freely undertake foreign direct investments and purchase real estate abroad.

Complete liberalization of entry into most lines of economic activity, including the entry of foreign investors, represented another plank in the overall deregulation process that contributed to the setting up of competitive market structures.

In the area of institutional reforms, the central component has been the privatization program embracing both small-scale and large-scale privatization. It has been completed within an extremely short time span, mainly due to the extensive use of the innovative "voucher method" of privatization. The bulk of the

privatization program had been completed with the conclusion of the second wave of voucher privatization in early 1995, bringing the private sector into a dominant position in industry, construction, trade, banking, insurance and (together with the transformed cooperatives) agriculture. There are still some privatization projects being considered in the area of railways, telecommunications, energy supplies, and health and educational services, though the major part of replacing the state with private owners has already been effected.

Considerable progress has also been achieved in fiscal and financial areas. The state budgetary system has been adapted to the requirements of the market economy, particularly through comprehensive tax reform. Reform in the banking sector has also come a long way, with an appropriate role accorded to the Central Bank, and with an expansion and consolidation of the commercial (including foreign) banks thereby creating the critical part of the infrastructure of a market economy. The establishment of stock-exchanges, which became operational in 1993, represents another step in developing capital markets as basic channels for the allocation of investment resources.

In the area of labor markets, a considerable degree of rigidity prevails. Still, a basic institutional framework and programs have been set up to facilitate the functioning of the labor market as well as providing an adequate safety net for the unemployed.

Finally, a massive effort has been exerted by the government and the Parliament in providing the legislative framework for the transition to a market economy. The whole legal structure has been revamped to provide a solid foundation for a democratic society with a market economy based on private ownership.

All the above outlined systemic changes have been implemented within the framework of macroeconomic policy that was aimed at achieving and maintaining a high degree of economic stability. Here one has to acknowledge that the policy pursued by both the CSFR and later by the CR government has been a spectacular success. Through prudent fiscal and monetary policies, the state budget was kept in balance, inflation was controlled and brought down to the lowest level among the transition countries (declining to 9 per cent per annum in 1995), the exchange rate was kept stable, and external indebtedness has been kept at very low levels, with the balance of payments in surplus until 1994 and foreign exchange reserves increasing substantially.<sup>1</sup> The credit rating of the Czech Republic has been steadily rising, with its balance of payments comfortable enough that the CR government could afford to repay the IMF stand-by credit ahead of schedule in 1994, thus ceasing to be a debtor to the IMF. However, certain problems arose in the external relations area. Because of the rapidly increasing trade deficit, the current account went for the first time in the Czech Republic from a surplus to a deficit in 1995, amounting to about 4 per cent of GDP. This deficit was easily financed and more than compensated for by an increased capital inflow, which resulted in a further increase in foreign exchange reserves, covering almost nine months of imports. The balance of

<sup>1</sup> In fact, the inflow of short-term foreign capital has brought the reserves to a higher level than necessary, and the Central Bank has to deal with the problem of neutralizing the inflationary pressures of foreign exchange inflows.

payments position of the Czech Republic thus remained quite comfortable in the short-term. Nevertheless, some structural and long-term aspects of the increasing trade deficit and capital inflow were cause for concern among analysts.

The successful systemic transformation of the Czech economy, and achievements in macro-economic stabilization policies, found a formal recognition in the Czech Republic becoming - as the first among the transition economies - a full member of the OECD just before the end of 1995.

The systemic transformation together with effective macroeconomic policies has brought the CR quite close to meeting the so-called Maastrich convergence criteria (EMU "membership rules"). Out of the seven criteria the CR already meets the following requirements: a strong central bank, low public debt, low government deficits and a stable currency. Inflation and interest rates, though declining, are still substantially higher than the required level (1 1/2 and 2 per cent respectively above the three highest performing EU economies). And the last criterion - full convertibility - was recently achieved.<sup>2</sup>

Under these circumstances the thesis that the transformation of the Czech economy has been essentially completed seems to be well substantiated. According to the recent statements of Prime Minister Václav Klaus, "The Czech economy and society has already entered what I call the early post-transformation stage, which is a situation where basic transformation tasks have been fulfilled."<sup>3</sup>

One can fully agree with Klaus' claim, provided that it refers to the basic transformation tasks and/or fundamental systemic changes. However, it seems that there are still quite a lot of demanding tasks to be accomplished before one could assert that there is a full-fledged, smoothly functioning market economy in the Czech Republic. Among these one can identify the following (without claiming the completeness and/or correct priority ranking of the issues):

- privatization, especially in regard to the outcome of the "voucher scheme," has yet to bear fruit in terms of a vastly improved corporate governance and a resulting restructuring and more efficient functioning of the privatized firms;
- the basic elements of banking and a financial infrastructure are in place, but the commercial banks have to be strengthened and especially the capacity for long-term financing increased. Capital markets (stock markets) are still in a semi-embryonic stage and are in need of greater transparency and possible protection for small share holders (originating from the voucher privatization scheme), which may require a certain revision of rules regulating stock market operations;
- setting up appropriate legal and institutional structures (which essentially are in place in the CR) is a necessary but not sufficient condition for an effective functioning of the market economy. In addition, it is absolutely essential to develop and instill informal codes and standards of behavior, including managerial and business practices, which naturally is a long-term process.

<sup>2</sup> For the EBRD comparative evaluation of the progress of systemic transformation, and OECD expert opinion on meeting the EMU "membership rules," see Appendix A.

<sup>3</sup> Prime Minister Václav Klaus' statement at the Economists' Conference, Prague, February 21, 1995.

Here countries in transition are experiencing a crisis of sorts, in that dubious practices are becoming rampant and are thus increasing considerably the transaction costs of the emerging market economy. The Czech Republic cannot claim to be an exception in this regard, as well as in regard to tax evasion and other similar phenomena. Hence the strengthening of the role of the state (including in particular the capacity of the courts) in the enforcement of laws and regulations is of vital importance.

Another set of issues is related to the economic policy mix and, more generally, to the role of the government in influencing the economic processes in the post-transformation phase. One may, with a lot of simplification, propose the hypothesis that, with the completion of systemic changes, the goal of catching up with the developed market economies in terms of productivity, efficiency and living standards has come to the forefront. In other words, this implies a shift from stabilization to growth objectives, which inherently also carries a structural aspect. Concerning the role that the government should play in this, we find a broad spectrum of opinions ranging from those advocating minimal involvement of the state (the invisible hand of the market is the best and only guide and stimulator) to those believing that, together with market forces, the state has a crucial role to play in devising and implementing policies to support and stimulate growth and structural changes. We will come back to this issue in the last section of this paper.

## *II. Performance of "Real Economy" and Structural Changes: A Mixed Picture*

**Transitional recession.** The performance of the "real economy" was much less spectacular than the above-described achievements in systemically transforming and stabilizing the economy. Czechoslovakia (and its successors, the Czech and Slovak Republics) has not escaped the phenomenon of the "transitional recession," which depressed output and employment well below pre-transition levels in all east and central European countries attempting to move from a centrally planned to market economy.

It was anticipated that, with the transition to a market based system, a large part of the previously produced output would become useless and unsustainable, and, due to a slower supply-side response to the revised demand, a certain decline in output would be inevitable. Thus, in Czechoslovakia at the outset of reforms in 1991, the government expected a possible decline of output of between 5 and 10 per cent. However, the actual result was a 14 per cent fall in GDP in 1991 alone, followed by another drop of 7 per cent in 1992. In 1993, though the original forecasts for the Czech Republic pointed to a recovery and a GDP increase of about 2 per cent, the GDP declined by about 0.5 per cent.<sup>4</sup> The recession thus proved to be deeper and longer than expected.

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<sup>4</sup> This estimate was recently revised to -0.9 per cent.



It is not intended to go into an extensive discussion of the factors that were responsible for this adverse development.<sup>5</sup> Let us limit ourselves to pointing out that, in the case of the Czech Republic, the recession was prolonged into 1993 by the disruptive effects of the division of the former CSFR. Concerning the depth of the recession, an important factor at play in 1991/92 was the collapse of the former CMEA market, which, given its extremely high share in Czechoslovakia's exports (about 75 per cent in the late 1980s), led to a substantive contraction of output in large segments of the industrial sector.<sup>6</sup> An open issue still being debated is the impact of fiscal and monetary policies, which, according to some observers, were excessively restrictive and thus contributed to the deepening of the recession via domestic market contraction.<sup>7</sup>

However, with the resumption of growth in the Czech economy in 1994 and 1995 (the GDP increased by 2.6 and 4 per cent respectively), this issue is losing some of its urgency (though not its relevance). It is encouraging that, for the first time since 1990, substantial growth (by about 7-8 per cent) was resumed in the industrial sector, including among the large industrial firms. The recovery in the 1994-1995 period was clearly led by domestic demand, with investments being the most dynamic factor (increasing by 17 per cent in 1994 and about 12 per cent in 1995). In the context of this paper, we are more concerned with the structural features of the economy, be it during recession or expansion.

*Structural changes-- ownership and concentration patterns.* The first structural change which strikes the observer of the Czech economy is the fundamental change in its ownership structure that took place within a short time span of the last four years. A massive privatization program transformed the Czech economy from one with the most extensive state ownership and the most negligible private sector among the former CMEA countries, into an economy with the most advanced degree of privatization among the transition countries. At present, after the completion of the second wave of large-scale privatization, it is estimated that about 80 per cent of GDP is generated in the non-state sector. More detailed data indicating the breakdown of employment up to the end of 1993 (i.e., before the second wave of privatization was completed) is provided in Table 1 below.

<sup>5</sup> For a discussion of possible explanations of the unexpected depth and persistence of the "transition recession" in central and east European countries, see Chapter 1 of the *UN Economic Survey of Europe in 1994-1995*, and especially Dariusz K. Rosati, "Output Decline During Transition from Plan to Market: A Reconsideration," *Economics of Transition* 2:4 (December 1994).

<sup>6</sup> This certainly also applies to armaments production, which was very much "Warsaw Treaty market" oriented.

<sup>7</sup> For a number of contradictory opinions on this matter see the publications of the WIIW: K. Laski et al., *Transition From the Command to the Market System: What Went Wrong and What to Do Now?* (Vienna, March 1993), and J. Poschl, ed., *Czech Economists on Transformation* (Vienna, May 1994).

**Table 1. Czech Republic: Workers in the civil sector of the national economy by type of ownership (as of 31 December, 1000 persons)**

Including organizations in ownership						
Year	Total	State and municipal	Cooperative	Associations, political parties and churches	Mixed	Private
<b>1985</b>						
number	5295	4529	685	67		14
percentage	100.0	85.5	12.9	1.3		0.3
<b>1989</b>						
number	5433	4581	703	80		69
percentage	100.0	84.3	12.9	1.5		1.3
<b>1990</b>						
number	5387	4289	662	60		376
percentage	100.0	79.6	12.3	1.1		7.0
<b>1991</b>						
number	4889	3449	470	37	17	917
percentage	100.0	70.5	9.6	0.8	0.3	18.8
<b>1992</b>						
number	4766	2869	357	41	15	1483
percentage	100.0	60.2	7.5	0.9	0.3	31.1
<b>1993</b>						
number	4777	1919	273	29	306	2250
percentage	100.0	40.2	5.7	0.6	6.4	47.1

Notes: 1) Preliminary data

2) Various proportions of the Czech private, cooperative and state ownership

3) Czech and foreign private companies, joint ventures with foreign property participation and private entrepreneurs not in the Business Register plus their employees (only main job)

Source: Czech Statistical Office, 1994 Yearbook, p. 183.

Privatization and the general liberalization of entry into all kinds of economic activities also completely changed the structure of the Czech economy in regard to the number and size of firms. Before 1989 the Czech economy was characterized by an extremely high degree of concentration and centralization in all sectors of the economy, be it industry, agriculture, construction, trade, etc. Without going into detail, it can be stated that, for example in industry in 1990-1992, the number of enterprises almost doubled and the average size of an industrial enterprise (measured by the number of employees) declined from about 2,000 in 1989 to about 900 in 1992.<sup>8</sup> And this process of deconcentration of Czech industry continued with further advances in privatization in 1993-1994. Also in trade, both wholesale and retail and exports/imports, thousands of new firms have started operating in the place of a few dozen state companies that dominated the sector before 1990. The number of firms substantially increased in construction and agriculture as well, with small and medium-sized firms gaining in importance.

<sup>8</sup> For detailed data of various branches of industry, see A. Buchtiková and V. Flek, "Vývoj dekoncentrace průmyslu (Deconcentration of Industry)," in *Integrativní studia národního hospodářství ČR* (Prague, 1993), pp. 46-55.

On the whole, the process of deconcentration has had a very positive impact on the creation of a competitive market environment. The breaking up of oversized state companies has resulted in the establishment of more manageable, flexible and efficient firms. However, in some cases the process of disintegration and downsizing has resulted in a decline in efficiency, occurring, for instance, in certain lines of export/import operations.

**Sectoral structures - macro levels.** Turning to the sectoral (or branch) aspect of the structural changes, one can discern a mixed picture. Rapid changes in some sectors contrast with elements of rigidity in other segments of economy. Moreover, while some changes (such as, for example, the increased importance of services) are undoubtedly positive, other structural changes within the industrial sector can hardly be welcome.

Looking first at the "megatrends," it can be observed that the Czech Republic is following a path typical for a transforming economy - i.e., redressing the basic structural weakness of a typical centrally planned economy (CPE) consisting in underdeveloped services. The services sector has demonstrated the fastest expanding productive activity, and has replaced industry within a very short time as the major contributor to the GDP. Most of the expansion has occurred in the areas that are essential for the market economy, such as retail and foreign trade, and privately-supplied paid services like tourism, catering, banking and insurance. At the same time, the declining share of industry may be interpreted to a certain degree as a sound development that has effectively cured another CPE disease: over-industrialization (or hypertrophy of certain segments of industry). In Table 2 comparative data on these trends in the Czech Republic, Hungary, Poland and Bulgaria is provided that clearly shows the general trend, the differences in levels of industrialization, and also the impact of an early start of market-oriented reform in Hungary on the stronger position of the services sector.

**Table 2. Selected transition countries: share of major sectors in total output 1990 and 1993 (GDP= 100)**

Industry	Czech Republic		Hungary		Poland		Bulgaria	
	1990	1993	1990	1993	1990	1993	1990	1993
Agriculture	50	40	27	26	45	33	43	35
Construction	7	6	13	6	8	7	18	9
Services	32	50	59	62	36	53	30	47

Source: UN ECE Economic Survey of Europe in 1994-1995, p. 79

Note: Current prices. Totals do not always sum up to 100 due either to non-attribution of certain activities to the sectors shown, or because of rounding.

It is worthwhile to supplement the data on structural changes in output with data on employment (see Table 3). This gives a very interesting picture indicating that the most important shift in the CR employment structure was a mass exodus from agriculture, where the number of people declined from 631,000 in 1990 to 331,000 in 1993. The share of agricultural labor in total employment thus dropped from 11.79 per cent in 1990 to 6.82 per cent in 1993, reaching the level common to many OECD countries. It should be added that such a major structural change, the cutting of the size of agricultural labor practically by half within three years, has not resulted in any social disturbances. The explanation lies in the fact that many redundant workers took the opportunity to retire (the average age of agricultural labor was traditionally higher than in other sectors), or found employment in services within the fast-growing private sector. Some of the shift is also connected with "streamlining" of agricultural cooperatives, which formerly were heavily engaged in the so-called ancillary non-agricultural activities (construction and the like). The units carrying out these activities were taken out of the cooperatives, becoming independent private firms, which has been reflected in their statistical classification. This also partly explains the increase of the number of those employed in the construction sector.

Another, though less pronounced, structural change is the reduction of the industrial labor force from about 2 million to 1.7 million people, bringing industry's share total employment down from 37.83 per cent in 1990 to 35.23 per cent in 1993. In contrast to agriculture, where, according to preliminary data, the number of workers had stabilized in 1994, industrial employment continued to decline (by 70,000) to comprise 32.88 per cent of total employment. Some analysts predict that this trend of shedding workers is likely to be accelerated as the new management of recently privatized industrial firms takes more energetic measures to increase efficiency. Of course, the final outcome depends to a great extent on the overall dynamics of the industrial sector, which made its first hesitant steps to recovery only in 1994, increasing output by 2.3 per cent. This increase, however, was solely due to an expansion of output by firms with less than 25 employees, for the large-scale industrial sector continued to stagnate in 1994.

Within the services sector, the various segments showed different rates of employment expansion and/or contraction. While a considerable increase in employment was recorded in trade, the most dynamic element proved to be banking and insurance, which tripled their share in total employment within four years. It should be noted that banking and insurance also showed the greatest increase in salaries, making banking the highest paid profession in the economy.

Another positive development has been a tremendous boom in tourism, which created demands for all kinds of services (trade, hotels, restaurants, banking, etc.), and generated considerable income, foreign exchange and employment. It is difficult to provide an exact quantification of this phenomenon because of the important role played by the so-called "informal" sector. However, an indication of the dynamism involved is the fact that the number of foreign visitors to the CR increased from 24 million in 1988 to more than 100 million in 1994. Here the liberalization and free interplay of market forces provided a strong impetus for fully exploiting the comparative advantages of the Czech Republic.

**Table 3. Czech Republic Average number of workers in the civil sector of the national economy by branch**

Branch	1990		1993		1994	
	Persons (1000)	Per cent	Persons (1000)	Per cent	Persons (1000)	Per cent
Agriculture (Including hunting and forestry)	631	11.79	331	6.82	333	6.66
Industry total	2025	37.83	1710	35.2	1643	32.88
including mining and quarrying	186	3.47	111	2.27	"	"
manufacturing	1760	32.88	1511	31.14	"	"
utilities	79	1.47	88	1.81	"	"
Construction	403	7.52	453	9.33	452	9.05
Wholesale and retail trade repair shops	4	9.79	609	12.54	708	14.17
Hotels and restaurants	90	1.67	112	2.30	"	"
Transport storage and telecommunications	371	6.94	385	7.93	359	7.18
Banking and insurance	28	0.52	65	1.33	79	1.6
Real estate, R & D activities, other commercial services	382	7.14	303	6.25	"	"
Public administration defence, social security	96	1.79	137	2.82	149	2.98
Education	317	5.92	324	6.67	330	6.60
Health and social work	280	5.22	263	5.42	265	5.30
Other public, social and personal services	204	3.82	159	3.2	"	"
<b>Total</b>	<b>5351</b>	<b>100.00</b>	<b>4853</b>	<b>100.00</b>	<b>4997</b>	<b>100.00</b>

**Structural changes within industry.** Turning to the structural changes within the traditional pillar of the Czech economy, the industrial sector, the overall picture is much less encouraging, and there are some trends emerging that are a cause for concern.

The decline in industrial output was much deeper than that of an overall transitional recession. While the GDP in 1993 declined by about 20 per cent compared to the 1989 level, industrial output declined by 36 per cent, and that of the engineering industry by 55 per cent.<sup>9</sup> Looking at the more detailed breakdown of industry, we get the following ranking of industrial branches in regard to the depth of the recession:

<sup>9</sup> Federal and Czech Statistical Office data quoted from M. Pick, "Transition to Growth and Structural Adaptation," in J. Poschl, ed., *Czech Economists on Transformation* (Vienna, 1994), p. 34.

**Table 4. Decline in output of selected industrial branches in 1993 (index, 1989=100)**

mechanical and electro engineering	45
textiles, clothing and leather	49
metallurgy and metalworking	55
wood manufacturing	59
chemicals, rubber and plastics	65
glass and ceramics	67
food processing	71
fuels (particularly coal mining)	73
electricity	86

Source: Federal and Czech Statistical Office, Prague

It is difficult to make clear-cut conclusions regarding the impact of demand contraction on different types of industry, be it capital intensive, labor intensive or R & D intensive categories. The combination of various factors - the collapse of the former CMEA markets, a substantial reduction of the real income of the population (by about 25 per cent) in 1991, the liberalization of imports and a massive inflow of consumer goods, and a decline in domestic investment - all cut across the whole range of industries with different factor intensities.

Nevertheless, some broad features of industrial restructuring can be discerned:

- The smallest decline has been recorded in the energy sector and mining, which is not a welcome phenomenon in view of the above average energy intensity and poor resource endowment of the Czech economy.
- Among the hardest hit industries are those that can be classified as high or medium technology industries.<sup>10</sup> It is quite obvious that some of these industries, such as electronics, computers, and certain lines of communications equipment, which were exclusively geared to the domestic and highly-protected former CMEA markets, were not viable and had no chance of becoming competitive by world market standards. On the other hand, branches like the aviation industry, mechanical engineering, transport equipment, etc., though in need of streamlining, may have the potential of becoming competitive. This, of course, requires time and investment resources, both of which may be the most scarce items, especially if the manufacturers involved are left without either a strong foreign partner or the support of the government.
- There is as yet no indication that the hardest hit branches of industry, such as the engineering industry, are showing significant signs of recovery. According to the analysis of the Czech National Bank Economic Institute,<sup>11</sup> the largest portion of industrial investments (33 per cent) went into the energy and coal mining sector. Moreover, 39 per cent of investments in the manufacturing sector went into export-oriented firms producing basic products, and only

<sup>10</sup> Classification used as defined in OECD, "Industrial Policy," *Annual Review 1994* (Paris, 1994), p. 94.

<sup>11</sup> M. Hájek a kol, *Makroekonomická analýza české ekonomiky (1990-1994)*, Česká národní banka, Institut ekonomie, (Prague, 1995), pp. 69-70

21 per cent went to machinery and transport equipment manufacturers (including the Skoda and Volkswagen works).

- Some of the manufacturers in aviation and truck manufacturing industries are working at 10 per cent capacity load, and may shortly be facing complete extinction.

*Changing structure of exports.* The trends outlined above are very closely intertwined with the structural changes of Czech foreign trade, especially the export structure.

The collapse of the former CMEA (especially FSU) markets, and the speedy reorientation of Czech trade towards the OECD (especially West-European) markets, was accompanied by a profound structural change in the commodity composition of Czech exports. Whereas in the past the former Czechoslovakia was an important supplier of machinery and equipment to other CMEA countries, with SITC 7 commodities exceeding 60 per cent of total Czechoslovak exports to these countries in the mid-1980s, today the leading Czech exports to OECD countries are manufactured goods (SITC 6), amounting to about one-third of total exports, while machinery and equipment (SITC 7) represented only about 10-12 per cent of OECD-bound exports.

The SITC 7 exports were geared to the needs of the CMEA, consisting of items such as a broad range of machinery, complete plants, heavy duty trucks, both military and civilian aircraft, extensive supplies of armaments, etc. These products, of course, could not be easily shifted from eastern to western markets. Therefore, with the drastic geographical reorientation of trade from east to west, and with Germany replacing the former Soviet Union as the main trading partner, the commodity structure of Czechoslovak (or Czech) exports underwent a profound change. The basic data on this is provided in Table 5.

While in mid-1980s the share of machinery and equipment (SITC 7) came close to 55 per cent of total exports, in 1991-1994 it declined to 30.4%, 25.4%, 27.4% and 26.3% respectively. On the other hand, the share of manufactured goods, classified chiefly by material (SITC 6) and chemicals (SITC 5), increased from about 17 and 6 per cent in the mid-1980s to about 31 and 10 per cent in 1994. The share of food, raw materials and fuels (SITC 0-3) jumped from about 8 per cent in 1988 to almost 20 per cent of total exports in the 1992-1994 period. Thus, on the whole, the structure of Czech exports moved closer to that of the developing countries.

This is the natural outcome of the basic instrument used for export promotion, i.e., the massive devaluation of the currency in 1990, which, together with low-level wages, enabled exporters to be competitive with less sophisticated, standardized products and commodities. However, with the real appreciation of the Ck, this kind of export expansion is reaching its limit.

**Table 5. Structure of exports by SITC categories, 1983-1994 selected years, 1983-1988 Czechoslovakia, 1991-1994 Czech Republic (Percentage)**

SITC categories*	1983	1985	1988 CS exports to OECD countries	1988	1991	1992	1993	1994
<b>Total</b>	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0	2.4	2.5	2.3	9.6	7.9	8.1	6.5	5.2
1	0.5	0.6	0.4	0.5	0.9	0.7	1.2	1.2
2	3.4	3.3	2.0	8.0	7.5	6.5	6.1	7.0
3	4.8	4.3	3.1	9.3	5.5	5.7	6.2	5.7
4	0.0	0.1	0.1	0.4	0.2	0.1	0.2	0.3
5	6.1	6.0	7.0	15.1	9.9	9.2	9.3	9.9
6	17.4	16.8	16.4	32.9	28.1	32.3	30.8	30.5
7	52.0	53.6	53.6	11.8	30.4	25.4	27.4	26.1
8	12.0	11.3	11.1	11.8	11.5	12.0	12.4	14.1
9	1.6	1.7	4.0	0.6	0.0	0.0	0.0	0.0

Source: Federal Ministry for Foreign Trade, Prague, Center for Foreign Economic Relations,

Prague

\*Standard International Trade codes (SITCs)

0=Food and live animals

1=Beverages and tobacco

2=Crude materials, inedible, except fuels

3=Mineral fuels, lubricants and related materials

4=Animal and vegetable oils and fats

5=Chemicals

6=Manufactured goods classified chiefly by material

7=Machinery and transport equipment

8=Miscellaneous manufactured articles

The low share of high and medium-technology industrial products in exports, and the deteriorating state of science and technology base, became an important factor in the new "structural" problem, i.e., the sizable trade deficit which emerged in 1995. The issue of the trade deficit itself has become a subject of extensive debate. On the one hand, is it quite obvious that the rapid growth of imports (at 31% during the first half of 1995, about four times higher than the 8% growth rate of exports during this same period) was caused to a large extent by the robust recovery in economic growth and domestic spending on both consumption and especially investment. In this context there is nothing wrong with running a sizable trade deficit, provided it can be financed by inflows of capital, and provided that external resources are used for investment leading to increased productivity and export capacity.

From the short and medium-term view, it seems that the Czech Republic can afford to run a merchandise trade deficit at the 1995 level (8 per cent of GDP), considering the surplus on services (especially tourism) account (about 4 per cent of GDP), which cuts the current account deficit to half. Moreover, such a deficit can



be easily financed by the inflows of long-term capital, which amounted to about 6 per cent of GDP in 1994.

However, there are some disturbing structural features of capital inflow that may become a matter of concern. In 1993-1995, an increasing share of capital inflow was taken by portfolio investment and bank deposits, which are essentially of a short-term nature and can leave the country within a very short time. This type of "fast footed" assets amounted to about 3 billion US dollars in mid-1995, which represented roughly 7 per cent of the Czech GDP. Needless to say, a sudden outflow of a large portion of these financial resources could have a profound destabilizing effect.

As has been mentioned, in the long-term it is essential for external equilibrium that investments financed by external resources result in increasing export capacity. This applies especially to the use of foreign bank loans by the Czech firms, which have been running in 1994-1995 at double the level of foreign direct investment (FDI) inflows. In general, with increased reliance of Czech firms on foreign bank loans and FDI operations, one can expect in the future an increase in factor income transfers (interest payments plus profit transfers), putting additional strain on the current account. Considering that the scope for expanding income from tourism is not unlimited, the only way to maintain the balance of payments in dynamic equilibrium in the long-term is to dynamize exports.

*The weak spot in restructuring: science and technology, R & D activities.* Another disturbing structural trend which is closely connected with the prevalence of short-term criteria applied by both the government and economic agents lies in the shrinkage of resources devoted to research and development activities. This applies to both fundamental (academic) and applied research.

The government's hands-off policy, combined with the efforts to economize on "non-essential" (from the short-term point of view) outlays, resulted in a substantive decline in government financed R & D activities. For instance, cuts in the Czech Academy of Sciences budget in 1993 resulted in the closure of 22 research institutes in the social, natural and technical sciences. In the area of applied research, it was reported that state budget resources providing for industrial R & D, directly or in the form of interest-free loans, have declined over the past few years: such funds fell from 288.6 million Kc in 1991 to 193.7 million Kc in 1992, 150.0 million Kc in 1993, and to no more than 98.0 million Kc in 1994.<sup>12</sup> If inflation is taken into account, the reduction in real terms becomes even more drastic, with the real level of resources earmarked for industrial R & D amounting in 1994 to about one-sixth of the volume budgeted in 1991. This situation did not change in 1995.

The difficult conditions in which the industrial, agricultural and construction firms have operated recently (low, if any, profit margins; high interest rates) led them to economize on internal R & D activities as well as outlays for services of independent research institutions. This, together with lack of government support, led to a virtual collapse of the entire sector of R & D activities.

<sup>12</sup> "Industrial Policy in OECD Countries," *Annual Review 1994* (Paris, 1994), p. 161.

One should point out, of course, that the R & D sector, as it developed in the era of a centrally planned economy, contained a lot of “fat” that had to be trimmed if it was to efficiently serve the needs of an emerging market economy. However, the pace at which this process evolved after 1989 came close to liquidating the base of research and development, which could have very detrimental consequences for the competitiveness of the Czech economy in the medium and long term. The most synthetic indicator of this phenomenon is the dramatic decline in the number of workers in the economy’s R & D sector. The relevant data in Table 6 shows that the number of people employed in R & D sector was reduced from about 138,000 in 1989 to roughly 40,000 at the end of 1993, and the number of those directly engaged in R & D activities dropped from about 78,000 to 23,000. These figures relate to the whole of the so-called R & D base, which consists of

- \* Academy of Sciences of the Czech Republic
- \* Higher learning institutions (universities and the like)
- \* R & D institutes and organizations financed and/or subsidized from the state budget
- \* R & D institutes and organizations that are parts of an enterprise or other organization and deal mostly with R & D projects.

So the trends reflected in Table 1 are pertinent to both the fundamental as well as applied research. One may conclude that the R & D sector has been recently subjected to a massive brain drain with potentially damaging effects that could be very difficult to redress. The research institutes, research departments and research and designers’ teams can all be disbanded overnight, but it usually takes years to build them up into well-coordinated, efficient working units.

**Table 6. Czech Republic, research and development base: employment structure (as of year-end)**

Year	Total workers	Research and development workers	including University graduates
1989	137.927	77.850	46.279
1990	105.916	62.268	31.248
1991	76.487	41.668	23.277
1992	57.227	31.543	18.821
1993	40.214	23.336	13.266

Source: Czech Statistical Office, Statistical Yearbook 1994, p. 216

According to a study carried out by the Institute of Philosophy in Prague, the transformation of applied research institutes through privatization led not only to a "slimming down" of these institutes (which in many respects was a sound process), but also to a change in the nature of their activities. These institutes are classified as R & D units, but R & D activities at present constitute only about one third of their output.<sup>13</sup> In order to survive in the short-term, the institutes switched to a large extent to direct manufacturing and the marketing of products based on past R & D efforts. This, of course, makes sense when one's survival is at stake; however, in the long term the true R & D capacity is impaired.

A difficult situation has also developed at the Academy of Sciences, which has been the mainstay of scientific and (particularly fundamental) research activities in the CR. The number of employees has been reduced from about 14,000 in 1989 to 7,000 in 1994. This includes both the welcome departure of non-productive, superfluous staff as well as the increasing exodus (especially abroad) of highly skilled, competent researchers and young talented researchers to much better paying (non-research) jobs in the private sector - especially to branches of foreign companies operating in the CR. The healthy process of "slimming down" may turn into a "bleeding out" of the essential core of scientific and fundamental research capacity in the Czech Republic.

Under these circumstances, it is quite understandable that the calls for the reversal of such adverse trends are growing stronger. Hence, on March 15, 1995, the Scientific Council of the Czech Technical University in Prague adopted a proclamation addressed to the government and Parliament of the CR, in which a deep concern over the present system and level of financing of universities in the Czech Republic was expressed. The members of the Scientific Council maintained that the present system practically leaves no room for significant research activities, and that "the continuation of this trend leads to a gradual liquidation of technology development...[W]ith this a danger arises of relegating the Czech Republic to the role of an 'assembly workshop' ". The statement points out that the critical shortage of financial resources makes even the simplest replacement of physically worn out and technologically obsolete equipment impossible. This, together with the low salaries of university teaching staff, results in an increasing brain drain, especially of young, talented professionals. The continuation of this trend could lead to a loss of the whole generation of academic and scientific workers, with a disastrous impact on the quality of the Czech universities. "Taking into account the fact that the main determinant of wealth in a global context has become knowledge and technical and technological progress, the CTU representatives call on the government and parliament to deal with these issues and adopt the necessary systemic measures in the area of education, science and technology policy."<sup>14</sup>

It should be noted that the government showed an awareness of the problems faced by the R & D sector, and on May 25, 1994 adopted a resolution stipulating

<sup>13</sup> For a more detailed analysis, see A. Adámková, "Léčba sokem, aplikovaný výzkum (Shock treatment, applied research)," in *Ekonom* 37 (1994), pp. 43-47.

<sup>14</sup> "Prohlášení Vedecké rady CVUT" (Statement of the Scientific Council of the Czech Technical University), Prague, March 15, 1995.

that, "with the improvement in the economic situation, the government will gradually increase the volume of financial support for research and development. Governmental support adequate for a stabilized economy should represent about 0.7 per cent of GDP."<sup>15</sup> Reaching this level (from the present 0.46 per cent of GDP) would require a substantial increase in the volume of financial resources flowing into the R & D sector, considering the recovery in GDP that began in 1994.<sup>16</sup>

Actually, however, it seems that no step has yet been taken to implement the Scientific Council's resolution. The budget proposal for 1995 allocates roughly 5 billion CK to science and technology support, which means that its share in GDP remains stationary at the level of 0.46 per cent. This phenomenon is undoubtedly linked to a more substantive issue, the desirability of involving the government in pursuing active structural (industrial) policy, which we will address in the last section of the paper.

### *III. Tentative Conclusions - Need for Policy Response*

Some of the adverse trends in the structural characteristics of the CR economy outlined above, especially its industrial sector and exports, have recently brought into the limelight the issue of the role of the state in shaping the pattern of economic development, or, more specifically, the relevance of structural (industrial and export promotion) policies.

Interest in these discussions has been intensified by the fact that, in the second half of 1994 and throughout 1995, the expansion of exports of non-sophisticated standard products to OECD markets has apparently reached its limit, and that the trade balance had turned into an overall and growing deficit. The expansion of exports of machinery and equipment to alternative markets thus becomes highly desirable, but it cannot happen without a supportive export-oriented policy, especially in the area of financing and information infrastructure. At the same time, concern has been expressed that, at present, with entrepreneurs tending to base their decisions on short-term criteria (due to a lack of long-term financing), and with comparative advantage momentarily based in low labor costs, the prospects of the Czech economy advancing to higher levels of productivity and technological "maturity" may indeed be impaired.

In this context one can discern two lines of thinking at the governmental level. One, represented by the Prime Minister, maintains that, in the post-transformation period, "[w]e do not intend to mastermind the economy...[nor] start industrial, trade, growth or similar interventionistic policies."<sup>17</sup> On the other side of the

<sup>15</sup> Quoted in the *Mladá fronta Dnes*, November 28, 1994.

<sup>16</sup> However, the target of 0.7 per cent of GDP seems quite modest in comparison with the share of R & D outlays in GDP found in OECD countries, ranging from 1.3 per cent (Austria) to 4 per cent (Japan) of GDP.

<sup>17</sup> See the earlier quoted statement of V. Klaus of February 21, 1995. Mr. Klaus expressed a similar view in his address to the Trade and Economic Chamber. See *Hospodářské noviny*, March 2, 1995, p. 90.

spectrum are the views of president V. Havel, who in recent speeches called for a more active role of the state. “[E]specially a state undergoing transformation simply cannot get by without a number of decisions that stimulate the economy in one way or another, limit it or give it direction...[T]he task of the present is therefore to think in a genuinely synthesizing way and to create a more effective idea of the Czech Republic's economy identity and its future.”<sup>18</sup>

The issue of the desirability of more active government involvement in promoting industry, science and technology has become a topic of professional and scholarly debate. The Czech Economic Society organized a discussion in March 1995 at which, in the presence of members of the government, many economists argued in favor of switching from the present *ad hoc* vertical industrial policies of the government to a more comprehensive industrial policy of a horizontal type (firm and industry branch neutral), which would facilitate structural changes and the dynamization of the economy, and bring it closer to the efficiency and technological levels of the EU. In other words, calls have been made for a transition from the implicit *ad hoc* policy of solving problems of individual firms to the formulation and implementation of a well-conceived “market friendly” industrial policy that focused on promoting investment in human capital, R & D activities and an export orientation.<sup>19</sup>

The author of this paper shares these views in principle, and believes that, in this respect, the experience of the newly industrialized Asian economies is of the utmost relevance and has great inspirational value for the CR<sup>20</sup> and other transforming economies. I am convinced that the governments of Japan and the Asian NICs, in devising and pursuing “market friendly” industrial policies, acted as the catalysts and organizers of broad-based efforts within the private sector, universities and other research institutions, which aimed at advancing the comparative advantage by attaining a higher technological level. It is very likely that without an active government role, the Republic of Korea, for one, would not have achieved competitiveness in high technology fields within such a short time span, if at all.

In conclusion, one should point out that, despite often making quite categorical statements, the government has recently taken some very useful steps of practical importance in promoting exports. In addition to the EGAP (Agency to Insure Exporters Against Risks), the government approved the establishment of an Export Bank to fill the gap in long-term financing for exporters of machinery, equipment, complete plants, etc., without which they could not compete in the world market. In addition, the Ministry of Trade and Industry is currently implementing a series of measures in the area of providing an information infrastructure for exporters, including establishing a special information center in Prague that would have a network of offices in important markets.

<sup>18</sup> Official translation of President Havel's New Year Speech of January 1, 1995.

<sup>19</sup> For a succinct exposition of these ideas, see J. Klacek, “Why the Industrial Policy is Needed,” *Hospodářské noviny*, April 20, 1995. [in Czech]

<sup>20</sup> For a more detailed explanation, see N. Ordnung, *The Rise of Newly Industrializing Asian Economies: Internal and External Factors and Possible Inspirations for the C.R.* (Prague, 1993). [in Czech]

The increasing trade deficit most particularly calls for a more active role of the state in the formulation and implementation of a well-conceived "market friendly" industrial (competitiveness) policy that focuses on promoting investment into human capital, R & D activities and an export orientation. Here may be found the basis of a long-term solution to the trade deficit problem that has come to the forefront in recent discussions.

In this context, the author believes that calls for a massive devaluation of the Czech currency to reduce the size of the trade deficit are unfounded. Also, the recent highly publicized forecast of the Nomura Institute (Vienna branch) maintaining that the solution to the Czech trade deficit problem will be found in a 20 per cent currency devaluation after the mid-1996 elections seems to be based on very simplified assumptions.

First of all, the proposals for massive devaluations as an imminent necessary measure ignore the fact that, taking into account its overall balance of payments positions (plus the low level of external indebtedness), the Czech Republic can afford to finance a trade deficit of the size of 1995 at least for another one or two years. Second, a massive devaluation would have a strong inflationary effect that would undermine monetary stability and lock the Czech economy even deeper into a "low cost labor" comparative advantage approach. And this in the long run is in conflict with the aim of advancing to the level of those countries where competitiveness is based on, and comparative advantage related to, highly skilled labor and advanced levels of technology.

## Appendix A

**Table A/1. Progress in transition in Eastern Europe and the former Soviet Union\*** (see classification system for transition indicators below)

Financial institutions		Enterprises			Markets and Trade		
Countries	private sector share of GDP Mid-94 in % (rough EBRD estimate)	Large-scale privatization	Small-scale privatization	Enterprise restructuring	Price liberalization and competition	Trade and foreign exchange system	Banking reform
Albania	50	1	3	2	3	4	2
Armenia	40	1	3	1	3	2	1
Azerbaijan	20	1	1	1	3	1	1
Belarus	15	2	2	2	2	1	1
Bulgaria	40	2	2	2	3	4	2
Croatia	40	3	4	2	3	4	3
Czech Rep	65	4	4	3	3	4	3
Estonia	55	3	4	3	3	4	3
FYR Macedonia	35	2	4	2	3	4	2
Georgia	20	1	2	1	2	1	1
Hungary	55	3	4	3	3	4	3
Kazakhstan	30	2	2	1	2	2	1
Kyrgyzstan	30	3	4	2	3	3	2
Latvia	55	2	3	2	3	4	3
Lithuania	50	3	4	2	3	4	2
Moldova	20	2	2	2	3	2	2
Poland	55	3	4	3	3	4	3
Romania	35	2	3	2	3	4	2
Russian Fed.	50	3	3	2	3	3	2
Slovak Rep.	55	3	4	3	3	4	3
Slovenia	30	2	4	3	3	4	3
Tajikistan	15	2	2	1	3	1	1
Turkmenistan	15	1	1	1	2	1	1
Ukraine	30	1	2	1	2	1	1
Uzbekistan	20	2	3	1	3	2	1

Source: EBRD, Transition Report 1994, p. 10

\*Many West European countries would qualify under category 4 for almost all transition elements. What is being assessed in Table A/1 is the status rather than the pace of change. Thus, for instance, the placement of Slovenia's small-scale privatization in category 4, despite the absence of comprehensive small-scale privatization programs in that country, reflects the fact that small-scale activity in Slovenia was largely private before a comprehensive transition process was initiated.

**Classification system for transition indicators**

<b>Transition element</b>	<b>category</b>	<b>Description of the category</b>
Large-scale privatization	4	More than 50 per cent of state-owned enterprise assets privatized in a scheme that reflects support for corporate governance
	3	More than 25 per cent of large-scale state-owned enterprise assets privatized or in the process of being sold but with major unresolved issues regarding corporate governance
	2	Advanced comprehensive scheme almost ready to be implemented; some sales completed
	1	Little done
Small-scale privatization	4	Comprehensive and well-designed program implemented
	3	Nearly comprehensive program implemented, but design or lack of central supervision leaves important issues unresolved
	2	Substantial share privatized
	1	Little done
Enterprise restructuring	4	Restructuring program which substantially improves corporate governance in operation; strong financial discipline at the enterprise level; large conglomerates broken up
	3	Structures created (for example through privatization combined with tight credit and subsidy policies and/or enforcement of bankruptcy legislation) to promote corporate governance; or strong action taken to break up conglomerates
	2	Moderately tight credit and subsidy policy; weak enforcement of bankruptcy legislation; little action to break up large conglomerates
	1	Lax credit and subsidy policies weakening financial discipline at the enterprise level; few other reform to promote corporate governance
Price liberalization and competition	4	Comprehensive price liberalization and price competition; anti-trust legislation in place
	3	Comprehensive price liberalization and price competition
	2	Price controls remain for several important product categories
	1	Most prices remain formally controlled by the government
Trade and foreign exchange	4	Few import or export quotas; significant direct involvement in exports system and imports by ministries and state-owned former trading monopolies; almost full current account convertibility at unified exchange rate; no major non-uniformity of customs duties
	3	Few import quotas; almost full current account convertibility at unified exchange rate
	2	Few import quotas; almost full current account convertibility in principle but with a foreign exchange regime which is not fully transparent (possibly with multiple exchange rates)
	1	Widespread import controls or very limited legitimate access to foreign exchange
Banking reform	4	Well-functioning banking competition and prudential supervision
	3	Substantial progress on bank recapitalization, bank auditing, and establishment of a functioning prudential supervisory system; significant presence of private banks; full interest rate liberalization with little preferential access to cheap refinancing
	2	Interest rates significantly influencing the allocation of credit
	1	Little progress beyond establishment of a two-tier system

Source: EBRD, Transition Report 1994, p. 11.



**Table A/2. CEFTA countries: degree of meeting the Maastricht convergence criteria**

<b>Criterion</b>	<b>Czech Rep.</b>	<b>Slovakia</b>	<b>Hungary</b>	<b>Poland</b>
Full convertibility	No	No	No	No
Strong central bank	Yes	Yes	Yes	Yes
Low inflation	No	No	No	No
Low public debt	Yes	Yes	Yes	Yes
Low govt. deficit	Yes	No	No	No
Low interest rate	No	No	No	No
Stable currency	No	No	No	No

Note: The criteria (also known as EMU "membership rules") are as follows. All restrictions on the movement of capital shall be prohibited. Establishment of an independent central bank. Price inflation shall not exceed that of the three best performing EU economies by more than 1 1/2 percentage points. General government debt shall not exceed 60 per cent of GDP. General government deficit shall exceed neither 3 per cent of GDP nor the level of government investment ("the Golden Rule of public finance"). Long-term interest rate shall not exceed that of the three best inflation performers by more than 2 percentage points. Normal currency fluctuation margins in the ERM and no devaluation during the previous two years.

Source: OECD expert opinion.

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