

THE LIMITS OF CONSERVATIVE INNOVATION
IN A COMMUNIST POLITICAL ECONOMY:
The Case of Hungary

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A Thesis presented to the University of Manitoba
in fulfillment of the Thesis requirement for the
Degree of Master of Arts.

The Department of Political Studies

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POLITICAL ECONOMY:

THE CASE OF HUNGARY

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A Thesis submitted to the Faculty of Graduate Studies of the University of Manitoba in partial fulfillment of the requirements for the degree of

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Glossary of Abbreviations

CDP	Central Development Plan
CMEA	Council for Mutual Economic Assistance
CPB	Central Planning Board
GOSPLAN	Soviet State Planning Commission
HSWP	Hungarian Socialist Worker's Party
NEM	New Economic Mechanism
CSSR	Czechoslovakia

Glossary of Prominent Names

Janos Kornai The most prominent Hungarian political-economist who is an expert in the Hungarian political-economic reform under communism. He has written many works in this field including several on Market Socialism and its inherent difficulties. One of his most known works in North America is his two volume book on the "Shortage Economy", a concept he developed independently.

Gabor Revesz A well known Hungarian Political Economist who has also made numerous contributions to the subject of Hungarian Reform. His most recent book published in english: Peresztroika in Eastern Europe: Hungary's Economic Transformation

Rudolf Tokes A Professor of Political Science at the University of Connecticut. He has written extensively on East European and Soviet politics, particularly Hungary.

Ivan Berend A Hungarian Economist who has written many Hungarian language works on the Hungarian reform process, both during and after the collapse of communism in Hungary.

George Schopflin A Professor of Political Science at the London School of Economics who has written extensively on Hungarian political-economic reform under communism. He has also written extensively on other East European countries.

Ivan Volgyes A Political Science Professor at the University of Nebraska/Lincoln who has contributed to the study of Hungarian reform in numerous articles published in a variety of journals and periodicals, including: Problems Of Communism, Current History, and International Affairs.

E.Comisso and Paul Marer oth individuals have published extensively on the Hungarian reform experiment; frequently producing co-written articles.

Wlodzmiarz Brus A prominent Polish economist who has made a significant contribution to the understanding of Market Socialism, and thus the Hungarian Reform experiment.

Oskar Lange Also a Polish economist and expert in the study of Market Socialism who has made significant contributions to the understanding of this concept.

Ludwig Van Mises An early twentieth century, Dutch economist who has made several provocative contributions to the critique of Market Socialism.

Tamas Bauer A prominent Hungarian Economist who has made numerous contributions to the understanding of Hungarian reform, particularly the function of state enterprises under NEM.

Charles Gati A Hungarian political scientist who is probably most recognized for his works written on the 1956 Revolution. However, he has made a number of more recent contributions helping to understand the failure of the Hungarian reforms.

O.Gado Also a Hungarian Economist who has written in both English and Hungarian on the New Economic Mechanism introduced in 1968.
(NEM)

*Please note that this is only partial list of the most prominent authors cited in this study. For a more thorough list of references, please consult the bibliography.

Introduction

The Hungarian reform experience between 1968 and 1989 was one of the most significant attempts to introduce marketizing measures in a very rigid, centralized command economy. Hungary could easily be dismissed as being a relatively small and insignificant nation in the communist world, and thus the relevance of studying the Hungarian model for reform could be overlooked as well.

Nonetheless, The study of the Hungarian reform experiment helps us to gain a better understanding of the failure of communism overall, and some of the current difficulties faced by former communist countries. The study of the Hungarian case is important because, the reforms were the most comprehensive, and went the furthest anywhere in the communist world. Attempts to reform the command economy were not unique to Hungary, it was the fashion in which they were implemented which was so unique. The Hungarian reforms introduced reform with a single stroke throughout the entire economy. No exceptions were made for specific regions of the country or sectors of the economy. Other countries, such as Communist China, made similar far reaching reforms. However, these reforms were limited to certain sectors or regions of the country. Hence, the Hungarian model was unique and it became a model which others observed and studied as a potential model to follow.

Even though the Hungarian version of reform differed from its communist neighbors, reformers in Hungary did not disregard

alternative reform plans, such as the Kosygin Reforms in the former Soviet Union, the Sik Reforms in the former Czechoslovakia and even some of ideas and concepts emanating from former East Germany and Yugoslavia. Hungary paid particular attention to the ideas and concepts introduced by Wlodzimierz Brus, a Polish economist who was a proponent of Market Socialism.[1] Brus believed that the traditional role of central planners in a command economy could be changed. Instead of issuing detailed annual plan directives, which interfered in every aspect of the economic activity of enterprises, the planners could assume a guiding role in the economy. This meant that planners would concern themselves only with long term macro-economic objectives. Day to day, micro-economic decisions would be left to enterprise managers, and ideally they would be governed by market forces. The Hungarian version of this model, introduced in 1968, was named the New Economic Mechanism (NEM).[2]

The Hungarian version of "market socialism" contained three principle features. It eliminated plan directives, the market was to facilitate the planners objectives, and it promoted competition between firms. These principles were never followed in their purest sense. For instance, the market was never given a dominant role in the economy, even though plan directives were virtually eliminated. The state continued to hold significant regulatory powers. Simply, the institutions and the structures of the command economy were unchanged.

For the market to function effectively, certain conditions had to exist, that is the ability for individuals, groups and

firms to compete and make spontaneous decisions regarding the economy. These conditions were not met. In fact, the idea of free competition ran contrary to the imperatives of the communist establishment. The state planners were not able to relinquish their power to facilitate the market. As a result, the market could not function to its fullest potential. A form of forced marketization resulted. Firms and enterprise managers were instructed to compete. However, market behavior cannot be coerced. Competition in the market relies on independent entrepreneurial initiative, which occurs spontaneously and dynamically. These conditions cannot be artificially created. If they are, they are not true representations of market competition. They are only distortions of it. The Hungarian case is an example of decentralization attempted by a highly centralized authority. Marketizing measures were not to jeopardize the existing political/economic institutions. Therefore, marketization was ineffective because spontaneous competitive behavior could not occur in the very rigid and controlled environment of the command economy. The central problem of the Hungarian reforms experiment emerged, and also the central argument of this study. The political inflexibility of the communist command economy could not support extensive marketization, and thus, the Hungarian reforms were very limited and subsequently they failed. The combination of market and plan were not compatible.[3]

Still, the main objectives the NEM reforms gave the impression of significant change. Briefly, plan directives were

replaced by a complex system of indirect regulators. Pricing was to become more flexible and responsive to market forces and world market prices. Profit was to be an objective for all enterprises. Profits earned would also provide bonus and investment funds designed to be incentives for continued profitability. Lastly, trade multipliers were adjusted for Western and Inter-Bloc trade accordingly.

The most significant of these objectives were the indirect regulators because, in large part they replaced the plan directives. The regulators took the forms of various subsidies, credits and tax breaks. They had a very profound effect on the success of a firm. In fact so much so, that traditional bargaining for favorable plan directives by enterprise managers, was replaced by bargaining for favorable regulators. Consequently, one form of central intervention was replaced by another. More importantly, vertical ties between central planners and enterprise managers were strengthened and not weakened. Since, vertical ties were maintained, horizontal competitive ties between enterprises lagged behind, and therefore progress towards greater efficiency, cost effectiveness, productivity and profitability were limited. Instead, the state continued to burden itself by continuing heavy subsidization. Central planners were unable to make a significant retreat from the economy. It's worth mentioning that there was an implicit understanding between planners and enterprise managers. Both realized the dangers of significant decentralization and marketization. For the planners, it meant compromising their traditional directive role in the

economy. For enterprises, it meant that market forces could effectively force their firms to exit the market, and jeopardizing the livelihood of enterprise managers and workers. The socio-political effects of vigorous reform would not be tolerated by either side.

The rigidities of the centralized bureaucracy kept marketizing efforts from taking off. Until central planners would give up the need for central control, they could not expect enterprises to function as if they were in a free unrestricted market. Enterprises were forced to behave according to the conditions they were subject to. Marketization, as a result was very partial and distorted. Competitive relationships between firms were minimal and based on arbitrary value relationships. Central planners would have been required to make a significant withdrawal from the economy for marketizing reforms to succeed. This would have also required significant political change, in fact fundamental institutional change. This was a boundary which reformers were not willing to move beyond in Hungary.

Political inflexibility as an impediment to reform was not a problem unique to Hungary. It was common to all communist countries. Today, the most vibrant economies in the former communist states are those where political change has proceeded the furthest; Hungary, the Czech Republic, and Poland are good examples. Inversely, those nations where political change has been limited are also those which are suffering economically as well. Romania, for instance is an example where the communist

establishment has remained virtually unchanged, and only the leadership is new. Likewise, the Ukraine's reform agenda is also stagnating due to the lingering affects of the former communist establishment. Even in Hungary, many of the difficulties faced by the current leadership can be attributable to the lingering effects of the former regime.

An examination of the Hungary reform experience offers a very good insight into the understanding of the difficulties and the failures of reform in a communist political economy. This study encourages the reader towards comparative analysis, since the Hungarian experience reflects all of the difficulties faced by other former communist countries.

Endnotes

1. "Market Socialism" a term used to describe the Hungarian economic reforms from 1968 onward. It was an attempt to introduce market principles to facilitate competition in a principally planned economy. The basic features of the command economy were not altered (direction from the center); only plan directives were replaced by indirect regulators, This reduced the level direct interference in the economy.

2. NEM was introduced in 1968 by Rezső Nyers, politburo member and chief architect of NEM. The blueprints for NEM were revealed within party circles already in 1966. It facilitated Market Socialism by introducing guideline planning. Guideline planning eliminated plan directives and extensive state interference in micro-economic decisions. Instead, the state focused on macro-economic policy. Guideline planning was enforced through indirect regulators. Instead of issuing plan directives, central authorities manipulated prices, wages, and taxation to encourage adherence to guidelines and to respond to quasi market forces simulated between enterprises. Many enterprises were free to make day to day decisions as long as long term targets were met.

3. Janos Kornai, A Szocialista Rendszer, (Budapest, 1993), p.592.

A NEW COMMAND ECONOMY: FURTHER STAGNATION (1956-1968)

The discontent and volatility following the 1956 revolt in Hungary determined the political motivations of the Janos Kadar leadership. Reconciliation with the population in the interests of legitimacy was the main priority in the post revolutionary period. This theme of reconciliation, acceptance, and legitimacy lay behind the economic reforms introduced in this period.[1]

The task of consolidating both the party and the general population seemed at first to be a mammoth task, especially since Hungarian history reflects a legacy of authoritarian rule. Yet, Hungary's legacy of failed revolutions and consequent experience with various forms of authoritarian rule gave the people the tools to tolerate and even exploit authority for what it had to offer. Often this occurred by focusing on a specific leader and not a general ideology.[2] Hungary's struggle with authoritarianism over the centuries could actually be viewed as an advantage. Like some of its communist neighbors, Hungary developed a fantastic tolerance and resilience towards authoritarianism, and thus giving it the benefit of experience to deal with various forms of oppressive rule, like that of communism.

The Kadar leadership recognized that it faced volatility and dissatisfaction in the Hungarian population after the 1956 Revolution. As a result, Kadar tried to develop a persona which was likable. Instead of trying to earn acceptance for the regime and the ideology it propagated, he cultivated support for himself as leader. He achieved this by promising a high standard of

living and swift elimination of overt secret police action. He also tried to cleanse himself from the 1956 revolution by blaming Matyas Rakosi, his predecessor as the source of deception and sinistry from the previous regime.[3] By offering economic incentives Kadar was able to develop passive acceptance and thus allowed him to reduce the need for overt secret police control.[4] The passive acceptance of Kadar was viewed as a necessary evil to be tolerated along with all the other constraints.[5] Adherence to the compromise was strengthened by the presence of occupying Soviet forces which acted as a deterrent towards opposition forces in the population and the leadership.[6] The implicit compromise between the Hungarian populace and the leadership reflected a form of moderated political authoritarianism which wove itself into the fabric of Hungarian political culture over the centuries. The shallowness of support for Kadar became apparent in the late 1980's as support for the leadership deteriorated proportionately to the deterioration of the economy.

The economic reforms under-taken before 1968 were far from earth shattering. The fundamental aspects of the command economy remained intact.[7] There was some brief discussion that the pre-1948 economic system might be studied to facilitate radical change. The idea was dropped and recovery from the revolution materialized under the established system. Cautious pragmatism characterized the Kadar leadership. They tried to convince people that not only was life was getting better, but that it was happening with in the established order. The slogan: "by means

of the established instruments of socialism but better!" encapsulates this idea [8] In keeping with his conciliatory approach, Kadar also re-phrased Matyas Rakosi's slogan "he who isn't with us is against us" to read: "he who is not against us is with us". [9]

In 1957 Kadar took the first steps towards fulfilling his promise by legalizing higher wages which were paid during the period of chaos and strikes. The increase was a uniform 20%. Agricultural policy followed a more moderate approach towards collectivization with less attention given to coercion and more to economic incentives. Kadar persuaded voluntary collectivization by trying to ensure that cooperatives could only be formed when the necessary expertise and equipment allowed it. Using this approach he had a better chance of ensuring strong yields and potential wealth for peasants. The result was that by 1961, the regime had largely succeeded in collectivization [10] However, the original collectivization plan was modified in 1959 to facilitate a quiker pace, since Hungary lagged behind its communist neighbors. Bulgaria achieved full collectivization by 1958. In the same year Czechoslovakia completed 75% of collectivization. In Hungary, Special efforts were taken to persuade highly respected middle class farmers who would persuade others. The government offered positive incentives such as pension and health insurance to attract peasants. More importantly extensive state subsidies financed nearly half the income paid to cooperatives, though some was recovered through compulsory rent paid by peasants. Thanks to the initial

disorganization of cooperatives and the pragmatism shown by the state towards private production, the income of the peasant farmers increased and an adequate food supply was established even for large cities like Budapest. The cooperatives or the state sector of agriculture continued to be plagued with poor equipment and lack of expertise. However, tolerance and legalization of private plot production would increase under the NEM reforms in 1968.[11]

Plan directives remained a feature of the economy between 1956-1968. Yet, the planners admitted to the irrationality of the Planning Office and the branch ministries which made almost all important economic decisions. Rational decision making was handicapped because the ministries and the planning office lacked sufficient information. Knowledgeable people at the enterprise level who had more of the relevant information could make better decisions. These however, were subject to rigorous control by state and party bureaucracies. To address this difficulty steps were taken towards simplifying the plan directive system. Micro-economic decisions were left to individual enterprise managers. Plan directives would affect macro-economic decisions concerning value of output and quantity targets. The details of how to attain these targets were left to the individual enterprise managers. Some products like coal, electric power, & foundry products continued to be subject to detailed production and distribution plans. Major investment in all areas were to remain under direct state control. Minor investment such as equipment improvement was left to the discretion of the enterprise manager.

Here the simplified directive system was in effect.[12] The simplified directive system was intended to stimulate more independent initiative and thus better production. In reality however, most managers paid little attention to increasing productivity and efficiency; they were more concerned with establishing favorable contacts with state and party bureaucrats in order to secure the resources necessary to fulfill production targets stipulated under the plan directives. Hoarding and stockpiling of necessary resources became common practice.

For agriculture, the simplified directive system led to different changes. The compulsory delivery system (production quotas) was replaced with a contract system between cooperative farms and state purchasing monopolies. Farmers would no longer be told according to regional and community plans how much to produce and sell. The revised system also permitted some degree of free marketing of farm products.[13] The new system did not, however introduce far reaching change since contractual agreements functioned more as agricultural quotas. It did however appear to give some leverage to cooperatives for bargaining with state authorities. By allowing some free marketing, prices were closer to the cost of inputs. Under the old system, delivery prices were often below the cost of production. This meant that the burden of cost was shifted from cooperative farmers to the state, because the state channeled significant subsidies towards maintaining low prices for agricultural products.

There were attempts already in 1959 to find a more

realistic price system. The practice of arbitrary price setting, which was often well below the cost of inputs, especially for raw materials was eliminated. Instead, prices would be based on "the generally acknowledged input costs, including a profit margin of a few percent".[14] Already, one could recognize the flaws in such a system because it would require an extremely well developed and accurate information system. One of the biggest flaws of the command economy is its inability to gather accurate reliable data on economic indicators especially when there is an absence of a mechanism able to perform such a task. This often results in arbitrary and irrational decisions. Nonetheless, the revised price system resulted in substantial increases in producer prices. To prevent an equivalent drop in real income or rise in consumer prices, a system of turnover taxes and commodity price subsidies were put in place, thus negating any steps towards a more realistic price system.[15]

The centrally specified and controlled wage system was also discarded. Each firm was told what their average wage should be; a ceiling was also placed on the wage budget. Firms were allowed to establish forms and terms of payment within these parameters. The wage budget was usually based on a firm's success in fulfilling the central plan. Wage budgets and ceilings were adjusted accordingly.[16]

In theory, profit was to have a place in the economy as well. Since product lines remained largely unchanged and prices static, a firm manager was given the incentive to reduce costs by increasing efficiency. The difference between their set budget

and their actual costs would be their profit margin. Part of this had to be invested in the plant or in equipment; the remainder was allocated in a bonus fund whose function was to inspire rational, and reasonable use of resources. All this was to be accomplished within the parameters of the central directive system.[17] The emphasis on central directives was the single biggest impediment to the profit objective, especially since all the factors determining profitability were directly or indirectly influenced by central directives. Pricing, in particular was the biggest determining factor. If the set prices didn't reflect actual cost, regardless of the efficiency of the firm, profitability could not be attained. Only under a rational value system such as under the market mechanism could profitability be achieved. Even if the prices set in 1959 reflected actual cost, they did not reflect supply and demand. Prices in a market situation are dynamic. Even a minor change in production technique can spur a price change. Continuous price revisions would have been required, but this would have also made adherence to the central plan almost impossible.[18] The share of prices earmarked for profit became increasingly differed year after year and it also encouraged enterprises to increase production of certain goods while neglecting others. Planners had to respond accordingly, which resulted in a more complex plan.[19] The predominance of central directives lead firms to cultivate vertical ties with branch ministries to secure their supplies. It was unrealistic for planners to believe that individual enterprise managers would behave as entrepreneurs in a highly

centralized and regulated economic environment. This problem was further exacerbated under the industrial reorganization in the early 1960's.

Between 1960 and 1965 the Hungarian government began merging factories to form bigger state enterprises which sometimes represented entire industries. The reasoning behind the mergers was to reduce the sphere of intervention for central planners. It was believed that large enterprises would be more independent and flexible especially when minor changes were needed in the planning process. Large enterprises could also better accommodate input and output quotas, as well as dealing with suppliers and customers. Research and development departments would be formed within the enterprises to determine investment decisions and improvements in technology, as well as solving production problems.[20]

Although the formation of giant enterprises did make the Hungarian economy more flexible, it also strengthened the traditional vertical relationships between enterprises and central authorities. As a result, the mega-enterprises were given a stronger hand in influencing planners, which allowed them to get bigger budgets and less resistance in establishing production quotas. Those enterprises which represented entire industries had even greater influence over planners. They could threaten with reduced production, to get investment funds, favorable import quotas and wage increases [21] In short the "mega-enterprises" were given tremendous political leverage over central planners. The flexibility they should have gained by reflecting greater

economies of scale and increased independent initiative was lost in strengthened vertical ties between enterprise and the center. What in fact happened was that enterprise managers usurped the function of branch ministries. So, even though the strength of planning authorities at the branch level was weakened, enterprise managers sustained and strengthened vertical ties with central planners to keep the structure of the existing system intact.

In Hungary, the deficit between imports and exports were financed through foreign borrowing.[22] Hungary's foreign trade balance suffered: it fell from a 600 million forint surplus in 1958 to a deficit of 1.7 billion in 1964. Domestic consumption consistently outstripped national income; by 1964 consumption was 3.3% greater than national income.[23] The government finally realized that a slow down was necessary. Several problems needed to be addressed. The balance of payments needed attention. Greater emphasis had to be placed on quality rather than quantity. Structural change was required for balanced growth that utilized skilled labor; and which was more responsive to demand. All this needed to be cultivated. Finally, exports towards the West had to be increased proportionately to intra-CMEA exports. In order to achieve this, technology and efficiency had to be improved. To facilitate these objectives, a partial re-centralization to a more orthodox command economy followed.[24]

The problems inherent in the Stalinist model of industrialization became visible towards the end of the 1960's. Economic management was inadequate. Problems common to command

economies in neighboring countries began to emerge in Hungary as well. Practices such as "hoarding" or keeping huge concealed reserves of supplies to facilitate fulfillment of plan targets became more common. Enterprises tried to lobby for the easiest target. Even though the supervising authorities encouraged more realistic plans, all too often they shared the same attitude as the enterprises. It is under these conditions that the phenomenon of plan bargaining occurred.[25] The negative effects of vertical relations was even more apparent between branch ministries, special authorities, special agencies and the enterprises under them. Often, the most resources were allocated to those enterprises which belonged to the jurisdiction of the most important agencies. Budget constraints were soft [26]. High level authorities making decisions concerning enterprise demands and available resources were based on dilute, inaccurate, and biased information. Political considerations also distorted the rationality of decisions.[27] The overall result was low efficiency and productivity. Small and medium sized firms are virtually absent. Large firms tend to become autocratic and contribute to an economy of modest mass production, rigid structure, and minimal innovation. This structure places the people with the best personal contacts into managerial positions and not those with innovative ideas and entrepreneurial ability.[28]

The changes made to the economy in the pre-1968 period did little to improve the shortcomings of the traditional command economy. Instead, industrialization continued. Traditionally, The

Hungarian economy has always been agriculturally based. It possesses a natural advantage for agricultural production. Enclosed within the Carpathian basin and being positioned between two major river valleys the land and the climate is suitable for diversified agricultural production. Instead of cultivating this natural advantage, the Kadar leadership like its Stalinist predecessor, Rakosi was content to place greater emphasis on industrialization rather than agriculture. Agriculture lagged behind the industrial sector and required more expertise and equipment. The reforms were also limited by close Soviet scrutiny. Despite moderating trends from the Soviet Union itself, it was clear that radical reform such as the Kosygin Reforms which proposed a form of market competition, profit pursuit, elimination of plan directives and quotas were not acceptable. Nonetheless, the changes introduced before 1968 succeeded in augmenting the growth rate of the Hungarian economy, and its standard of living. However, He had to continue to use the traditional methods of the command economy (heavy subsidies) to ensure that the standard of living did not fall. For the leadership, this would be an impediment to future reform. Economic reform was inevitable because the pre-1968 pace could not be sustained for an extended period of time. Thus, the challenge for the leadership in subsequent reforms was to find a balance between reform (marketization) while retaining the existing system and the relative high standard of living it provided.

Endnotes

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10. Revesz, p.42.
11. Ibid, p.46-47.
12. Ibid, p.43.
13. Ibid, p.43.
14. Ibid, p.43.
15. Ibid, p.44.
16. Ibid, p.44.
17. Ibid, p.44.
18. Ibid,
19. Ibid, p.45. p.43.
20. Ibid, p.44.
21. Ibid, p.45.
22. Ibid, p.99.
23. Ibid, p.49.
24. Batt, p.96.
25. "Plan Bargaining" is understood to be a the practice of negotiating plan targets as opposed accepting fixed targets from central planners.
26. "Soft Budget" as defined by Janos Kornai, is understood to be conditions where there are no fixed economic rules governing the activity of firms but instead are often arbitrary and irrational. For example, a soft tax system could result in arbitrary tax exemptions as individual favors, taxes not collected strictly, and firms influencing tax rules. Suggested reading: Kornai, Janos. Contradictions & Dilemmas. Budapest: Corvina, 1985. (pp.33-51) and Nigel Swain, The Rise and Fall of Feasible Socialism, (London, 1992), p.4.
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The Concept of NEM

The attempt to reform the Hungarian Political Economy with the introduction of NEM in 1968, rekindled many long-standing theoretical debates on the principle of Market Socialism. One of the first problems appeared to be the lack of any accepted definition or conceptualization of Market Socialism. Since it sought to combine the competing principles of command and market regulators, market socialism remained an allusive concept which precluded a generally accepted notion of the idea. There is more debate and argument over the attempt to combine the two different concepts: market economy and a command economy, then there is any mutually acceptable definition of market socialism. The most elaborated model of market socialism comes from the Polish theorist Wlodzmiarz Brus who consistently insisted there was a workable model. Others deny any workable model, theoretical or practical. Perhaps the simplest definition of Market Socialism is the safest point of departure for an evaluation of the concept. Accordingly, Market Socialism is state property under market coordination.[1] The very word Market Socialism implies the combination of two different concepts: aspects of a market economy, and a command economy. Hungarian NEM and the subsequent reforms attempted to achieve such a combination. It appears that the Hungarian regime was not prepared to and in fact could not, reconcile the inherent contradictions in market socialism. In particular, the political incompatibilities of directed orthodox socialist society and a market driven society could not be overcome. The leadership made some progress in the practical sphere, but certainly none in the theoretical. The failure to

resolve or perhaps the decision to ignore the long-standing theoretical debates probably foreshadowed ultimate failure. The communist leadership sensed all along that the communist order could not survive any thorough going market reforms. So it is not surprising they opted for political survival over economic efficiency. Perhaps, the leadership already knew, but wouldn't admit that the debate was a foregone conclusion? The ensuing discussion will show that this was probably the case. The limits to their innovation were inherent in the concept they wished to pursue: market socialism.

In an orthodox command economy, the belief is that the party, by virtue of its access to the scientific knowledge of the laws of history, claims to provide an objectively correct definition of social interest, which is both separate from and superior to the interest of individuals. It is this assumption which in fact legitimizes the party's centralistic directive model of a planned economy. The realization of social interest is simply a matter of hierarchical organization for the execution of centrally formulated social objectives.[2] The party therefore assumes the central and guiding role of society. What is not clear is how the party can subjugate all individual and group initiative or interest and preference. The fact that the party holds singular claim to knowledge of social preference is in itself an indication of its subjectivity in its measurement of social interest. In fact, under these conditions, "social interest" is a contradiction; because only a select few make decisions for the masses. Marxist theory suggests that such a

special role for the few is only transitional. Yet, there is still the question why a select few are privy to this quasi divine knowledge. The answers to such questions led many to realize that quite often ideological theory and reality were two very different things and that steps taken in the name of social interest were sometimes only a smoke screen behind which party elites could defend their own privileged positions, at the expense economic efficiency and the material welfare of society.[3]

Annual plan decisions/ directives filter down to enterprise managers through an extensive bureaucracy. On a highly theoretical level, it could be possible that the enlightened party leadership possessed or had access to some mystical informational data bank through which their decisions reflected social preference. The reality is that social preference is a highly complex and dynamic concept which is extremely difficult to measure accurately by any central authority, no matter how qualified. The measurement of social interest would require the ability to calculate many millions of simultaneous equations.[4] The advocates of the orthodox planned economy fail to comprehend the infinite possibilities of social preferences. Although scientifically, it may be possible to calculate social preference, specifically to create an approximation of the market mechanism, the number of bureaucrats required for such a task would be astronomical. Even the most conservative planned economies had to contend with the problem of a "bulging" bureaucracy, and such bureaucracies did not come close to

anticipating the entire spectrum of social preference.

According to an authority on command economies, Ludwig Van Mises, most command economies must prioritize social need in some hierarchical fashion.[5] As a result, that which the deciding body deems low on a priority scale is eliminated. "Such targeting processes" account for the constant state of shortage and narrow scope of selection and choice common to most command economies. Because the command economy is so centralized in its decision making apparatus and because the task of even partially determining social preference is so great, some mechanism which would help facilitate this process eventually came into consideration in almost all of the East European command economies. Market Socialism became an alternative to the rigid Stalinist command economy.

The principle of market socialism implies that some concession is made to the market mechanism. In most cases, it is justified as a step necessary to facilitate more rational and efficient economic decision making. This is the fundamental idea behind the model of market socialism presented by Wlodzimierz Brus. Under the Brus Model, central authorities relinquish their power to intervene directly in micro-economic decision making. The state retains the role of being a macro economic coordinator to ensure that social interest is maintained. In the model, three categories are established to support the state's rule. The state retains basic macro-economic decision making power mainly in the service of long term goals and development. This involves the

division of national income between income and consumption; the determination of the main areas of investment; and the distribution of consumption between different groups of the population.[6] The key is to ensure central control over the flow of investment outlays to affect productive capacities. Central authorities retain the right to determine the rules of behavior to maximize profit motivation and to protect social interest. Under this model, pricing is also subject to central guidance so that it reflects social preference, and that it guides economic units toward rational decisions. Direct intervention is to be avoided and used only under exceptional circumstances.[7]

According to the famous Polish economist, Oskar Lange, Market Socialism is a somewhat different variant of Brus's. Brus effectively left all micro-economic decisions in the hands of individual enterprise managers. The party leadership simply assumes a guiding role in the economy through a complex system of regulators. Lange's model on the other hand also borrows from still another Polish economist, Leon Walras, in which the state or the Central Planning Board (CPB) became a quasi auctioneer under which prices for goods and services were repeatedly tested until a general price equilibrium was found. Naturally, it was assumed that the economic actors accepted this practice passively and adjusted supply and demand accordingly.[8] Only after equilibrium was reached, did any transactions take place. To many analysts, this system can be considered absurd, and rightly so. This method of determining prices for a complex economy would be

tremendously time consuming complex, rigid and inefficient.

Under the Walrasian model, the state or the auctioneer is really only an "optimizer".[9] Its function is to minimize cost and maximize profit with the given data.[10] It is of course a foregone conclusion that data will be inevitably distorted, since price is artificially determined. This problem leads into the model's other major flaw which is the omission of a key actor in a market economy: the entrepreneur and subsequent active competition. Instead of all this, optimization in fact occurred in a framework of subdued and restricted competition.[11] The following passage from Wlodzimierz Brus' text: From Marx To Market, seems to best summarize all the problems.

"The technological knowledge necessary to fill the elements of the Walrasian equations is not a datum but rather information which can only be discovered in the process of competitive struggle. Thus, what matters is the peculiar entrepreneurial thinking technique, a kind of intuition which is generated by actually finding oneself in a competitive situation. Such a situation exists in principle under capitalism, where entrepreneurs strive for profits, and this provides the foundation of the coordination of the market mechanism, which operates with huge imperfections but operates nonetheless. As Kornai observes: "In a genuine market process actors participate who want to make use, and can make use, of their specific knowledge and opportunities. They are rivals... Some win and some lose. Victory brings rewards: survival, growth, more profit, more income. Defeat brings penalties: losses, less income, and in the ultimate case exit."..."[12]

Under Lange's model, which is actually a modification of the Walrasian one, enterprise managers would be reduced to accepting prices as determined by central authorities. They would be responsible only for determining cost. Enterprise managers would have to determine under which level of output marginal cost

would equal price.[13] The CPB acts as an auctioneer by testing prices through a process of trial and error until supply and demand in all markets for producer goods becomes equal. It is debatable how realistic this would be, without some central intervention. Specifically, it would be inevitable that some firms would try to dodge CPB calculation principles. As a result, the CPB would have no choice but to implement regulators and ultimately interfere in the "market".[14] Moreover, the Lange model fails to address its most frequently telling flaw: it doesn't consider the need for hard budget constraints and it creates a seller's market not a buyer's market.[15] Both these shortcomings detract from effective marketization. In fact, the model is almost completely at odds with market principles.[16]

The Hungarian reform plan of Market Socialism borrows principles from both models. In the Brus model, the complex set of regulators manipulate the economic environment of enterprises so that their pursuit of profit is subjugated to the objectives of the national plan. The regulators include various taxes, levies, and charges on enterprise assets [17] Even if both models were perfectly incorporated into a real economy, the enormous task of measuring social preference, even if aided by partial marketization could not be met. It could of course be argued that more marketization could improve the practicality of both models. Further, more comprehensive and a less regulated form of marketization could make the feasibility of either model greater. However, one must keep in mind that both models were designed to operate under a single party system where the communist party

had to continue to exercise its unchallenged leading role in society, which included extensive oversight and manipulation of the political economy. Decentralization beyond what these models propose, would have required the party to relinquish a very important aspect of its ideologically legitimized position of administrator and defender of social interest. The party's legitimization, in fact its very existence was bound up with the centralistic-directive model of the planned economy.[18] The directive role of the party was incompatible with the market.[19] Ironically, the party's tendency to protect central power and to limit the market mechanism has in fact also limited its objective ability to measure social interest. Under market socialism, one of the chief objectives of incorporating the market is to create a more objective way of measuring the pulse of the economy and subsequently helping central authorities make more rational decisions.

As mentioned, by combining plan and market, the central authority must inevitably give credence to individual and group initiative. Logically, some form of democracy could become possible. However, the prospect or the option of democracy undermines the logical basis for the party's absolute claim to its leading role in society, provided by the totalitarian concept of social interest.[20]

The unwillingness of the party to surrender even partially its monopoly on political leadership resulted in the subsequent half-hearted marketization measures. Most theoretical opponents of Market Socialism single out this political problem as the most

intractable for the would be communist marketeer. Some of the more prominent opponents were Friedrich Hayek and Ludwig Van Mises or contemporaries like Janos Kornai. Van Mises was one of the first to challenge the very rationality of Market Socialism. He showed that the greatest deficiency of any socialist economy or for that matter any socialist directed market economy was the absence of an indicator of value. Value would always be determined by the political preferences of the communist state. Furthermore, he argues that although the state may be able to determine social preference in some limited degree by drawing up a list, and prioritizing it. The state would not be able to direct and use the means of production rationally because it has no way of calculating relative value. Prices must therefore remain arbitrary, and could give no information on relative scarcity or demand. Therefore, it was very difficult to calculate the costs of production. As a result, efficiency and productivity suffer too. Von Mises argues that the driving force in a market economy is the incentive to maximize profit. The profit motive ensures firms will be more responsive to demand, but also to the efficiencies of cost minimization. He argues that the lack of personal initiative and responsibility which is an inherent deficiency of socialism is what makes it so cumbersome .[21] Under market conditions, the opportunity to reward individual effort encourages rational economic activity. In the traditional command economy, decisions are guided by the political will of the central authority. Thus, decisions are often arbitrary and have little or no true reflection of actual cost, price,

scarcity, or the originally stated social preferences of the regime. Hayek adds to this argument and highlights another flaw in the socialist economy, that being the ability of an omniscient center to master the immensity and complexities of all the possibilities generated by the market.[22] According to Hayek, it is impossible to emulate the infinite possibilities of the market mechanism.[23] Social interest can only be accurately determined through a mechanism which allows all individual and group interests to be measured. This is an impossible task for any government bureaucracy.[24] Still, The advocates of the central plan claim to give stability, eliminating fiscal fluctuations, excess capital, excess labor, and unsatisfied need.[25] Market reform was only one response to the problems of the command economy. To a limited degree, the party's need to emulate the market led to the expansion of super-computers and cybernetics, which they believed would emulate the market mechanism. Unfortunately, advancements in Hungary and throughout the Soviet Bloc never reached a stage where super-computers became a realistic option. Traditionally, the chief motivation behind introducing market elements in socialist economies was not to transform, but rather to assist in the implementation of the central plan.[26] The Hungarian reformers and architects of NEM also shared this view.

Under the principle of Market Socialism, direct interference in the economy generally ceases to exist. However, significant indirect regulation remains. A clear contradiction emerges, that is the party's persistent drive to maintain a monopolistic

position of power while at the same time trying to incorporate a more rational economic mechanism to determine resource allocation, value and ultimately price. It is essentially an attempt by a centralized power to introduce decentralization.[27] In fact, by allowing the market to function even in a limited sense, the party in effect concedes that it is not capable of unilaterally determining social preference and that alternatives are possible. By allowing even a limited degree of marketization, one logically assumes that the individual in society has some legitimate function as a component of what makes up social preference. Democracy and pluralism are suggested here, and so the preservation of the centralistic character of the party is simply not possible, without altering its fundamentally ideological base of power. What was needed was the restructuring of political institutions and abandonment altogether of the centralistic totalitarian model of socialism. The theoretical justification for the introduction of the market is that it facilitates more rational economic decision making. The introduction of Market principles in Hungary did not lead directly to capitalism. The party managed to hold on to much of its directing role.

Janos Kornai, is very blunt in his analysis of the merits of market socialism. "It is a principle which has simply fizzled out" he says. He cites the market mechanism as the natural coordinator of private sector activities. He points out the futility of expecting the state unit to behave as if it were a privately owned unit. According to Kornai, the state is a

bureaucratic monolith, the state firm is but one part of this monolith. It is absurd to believe that the state can match the flexibility, spontaneity, accuracy, and infinite possibilities generated by the market mechanism.[28] The mere discontinuation of central plan commands does not create market co-ordination of state firms. In fact, he argues that it is naive to believe in the concept of the mutually correcting duality of plan and market. Under the principle of market socialism the party will inevitably manipulate the market as an instrument of its authority. The result is many micro interventions by the central authority. Enterprise dependence on the state is preserved and subsequently competition between enterprises is impeded.[29] In Western Market Economies too, government intervention is prevalent. However, interventions rarely result in major distortions in the operation of the market. This is so because a democratic government in a market setting does not lay claim to an over-arching "social purpose."

Motivation to succeed, to compete, and to generate profit is difficult to achieve when the economic actors are not operating with any risk to themselves. Like-wise, the state decision-maker doesn't make decisions with his or her own pocket book in mind.[30] Under socialist leadership failure is not excepted. Under market conditions, failure is frequently a result of poor entrepreneurship. The acceptance of failure and success as equally acceptable possibilities under capitalism contrasts sharply with the explicit unacceptability of failure in the communist scheme. It also accentuates the incompatibility between

the principles of capitalism and socialism. The hard-line socialists argue that market socialism is really only a bloodless form of capitalism; or capitalism without capitalists.[31] Still, the market mechanism is a more efficient and accurate method of measuring the pulse of the economy.[32]

The Hungarian Model of Market Socialism or its synonym: the New Economic Mechanism (NEM) followed the general theme laid down in the principle of market socialism, that being, the implementation of market elements in the economy was to facilitate a more rational, efficient, dynamic and somewhat decentralized decision making process.[33] It eliminated the practice of plan directives and commands from the center. Introducing aspects of the market were really only meant to modify traditional central planning without overstepping the existing socio-political system, thus preserving all the ideological postulates of socialism. In fact, it was characterized not as a reform of socialism, but as an alternative method of implementing it.

Central plan directives were replaced with indirect instruments of control or financial "regulators".[34] Immediately, the theoretical contradiction of combining plan with market emerged. The party leadership in Hungary intended to maintain all aspects of a traditional socialist economy including its unchallenged position as chief administrator of social preference expressed through the national plan. While on the other hand, the party yielded to individual and group pursuits as a more efficient and productive channel to revitalize the

economy. Despite conceding to aspects of capitalism, it used this concession very successfully, because in the practical economic sphere it promoted some individual autonomy leading to limited competition. Thus, the Hungarian model, briefly gave the appearance of success.[35]

Under the Hungarian model, the central role of the state and specifically the relationship between the sphere of politics and economics did not take separate courses. Politics, specifically the role of the party took precedence over everything including the economic sphere. The introduction of the reforms did not change this relationship. In the short term this was acceptable. In the long term, the contradiction between theory and practice began to manifest itself (ie. marketization versus plan directives) In other words, as the party tried to cultivate entrepreneurial initiative through methods, which at the same time continued to support centralization. For the party, politics and economics molded into a single unit, where politics determined economic decisions. As a result, economic decentralization, in theory could not be accompanied by political decentralization, since it would threaten the party's leadership. Inversely, marketization was left incomplete since true independent or group initiative was impossible under these conditions. Economic actors were curtailed by the political will of the central authority. For the participants in the reform process, politics and economics were two very different spheres. One is forbidden and the other is limited. This appears to be the end result, and ultimately the limit of Market Socialism. The

challenge to the party was to determine the threshold between politically unchallenged market socialism and market socialism which allowed for the logical transition to democracy. Some authorities argue that Hungary actually reached and then surpassed the threshold between communism and democracy and lead to the party's demise.[36]

NEM recognized that the central plan was not omnipotent and therefore conceded powers to individual enterprises. In theory, the state acquiesced in individual initiative which was meant to decide what, and how much should be produced and by whom.[37] However, the party continued to hold power which was evident in the static situation of political institutions in Hungary even as late as 1989![38] It became clear that NEM was not as innovative as many in the east and west originally thought. In fact, it was never intended to reform socialism, but rather to implement the planner's priorities through market based incentives. Substantial perogatives always remained with the planners, most of the time to subvert the influence of the market. Barnabas Buky, a prominent Hungarian Economist makes a compelling assessment concerning the essence of NEM. He argues how the Hungarian leadership knew exactly what they wanted to avoid and what they wanted to achieve.

"They intended to introduce a "new mechanism" which would make better use of the economic base without disturbing the political superstructure, a goal which not only violated the fundamental marxist tenet of the linkage between economics and politics (some think that it did not seem to disturb them) but also ultimately doomed the reform....."[39]

Buky continues to explain that the Stalinist command economy is

based on the the ideological assumption that the only repository of human rationality is the party. As a result, the actions of individuals, groups, or institutions which according to the state could only hinder the effective pursuit of rational goals was replaced by the absolutist power of the party state. Moreover, absolute rationality was embodied in the state plan which prescribed virtually all actions for the economic units. The same rigid relationship existed between center and unit as between state and individual. Initiative ultimately rested with the planner.[40] Under NEM, this theoretical relationship between the center and other economic actors remained essentially unchanged.

Even though the political-economic system under NEM was more or less Stalinist, it still made the quality of life better.(see appendix 1) This was especially apparent in the increased availability of consumer goods. Even more significant was the relative abundance of foodstuffs Hungary enjoyed with in the Eastern Bloc. Housing was difficult to obtain, but it was still much easier than in most neighboring communist countries. NEM was able to create an atmosphere of change. Life felt better and as a result, it created a more liberal society. Oddly, this liberalization was really only a a reflection of liberalized consumerism. The capital city, Budapest was most reflective of this change. Modernized, western style shopping and tourist facilities gave the appearance of significant change, even to many western observers. Hungary avoided many of the explicit signs of stalinism such as billboards with stalinist slogans, red stars, and overt police control. The combined effect gave a very

superficial appearance that things were genuinely changing. In reality, the essential features of the traditional stalinist political-economic system remained.[41]

Instead of direct commands from the center a system of complex indirect regulators regulated the apparent autonomy of micro-economic decision making. As with the system of central commands, entrepreneurial initiative was something the center tried to emulate and nurture by use of indirect regulators. The entrepreneurial mystique, which is an intangible quality cannot be artificially created, not even with the aid of the greatest super computers as was once thought possible by some of the former communist regimes. NEM became a manipulative mechanism.[42]

In theory, in order to make economic decentralization more effective individual freedom and some democratic political rights would be required to convince people that they have a real and actual role in society; not just subservience to the state. One of the unique features of the competitive market is that it supports inventiveness. The political system in Hungary, however continued to exercise an authoritative role, even in the market. As a result, individual initiative and inventiveness were limited by the political limitations of the communist leadership.[43] Exceptions did occur, and there were cases where the market and central authority could co-exist. The agricultural sector was one of these examples.(see chapter 5) The party did not completely ignore the theoretical debate over NEM. There were some like

Rezso Nyers, the architect of NEM, who continued to support the party's function as the guiding power in society. Imre Pozsgay (the most radical of the party reformers in 1989), already in 1968, called for the avoidance of theoretical stagnation and the continued existence of retrograde forces. Rezso Nyers, a moderate reformer saw more importance in the party's function of administering public interest. If the party didn't continue in this capacity, he believed it would impede and not facilitate progress.[44] Clearly, the party was preserving its traditional role of defender and facilitator of public interest. This however created the problem of implementing economic decentralization without the accompanying political decentralization.[45]

The party in Hungary put itself into a contradictory position. It is an inner contradiction which Kornai mentions too: "how does one encourage people to participate in a reform which could ultimately jeopardize their livelihood?" [46] This problem was common in other Soviet bloc countries as well. In fact, it still haunts many of them. In Hungary, the centralized state hierarchy was required to implement the reform, yet it was the centralized leadership and its inherent tendency to dictate policy from the center which inhibited the full implementation of NEM. The political inflexibility of the party's political will made the Hungarian version of Market Socialism inoperable.[47] The second major flaw of the Hungarian model of market socialism is consistent with many of its criticisms. Entrepreneurial initiative was stimulated by politically determined and administratively enforced rules. In essence, firms were told to

engage in free competition. This form of coerced, regulated, and emulated type of market behavior is less than accurate and is largely void of rationality, spontaneity, and dynamism required to create genuine competition and subsequently the entrepreneurial mystique.[48] Finally, in theory, the state was to formulate regulation to facilitate the implementation of NEM. Instead, regulators turned into directives.[49]

Even though the Hungarian version of market socialism failed, the two concepts of market and regulation can co-exist. In fact, all markets are regulated to varying degrees. It appears that the concepts of market and regulation were not fully understood by Hungarians. In particular, enterprise managers failed to understand the role of regulation in the market. Regulators were intended to function as guides to market activity. Instead, the tradition political ties were strengthened. In fact, more often than not, enterprise managers exploited vertical ties before they pursued horizontal ties, which encouraged competitive behavior. It was easier to turn a "profit" by exploiting vertical ties with branch ministries and central authorities. Enterprise managers interpreted the "guiding" role of the indirect regulators as traditional central regulators. By linking their success to strong ties with central authorities, enterprise managers could relieve themselves of any accountability. If the enterprise they led failed, the planners could be blamed as much as the enterprise managers. Of even greater consequence was that the enterprise managers weren't exercising any entrepreneurial initiative or responding to competitive forces. On the

flipside, state authorities were not willing to liberalize the political economic institutions to enforce marketizing measures. This was largely due to the fact that they were unwilling to sacrifice political control for greater economic liberalization. Change at the bottom could only occur if change occurred at the top. Until, central authorities would be willing to liberalize the institutions and structures which determined the nature of the political economic climate, real change at the enterprise level would be arduous.

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The Implementation of NEM

The Hungarian economic reform process really began with the introduction of the New Economic Mechanism in 1968 (NEM). NEM established the foundation for subsequent reforms which lasted until the collapse of the Hungarian Communist Regime in 1989. NEM was preceded by a number of partial and very limited reform experiments prior to 1968. Numerous factors both within Hungary and External to it helped facilitate the introduction of NEM in 1968.

Planning for NEM started in the mid-1960's. In fact, it took some of its queues from the Kozygin Reforms in the Soviet Union introduced under Brezhnev (1965). As a result, the first blue print for NEM was considered in 1966.[1] In brief, The Kozygin Reforms aimed at improving the existing economic system by simplifying directives, reforming the pricing system, placing greater emphasis on profit, and allowing enterprises to gain limited control over investment, using state credits. The radical faction in the Hungarian leadership proposed a much more deeper and significant reform. It believed that the rigid command economy which employed extensive central directives towards the fulfillment of the national plan was an impediment to progress, the division of labor, and integration into world markets. It suggested not only better development of commodities and money, but instead their employment into a market guided economy. The state would be relegated to macro-economic management, controlling money, credit supplies, wages, and employment policies. It would involve itself more with infra-structural

projects and very large scale industrial projects.[2] This line of thinking was evident already after the 1956 revolution. The most prominent of these thinkers in Hungary was Gyorgy Peter, a prominent economist and chairman of the Hungarian Statistical Office. Similar ideas were being put forth in surrounding Bloc countries such as those of Ota Sik of the Czechoslovakian Academy of Sciences' Institute of Economics. The book published by Wlodzimierz Brus on Market Socialism in 1964 in Warsaw, Poland was the most influential in the formulation of NEM.[3] The Hungarian reformers borrowed many of his ideas when formulating their reform plan.[4]

The external influences on the introduction of NEM were not limited to similar or alternative ideas of economic reform. The NEM plan was subject to very real and at times very threatening political attention from surrounding bloc countries, including the Soviet Union. The Hungarian Plan was jeopardized even before its first draft proposal in 1966. This apprehension was linked to the events transpiring in the Soviet Union at the time. In 1964, the ouster of Khrushchev made many fear, especially in Hungary that any attempt at reform which had been facilitated by the moderating waves coming from the Soviet Union following the 22nd CPSU, might be reversed.[5] Fortunately for Hungary, Khrushchev's replacement, Brezhnev, despite being considerably more conservative, initially did not exercise any significant negative influence on the Kadar Administration. A number of reasons can be given for the Soviet's apparent lack of concern for events taking place in Hungary. The most important and

plausible is Kadar's excellent record following the 1956 Revolution. He managed to pacify, de-politicize (at least all explicit anti-Communist sentiment) and most importantly he generated a great deal of stability in Hungary after the events of 1956. Even more important was the fact, he showed unwavering loyalty to Moscow which appeared to be enough to satisfy the Soviet Leadership. Soviet leaders believed Hungary would not deviate from the Soviet prescribed limits of tolerance especially in light of the implicit threat of Soviet forces stationed in Hungary. As far as the Soviet Union was concerned, NEM was given the green light.[6] However, despite the green light, there were other events simultaneous to the introduction of NEM in 1968 which were beyond the control and influence of Hungarian authorities.

The Czechoslovak uprising in 1968 created an atmosphere of apprehension throughout the Soviet Bloc. Most significantly, it stirred conservative elements and gave them reason to denounce reform attempts and moderating trends. Kadar was able to control effectively and to manipulate indigenous conservatives by systematically "forcing" them out of influential positions. It was the external conservative backlash from surrounding Bloc countries which gave him reason to worry. Conservative critiques from Czechoslovakia (CSSR), East Germany (GDR), and the Soviet Union all warned of the potential implications of NEM, especially in light of the events unfolding in CSSR. Conservatives warned that even moderate economic reforms would lead to instability. Kadar was able to brush off the negative

influence of communist conservatives by pointing towards three very important facts. Partial implementation of NEM principles before 1968 showed no sign of compromising Hungarian political institutions. Secondly, Kadar effectively normalized and stabilized the Hungarian polity following the 1956 revolt, and most importantly he reaffirmed his loyalty towards Soviet policy and leadership by participating in the Soviet suppression of the 1968 Prague Spring.[7] Kadar worried that confrontation between the Dubcek regime and the Soviets may jeopardize NEM. Kadar made it clear that NEM was to be very limited in scope, especially in the political sphere. However, conservatives at the time, viewed NEM as potentially dangerous and de-stabilizing, perhaps rightly so, since on paper it left many doors at least partly open to further more far reaching reform. In reality, it was the politically cautious and conservative attitude of Kadar which limited the potential innovative features of NEM. Nonetheless, Kadar did have some reason to worry since the "SIK" model for reform in Czechoslovakia which was one of the main targets of Soviet criticism, was actually quite similar to the Hungarian model. The SIK model differed in that it proposed political change to facilitate market reforms. This was beyond tolerable limits. Despite his apparent personal reluctance to participate in the 1968 invasion of Czechoslovakia, Kadar was one of the first to send troops.[8] He did this to confirm loyalty to the Soviets and to confirm that the Hungarian reforms would not exceed the prescribed limits which had apparently been exceeded by the Czechoslovak reforms. Soviet limits of tolerance were always vague, and consequently enhanced the fear factor in

reforms. People never really knew where the line of tolerability was; it kept people guessing. The risk of arrest and imprisonment was always present. The memory of 1956 was all too vivid for both Kadar and the general population to risk a second Soviet invasion. Though, it is important to note that the introduction of NEM was never accompanied by the level of explicit and free political expression seen during the height of the "Prague Spring".[9] Kadar remained sympathetic towards the CSSR reforms, as much as it was advisable. He was forced to reverse his opinion in March of 1969 after the Anti-Soviet demonstrations in Prague.[10] Politically, NEM has been viewed as a delayed reaction to the 1956 Revolution.[11] This might be true in the sense that NEM was an obvious extension of the Kadar "moderating policies" of the post 1956 period. The ruthlessness of the secret police activities also appeared to diminish as the reforms took effect. Kadar's opportunism and pragmatic leadership style emerged. NEM helped facilitate this political objective, but because it was so politically motivated, the economic liberalization intended by its introduction was quite diluted. Kadar's superficial faith in the merits of socialism, reform, and in NEM were apparent.

Passive Soviet support or at least tolerance was essential to the implementation and the survival of NEM. In March of 1968, the same month in which Anti-Soviet demonstrations flared in Prague, Moscow sent Hungarian authorities a telegram to acknowledge the 50th anniversary of the proclamation of the Hungarian Soviet Republic. In the telegram Moscow acknowledged

Hungary's contribution, on behalf of the CPSU, the Soviet Government, and all Soviet citizens to the theory and practice of Socialism, and it commended Hungary's successes in the building of Socialism . It is difficult to determine the sincerity of the telegram. It's possible that it was written out of necessity in response to the potential destabilizing effects of the CSSR situation. It is also plausible that Moscow did have genuine faith in the Kadar leadership and considered him as a trustworthy and reliable ally. It is certain that Kadar made absolutely sure that no explicit Anti-Soviet sentiment emerge in Hungary. In contrast to the extremely critical even aggressive, almost defamatory Czechoslovak Press in 1968/69, one would have searched in vain to find any Anti-Soviet sentiment in official or semi-official publications in Hungary. Regardless, some Soviet officials remained skeptical of Hungarian reforms. In particular, Nikolai Drogishinski, the head of the Department for the Introduction of New Methods of Planning and Economic Stimulation in the Soviet State Planning Commission (Gosplan) felt that Hungarian and Czechoslovak Reforms could be grouped into the same category. Their assessment was blunt when asked in an interview with Henry Shaffer, Associate Professor of Economics, University of Kansas:

"We do not like to criticize our Hungarian comrades, but we think their approach to central planning is totally incorrect; and we should know because here in the Soviet Union we have had 50 years of experience with central planning"[12]

Similar sentiments were apparent in a lecture delivered in 1968 by Prof. Rem A. Belosov, Section Chief of the Institute of

Economic Sciences attached to Gosplan. He said that the Hungarian experiment was being watched carefully and should it fail, the Soviet Union could help Hungary. He felt the Soviet Union should be much more careful before embarking on any similar reforms.[13] It is clear that the Soviets were apprehensive on many points. There were fears that the introduction of NEM might compromise the position of the party as understood in Soviet terms. Also, some felt the reforms might lead Hungary to compromise its COMECON obligations, perhaps its Warsaw Pact obligations too. Soviet reaction seemed to reflect the apparent radical nature of NEM as it was perceived at the time of its introduction. Kadar's loyalty and assurances to the Soviets, that Hungary would continue to fulfill its obligations to Bloc members led the Soviets to give passive support to NEM. Also, in the interest of overall stability, especially in the tense atmosphere following 1968 it was conceivable that Soviet authorities saw the value in "extending the leash just a little". Hungary engaged in a unique blend of give and take politics . It was careful to meet Soviet demands while implementing its own reform plan.

NEM had two functions: economic reforms, and secondly political stability. NEM and subsequent reforms which complimented it raised the possibility of political change. Political change was never initiated under NEM, and as a result political debate was kept with in the confines of party offices. It appears that the general population was more anxious to cultivate and maintain the idea of economic reform than to challenge the political establishment. On the same note, the party wished to

avoid confrontation with the Soviets. The immediate concern of NEM and subsequent reforms was to address the side effects of the orthodox command economy. The Hungarian economy reflected many of these side effects including chronic shortages, low productivity, inefficiency, lagging technological innovation, a deteriorating and inadequate infrastructure. Debt as a result of continued subsidization of large unprofitable firms just exacerbated this problem. There were few in the leadership who could deny these problems. During the 11th Hungarian Socialist Worker's Party (HSWP) Congress, there was a call for improvements in the implementation of socialist objectives. The statements of the Party were actually quite vague and often very general without leading to any concrete recommendations. For instance, they called for a stronger assertion of social planning by improving the efficiency of central control and raising the standards of planning at both the enterprise and national level. They also called for a creation of harmony between the objectives of the plan and the means used.[14] Some vague recommendations were made which called for the introduction of some market principles to stimulate efficiency. The congress was successful in recognizing all the major problem areas of the Hungarian economy, namely: the need to adjust the patterns of productivity to improve foreign demand for Hungarian products especially with in the Eastern Bloc; also the need for greater flexibility and adaptability to changes in the economy, through the use of regulators. Some mention was also made of the need for greater enterprise autonomy to help facilitate these changes.[15] Subsequent debate would center around the parameters of the economic reform.

NEM intended to combine the advantages of central planning with market incentives and private initiative. It avoided bureaucratic over-centralization, but also the anarchy of the market and unlimited profit orientation. It was a dynamic model. However, it was absolutely clear that it would not be complimented with reforms to the political structure.[16] The traditional institutional and organizational structure of economic management remained essentially unchanged.[17] However, NEM did eliminate direct and comprehensive involvement of central plan directives. Instead, a system of indirect regulators replaced the former plan directives.[18] At the time, this was a radical departure from the past. However, upon more detailed examination, it became evident that many of the characteristics of the orthodox planned economy remained, except in a more disguised fashion.[19] The first blue print for NEM was also very clear on its position on the basic tenets of the socialist system. Specifically, it stated that it intended to modify the basic traditional features of central planning without overstepping the parameters of the established socio-political system. The object was to improve the methods of "building socialism". NEM retained the fundamental features of the socialist economy, such as social ownership being the predominant means of production, as well as all the ideological postulates of socialism and the central role of the national plan in the allocation of resources. It envisaged a dominant role for the state sector with moderate scope for the private sector, and encouraged expansion of the cooperative sector. NEM did not

intend to replace the National Plan with the market, but instead it aimed to implement the planner's priorities through market incentives.[20] NEM was introduced with a single stroke throughout the whole economy, this differed from reform attempts especially in other Bloc countries and the Soviet Union where reform was more gradual: firm by firm, and industry by industry.[21] It was believed by the leadership at the time, that the swift all encompassing strategy of implementation would give the reforms the best chance to be effective and efficient. The wisdom of this tactic was somewhat questionable considering the political climate in which they were implemented. Experience showed that sudden whirlwind changes could pose a disruptive effect, especially apprehension in Soviet authorities.

The principle features of the Hungarian Reform Package (NEM) can be summarized as follows:

- 1.The reforms sought to increase the productivity of factors of production by improving the incentive system.
- 2.There was a general desire to stimulate greater efficiency in all branches of the economy and to improve the country's foreign trade performance.
- 3.It hoped to change the persistent seller's market that characterized the traditional system of economic management and make production more responsive to changes in demand.

To facilitate these objectives, the reform package introduced changes to the planning, pricing and the incentive system.[22] The reform attempted to decentralize economic decision making in order to achieve a higher level of efficiency and a more economical use of available resources.[23] Efforts were made to create market links between state owned firms, and firms and consumers. Also, greater independence and

responsibility was given to individual enterprise managers to encourage them to make day to day micro-economic decisions.[24] However, the state still remained the sole repository of rationality. Even though the relationship between state and individual was relaxed in the economic realm, it continued to make all major macro-economic decisions regarding economic development, investment, consumption, and foreign trade.[25] NEM attempted to free the country's productive resources and capabilities from the the stronghold of centralized economic management and inflexible budgetary allocation processes. It aimed to generate new incentives for higher productivity and more cost-effective management at the enterprise level.[26] NEM was to be confined to the economic sphere.[27]

Under the NEM reforms, individual enterprise managers were expected to work more effectively and profitably toward the realization of the national plan. The independence they received was actually quite limited, since they still had to comply with central policies. Instead of fulfilling central directives, they were now subject to a set of complex indirect regulators (formulas) which determined the division of investment, wage, price and most importantly the division of profits. Each aspect of enterprise activity: wages, total manpower, profit, investment etc. was linked by these formulas to the size of the profit sharing fund from which managers would receive bonuses. By manipulating the formulas, they manipulated the managers' bonuses and subsequently the flow of investment, wage levels, and the size of the labor force.[28] Through this method of indirect

regulation the state preserved its ideological claim to being the chief regulator of the economy. Secondly, it intended to stimulate more individual initiative in enterprise managers. One of the incentives used to achieve this was the profit sharing fund.[29] The fundamental flaw of this type of incentive program is that it wasn't stimulated by genuine market competition but instead by a manipulative mechanism directed by the state. The state manager really didn't enjoy the type of freedom that he would need to exercise true entrepreneurial initiative. Ultimately, he or she was accountable to the state, and the state reserved the right to intervene. As Janos Kornai points out, the state manager was not an entrepreneur, though the state expected him or her to be one. The state didn't allow the creation of the necessary circumstances for entrepreneurial initiative to function (ie. a dynamic free market). Kornai points out that the enterprise manager was not subject to hard budget constraints under the plan. Even though, the manager may resemble a quasi entrepreneur under the NEM plan, he or she still has to make day to day micro-economic decisions within the prescribed parameters of the central authority. The manager did not make decisions with his or her "pocket book" in mind. Instead, the maximization of state concessions to satisfy the or the national plan took precedence over entrepreneurial thinking.[30] This also eliminated any possibility for accountability. Unfortunately, entrepreneurial initiative like the regulators was imposed. Unlike regulators, entrepreneurial initiative involved a certain intangible spontaneity and dynamism which could not be coerced or even regulated. It is something which was unique to the

competitive dynamic conditions of the market mechanism through the interaction of supply and demand. The use of centrally determined rules to stimulate entrepreneurial behavior instead of market forces, rendered any manifestation of entrepreneurship very superficial.[31] Even the means used to create this quasi entrepreneurial initiative was often perverted. For instance, profitable firms paid bonuses to workers and managers from profits earned after taxes. However, unprofitable firms frequently received heavy subsidies which created fictitious profits. The result was that inefficient unprofitable firms used one subsidy to gain another, consequently negating the intended effect of the bonus system which was to encourage entrepreneurial initiative, efficiency, and ultimately profitability.[32] Of particular significance too was the branch ministries' continued reservation to appoint and dismiss enterprise managers as they wished.[33]

The fundamental flaws of the management function under NEM was the limited parameters within which it had to operate. Genuine competitive market conditions did not exist under NEM. The practice of bargaining remained essentially unchanged. Instead of bargaining over target figures imposed by the national plan, they bargained over tax credits, taxation and pricing [34] More often than not, questions of efficiency, profitability were given only secondary consideration. The mix of central bureaucratic control with market elements seemed always to give priority to the will of the central planners and only secondary importance to market influence.

In an effort to more accurately reflect foreign prices, NEM made steps towards a unified exchange rate. The regulators for pricing and exchange rates were made more flexible.[35] The multitude of exchange rates prior to 1968 were unified. Before 1968, exchange rates were adjusted by the central bank. Nevertheless, there was no exchange rate in the usual sense. The one established by the bank was used for statistical purposes only. In practice, exchanged rates varied widely. Part of NEM involved exchange rate reform; this resulted in a somewhat less arbitrary and slightly more rational exchange rate. Still, the establishment of value was vague and elusive. There really was no consistent policy, and because there was more than one rate, the exchange rate problem was never completely solved. The new system had a unified rate called the commercial exchange rate which was set to the average cost in forints of earning a unit of foreign exchange in none-ruble exports. There was also a non-commercial rate also known as the tourist rate. The tourist rate was often highly deflated in comparison to the commercial rate. The commercial rate clearly reflected heavy subsidization of consumer goods and services.[36] The inconvertibility of the Hungarian currency (forint) combined with the isolation of the Hungarian economy, and the very limited competitive market activity with Western firms made the establishment of realistic exchange rates almost impossible.

Attempts to liberalize foreign trade towards this end, often resulted in greater distortions and subsequent recentralization to ameliorate them. What is rarely mentioned in

official documents and literature, Hungary like most Eastern Bloc countries had a black market exchange rate which was as much as 20% higher than the already inflated commercial exchange rate which was supposed to be a reasonably accurate reflection of the value of the forint. Of course, the black market rate could be as much a four times the official tourist rate. The significance of the marked difference between official and unofficial rates is that it reflected the extent of state subsidization of prices, and more importantly the black market rate gave a more accurate measure of the actual value of the forint against foreign currencies.

Before the introduction of NEM, prices rarely reflected relative scarcity of resources. Differentials between foreign and domestic prices were compensated by transfer of special funds. Consumer and producer prices were separated by a complex system of turnover taxes and subsidies. NEM introduced a three level price system. Fixed prices which were set by the central authority. Flexible prices which were allowed to fluctuate between centrally determined limits, and free prices which were set by enterprises according to predetermined rules. This meant that the National Materials and Price Office still held the right to intervene if it deemed price increases excessive. Moreover, rules governing cost calculations and admissible profit margins required prior notification to the National Materials and Price Office. Regulations concerning the profitability of enterprises determined the extent to which producer price adjustments could be passed on to customers or absorbed in profits [37] Fixed

prices generally applied to most basic foodstuffs and raw materials. The variable prices applied to most capital goods, consumer goods, and processed foods. Free prices applied to such items as fashion goods and cosmetics (luxury items), as well as foodstuffs sold by smallholders.[38] The pricing structure introduced in 1968 added considerable flexibility and freedom to the ability of firms to adjust prices. However, they still had to notify central authorities of price adjustments. Thus considerable administrative intervention continued.[39] Ultimately, the accuracy of price even under the sharply limited parameters of NEM depended heavily on the level of genuine competition. The reality was that the price distorting practice of state subsidization continued even after the introduction of NEM. In particular, subsidies on essential items such as basic food stuffs remained very high.[40] All too often prices were cushioned making the effect of increases or decreases less noticeable. Even though there were some in the leadership who advocated more far reaching or liberalizing price reform. Fears of potential dislocation and a possible decreased standard of living kept authorities from reducing or stopping interference in price formation.[41] For instance, it wasn't uncommon that a price for a commodity was determined after the conclusion of the delivery agreement, instead of price being an integral part of the agreement as would be under competitive conditions. Prices and regulators were often made to fit the movement of goods. Inversely, the movement of goods often took place without regard for prices and applicable regulators intended to rationalize the

price system. Very simply, the NEM pricing system introduced in 1968 failed to establish concrete value relationships.[42] Pricing continued to be distorted and ended up reflecting the irrationality and arbitrariness of the system instead of any genuine reflection of value, demand, and scarcity which exists only under genuine competitive conditions.

Wage policy also underwent change with the introduction of NEM. Like pricing, wages were subjected to significant decentralization. However, it also had to function within predetermined limits and was subject to indirect regulators which manipulated wage and subsequently labor decisions of enterprise managers.[43] One of the most distinct features of the revised wage system (1968) was the allowance of profit funds to be used for wage bonuses. The size of these funds was of course regulated by various state taxes. Also as already mentioned, the bonus system didn't always reward profitable firms. The state would frequently subsidize unprofitable firms so that they too, could turn a profit and consequently collect on additional state bonuses for showing profitability! Also, managers benefited much more than did workers. As a result, already in 1971 steps were taken by central authorities to place more rigid supervision and control over re-investment especially as it pertained to wage bonuses.[44] Of course, the aim of the wage fund bonuses was to create some incentive for economic efficiency. Wage fund control and ultimately wage regulation was based on productivity indicators determined by the central authority.[45] However, inequities did occur since not all the firms were able to

generate the same profits and subsequently the same wage increases which ranged between 1-7%/yr. The result was that tax exemptions and subsidies were needed to equalize bonuses. Needless to say, this was a self-defeating exercise as it did little for inspiring efficiency and productivity since no differentiation was made between profitable and unprofitable firms.[46] The formula for the productivity indicators is not clear either; in fact it isn't spelled out. It is something arbitrarily determined by the state. As a result, exceptions could easily be made and sometimes productivity indicators affecting wage funds could be spontaneously changed. Thus, no uniform measure of productivity could really exist under such conditions, and subsequently no genuine reward system could be established.

The chronic problem with wage determination too, was that it was influenced more by central regulation than it was by market indicators. Central control of wage regulation was essentially maintained. The controls were fixed at the average level of the firms; its intended effect was to maintain full employment. This system brought with it chronic problems common to many firms. It prevented firms from expelling superfluous workers, raising wages for highly skilled employees, like engineers, scientists and managers. Simply, there was no room for taking an economically rational road.[47] Of particular significance is that the fixed average wage level prevented firms from increasing productivity and efficiency by hiring fewer but higher quality and better paid workers. It also prevented the firms from earning

higher profits. In fact, firms became more interested in hiring cheap low skilled labor in order to increase pay for their high skilled laborers.[48] To a Western analyst, it was especially peculiar that an employment position designed for one worker was often divided between several workers all for the sake of maintaining full employment (necessitated by the ideological postulates of socialism). This created "hidden unemployment". Wages remained uniform regardless of the amount and difficulty of work. Thus workers had no incentive to be more productive, knowing that they would be paid the same regardless of their productivity. The overall result was "overemployment" and "overspending" (state subsidies). Therefore, little was done towards rationalizing labor and wage policy, and most certainly little progress was made towards increasing economic efficiency and productivity.

The chronic problem of intense bureaucratic control continued, and less attention was given to developing unregulated market control. The 1968 wage reforms had two goals: to control consumer purchasing power, and to make labor more efficient in an environment of greater enterprise independence. However, they were still subject to indirect central regulation. Wage increases above a pre-determined level were heavily taxed; the taxes were based on the average wage or the enterprise wage bill.[49]

The wage reforms succeeded in improving the standard of living by increasing overall pay to workers. However, by increasing pay, in many cases through subsidy, and maintaining the heavily subsidized pricing structure, little was done to

reduce consumer spending. This aggravated the balance of payments deficit. It also continued to deplete state funds and force it to take counter-productive measures in the form of increased taxes on genuinely profitable firms and increased foreign borrowing. Moreover, since the bonus system rarely discriminated between profitable and unprofitable firms, little progress was made towards increasing individual initiative, motivation, and productivity. Thus both objectives of the wage reform failed.

The control of investment resources remained essentially unchanged with the introduction of NEM. Most investment decisions had to pass under the scrutiny of the central bureaucracy. The bureaucracy often lacked the competence to formulate rational coherent investment policy. Instead of at least allowing the administrative professionals to have final word on investment decisions, the central authorities often intervened and exercised their control to influence points of leverage in company management (investment).[50] As a result, it was common for industrial investment to benefit even inefficient spheres of production.[51] The state authorities were plagued with the problem of satisfying two conflicting objectives at the macro-economic level, by trying to maintain equilibrium between jobs and resources and by trying to provide finances for investment projects included in the national plan. Almost all insolvent firms requested finances for investment; in fact their appetite for finances was often encouraged by sectorial authorities. The second problem was technical in nature. Many firms failed to meet deadlines because of prolonged construction periods. The failure

to meet delivery dates dramatically increased costs to the state. Hungary was especially known for this practice. As Xavier Richet (Institute of Business Administration, Universite Jean Moulin, Lyon) points out, that on average it took 1.5 times longer for investment projects to be completed in Hungary compared to similar ones in the GDR and CSSR. It took almost 2-2.5 times as long as Western countries.[52] Firms would often deliberately underestimate the costs of their investment projects in order to secure the project's inclusion in the national plan. Once it was in the plan, the state was committed to complete no matter how long or costly it became to complete.

The Planning Office, the National Bank, or the Ministry of Finance weren't in the position to carry out checks mostly because of lack of time and resources, but also because of the inherent uncertainty built into the system itself.[53] The problems were inherent and could only be ameliorated if fundamental restructuring of investment policy could take place. Firstly, firms would have to be given more independence in investment decisions and greater freedom from the influence of plan preferences. Moreover, greater accountability should have been put on enterprise managers. Instead of managers being motivated to increase efficiency and productivity, they were content to exploit the system to the best of their ability and to make considerations of efficiency, profitability, and productivity secondary. The inability of the central authorities to control the wasteful manner of investment funds not only discouraged efficiency and productivity but ultimately progress

in the form of new technologies, upgraded infrastructure, and upgraded labor skills and methods. New reforms in this area were introduced later under the second round of NEM in 1979-80. Until then, little was done to improve the deficient nature of the investment system. The continued existence of an unrealistic pricing system and state subsidies blurred the line between dynamic profitable firms and unprofitable ones.

Modernization was also hampered because of the credit monopoly of the central bank and its refusal to allow foreign investment. Although provisions were made to allow firms to re-invest increasing amounts of their "profit" into capital investment and there by reducing the level of state investment, this too was distorted by the existing system of prices and subsidies. The low cost of labor often led firms to build new plants using existing technology instead of overall modernization. It was believed that the bigger the capacity the the greater the potential profits. This illusion led to the simultaneous start of many capital projects. Firms took for granted that they would be bailed out if they failed. Many did fail, and the state was left with the bill and a large number of unfinished capital projects.[54] Even Bankruptcy laws introduced under the auspices of NEM did little to encourage insolvent firms to adapt more profitable investment practices.

Under the 1970 enterprise statute, it was formally possible for an enterprise to file for bankruptcy. The statute was practically never invoked, except in the form of mergers which

meant a failing enterprise would be merged with more a successful one.[55] It appears the prospect of bankruptcy was simply not an acceptable principle, even though it was formally recognized. In theory it would pose a an ideological problem, because in a traditional socialist economy, bankruptcy of a state enterprise was not feasible. In principle, this was the same as the impossibility of unemployment in a socialist economy. On a highly theoretical level, bankruptcy of an enterprise contradicts the fundamental tenets of state ownership. As a result, failing enterprises weren't held accountable if they failed. Instead, the state continued to bail them out. This too, was an aspect of the reform which would require further development in subsequent modifications to NEM.

Since Hungary has been characterized as a resource poor nation, central planners placed a great deal of emphasis on Foreign Trade. Hungary's limited natural resources forced it to externalize its domestic economy through increased international trade with both socialist and market economies. The regime was forced to build up external links with the West and Third world trading partners. This also had a spin-off effect, it intensified Hungarian Foreign Policy especially its diplomatic activity in Western Europe.[56] In the context of NEM, this trade was a delicate balance between Western trade partners and CMEA partners. The central objective of NEM's trade policy was to improve Hungary's balance of payments especially with the West Under NEM, greater emphasis was placed on exports to the West in order to procure hard currency inflows to help finance Hungary's

growing debt, but more importantly to facilitate the improvement of Hungarian infrastructure, technology, and capital investments. The relatively good standard of living which Hungarians grew accustomed to, could only be sustained through continued hard currency inflows from exports and from new foreign credits. As with other reform measures, its success was linked to marketization. Hard currency exports by necessity had to be linked to the establishment of some form of market regulation.[57] Despite recognizing the need for market regulation to facilitate foreign trade and transactions, initially free competition with Western firms was infrequent and was subject to ministerial approval and regulation.[58]

Also in an effort to bolster hard currency inflows, Hungary made significant efforts to encourage tourism. As a result, travel restrictions in Hungary were relatively liberal compared to its neighbours. The capital city, Budapest was especially cultivated for this purpose. Western Hotels and western style shopping districts in downtown Budapest and cut-rate accommodations along Lake Balaton, Hungary's resort region combined to attract many western tourists.

Depending on which school of thought one belonged to, CMEA obligations functioned both as a stabilizing influence and also as a distorting influence. To those subscribing to the former school of thought, the CMEA offered much needed stability in trade especially in light of fluctuations in Western demand for Hungarian exports. At times, the CMEA could serve as a useful counterbalance to absorb excess exports not sold to the West.[59]

Ironically, one of the central aims of NEM was to increase the level of Western trade, particularly because Hungary desperately needed hard-currency exports to meet foreign debt obligations, but also to purchase Western technologies, capital stock, and raw materials. However, new hard currency in flows were often used to facilitate expansion of existing firms to meet CMEA obligations! The bulk of CMEA trade took place between Hungary and the Soviet Union. Contrary to the decentralizing influence of NEM trade policy, Soviet trade exerted strong pressures for centralization and administrative control. Already in 1968, authorities had to ensure that enterprises dealing with CMEA markets were neither excessively profitable or unprofitable. They did this through various taxes and subsidies. This conflicted with the posture needed by enterprises to assume trade with western firms. Technical specifications, lot sizes, production rhythms, delivery times and price relations differed.[60] The Central Development Plans (CDP) introduced by the Hungarian regime between 1968 and 1973 also ran contrary to the principles initiated by NEM.

The CDP's and Soviet Demand for large lots of manufactures supported big concentrated industries, even though NEM intended to decentralize and decrease the size of enterprises to facilitate competition through marketization. Strong external economic influence (USSR) as well as internal pressure made effective implementation of NEM investment principles virtually impossible. Instead, rapid economic expansion reminiscent of the traditional command economy seemed more attractive. Unfortunately, this practice was accompanied by familiar side

effects: shortages, tensions and ultimately increased direct intervention and resource allocation by central authorities.[61] Intra-CMEA trade did have some positive results. Annually negotiated bi-lateral quota agreements with CMEA partners ensured Hungary essential imports of energy and raw materials against which Hungary would export various agricultural and industrial products. This market was beneficial since it promoted economies of scale, minimum requirements for quality, packaging, punctual delivery, and servicing, though still much below the standards required for convertible hard currency markets. [62] Greater interaction, and cooperation with Western firms possessing this type of "know-how", could have improved the chronic problems associated with poor packaging and quality of products.

The continued need for hard currency exports to satisfy import requirements lead the government to sell almost anything which could be sold on hard currency markets.[63] Yet, it continued to pay little attention to the source of the problem, which was the restrictive influence of indirect regulators. This prevented profit from being a firm's first concern and subsequently alluded the necessary adjustments towards increased investment in new technology to increase quality and not quantity.

Trade difficulties were further aggravated by the pricing system(s) adapted by the Hungarian regime. Some were imposed externally because of CMEA obligations and some by NEM. The domestic price structure often had little or no reflection of foreign (Western) price structures.[64] Severe price distortions

resulted and were not uncommon, since domestically set prices were manipulated by taxes and subsidies while Western prices were market regulated. The domestic pricing further complicated trade since it employed three pricing categories neither of which were entirely market determined. The result was two broad sets of prices which made it extremely difficult for competitive firms to negotiate price.

CMEA guided pricing lacked any true reflection of value and rationality. Hungary was forced to adapt its structure of foreign trade to the rigid rules of the CMEA.[65] Up to the early 1970's, CMEA trade adjusted its pricing in five year intervals and in the mid 1970's to annual adjustments based on moving five year averages of world prices. The prices continued to bare little reflection of actual world prices because of extensive bargaining over technical aspects, rebates, discounts, and payment terms.[66] Thus, NEM's success in the sphere of trade was limited. Even hard-currency trade (free trade) was heavily regulated by the indirect regulators. The result was stagnation and lack of sufficient progress in improving the overall quality of trade, and the rationality of the accompanying pricing schemes. This led Hungary into serious balance of trade and debt problems, especially since the demand for hard-currency imports continued to grow. Involvement in CMEA trade made any involvement in global trade and profitable participation in the international division of labor difficult.[67] It also prevented Hungary from expanding and liberalizing trade with its more lucrative Western partners.[68] Khrushchev offset this trend by

introducing more multi-lateral trade between CMEA members. CMEA obligations were not the only factors behind Hungary's inability to expand its strongly Western oriented trade. The unwillingness of the conservative leadership to liberalize trade through the use of regulators prevented firms from engaging in further trade with Western partners. By letting firms engage in more liberalized trade with the West, they could have given Hungary even greater access to Western markets for sale of Hungarian exports. Instead, imports fueled by rising consumer demand and rapid investment forced the regime to finance trade imbalances through foreign credits obtained from the World Bank. Trade liberalization might have prevented this trend at least partly. However, it would have also forced the central authorities to implement marketization measures more rigorously. Political conservatives and the fear of political compromise prevented such measures from being implemented.

In 1972 a combination of factors both external and internal to Hungary brought NEM to a halt. NEM was not formally abandoned, but circumstances led the Hungarian leadership to a policy of retrenchment. Recentralization and increased central intervention characterized 1972 and subsequent years.[69]

International developments in the global economy were the first reasons for the partial reversal of the reforms in 1972-73. The world economy was suffering from the effects of the oil shocks which triggered a worldwide economic crisis. The Hungarian leadership believed it could shield the economy from the effects of events abroad by returning to a policy of accelerated growth

by way of traditional centrally planned investment and trade policy, and in some cases total reversal of earlier reforms. The Hungarian leadership like most of its CMEA neighbors failed to measure the degree of reliance it was developing on Western energy and resources. Despite largely unsuccessful attempts to shield domestic prices from foreign ones through increased state subsidies to offset rising prices, the increasing needs of Hungary and its fellow CMEA countries forced them to import many energy and raw material requirements. In the case of Hungary, the need for technology imports from the west increased as well. This resulted in higher prices. Growth is led by investment, but Hungarian hard currency exports weren't able to keep pace with import needs. Thus, accelerated growth did little to improve Hungary's trade balance. Salable exports weren't significantly increased to the West. Instead massive state subsidized investment continued to flow to large inefficient and wasteful state factories. The trend was toward obtaining more and more foreign credits (hard currency) to allow the continuation of state subsidies. These subsidies continued despite warnings from Kadar advisors of the obvious long term effects of accumulated debt. Subsequently, consumption also outweighed production. The result was a deterioration in both ruble and convertible hard currency trade. In 1974-75, the terms of trade deteriorated by 20% from the previous year.[70] This trend continued well into the decade. What made the trend dangerous was that the deficit was financed almost entirely by foreign credits from the West throughout the period.[71] Despite restrictive measures,

investment spending in Hungary leading up to 1972 far outstripped the state plan and available resources. 106 billion forints were expended of which close to 80% was lost in unfinished projects. Trade imbalances with CMEA partners were actually mostly recovered since Hungary had enjoyed several years of surplus trade with its CMEA partners, so it was actually recovering debts owed to it.[72] The situation was however not the same with convertible currency partners where the deficit was genuine.

In the broadest sense, the effects of continued state intervention and subsidization began to exhibit their effects on the Hungarian economy already in 1972. Heavy subsidization was required to help shield the Hungarian economy from the world economic crisis.[73] In hindsight, it appears that the single biggest economic factor that led to the temporary shelving of NEM was the rapid deterioration of trade attributable to sharp increases in imports of convertible hard currency consumer goods and technologies.[74] The oil shocks of 1972 affected the global economy including Europe. For Hungary, the negative effects of the of the oil shocks further handicapped its already rigid economic system.

The impending economic crisis actually increased the leadership's intervention in the economy. Instead of extending the limits of the indirect regulators, they were implemented more rigorously using the supervisory apparatus. As a result, any chance of the NEM principles prevailing diminished quickly.[75] The conservative contingent in the HSWP was able take advantage of the economic situation to advocate its position which called

for recentralization. For NEM advocates, the timing of the oil shocks and the subsequent world economic crisis couldn't have come at a worse time. NEM failed to meet the expectations of its designers because the traditional vertical relationship between enterprises and central authorities persisted even before to the crisis. In fact, this accounted for a big part of Hungary's poor economic performance. Nonetheless, conservatives launched an attack on NEM which also played a part in its shelving in 1972. Conservative criticism was largely ideological. They claimed that NEM gave an unfair advantage to intellectuals and peasantry. Workers were neglected and NEM apparently subjugated the national plan to the interests of individual and groups when in fact quite the contrary situation existed! Petty bourgeois attitudes led to the neglect of higher values and led to bourgeois consumption orientations. A distinctly wealthy class was emerging, which became most explicit towards the 1980's.[76] The trade unions foresaw the potential implications of NEM; two points in particular concerned them: dislocation as a result of the streamlining effects of marketization, and they felt social welfare was at stake.[77] Conservative elements within the Soviet Union too, had a profound effect on the further progress of NEM. In fact, it was implicitly known that it still feared that political instability would follow from from NEM, despite Kadar's assurances. The hard-line conservatives in the CPSU made every effort to instill fears of a second revolution if NEM proceeded.[78] It is difficult to determine exactly what changed Soviet attitude towards Hungary. It was attributable to

conservative elements with in the Soviet Union who opposed any independent economic reform initiative in Hungary and with in the Bloc[79].

The cumulative result of the conservative backlash in 1972 was an explicit re-assertion of central control, even the issuance of central directives by some branch ministries. As in the pre-reform period, centrally directed production decisions often disregarded questions of cost, efficiency and profitability. Party hard-liners tried to instill fears of capitalist restoration and anti-market sentiment in workers by fear mongering.

Fifty large factories nicknamed "white elephants" mostly, from the post-war Stalinist era were removed from the NEM umbrella and given large state subsidies. Restrictions were placed on profitable non-farming activities of agricultural cooperatives. Industrial workers were given across the board wage increases. Most significantly, the architects of NEM: Lajos Feher and more importantly Rezso Nyers were dropped from the politburo at the party congress in 1975. In the political sphere too, hard-line backlash was felt as a number of hitherto tolerated regime critiques, members of the Budapest Philosophical School were dropped from their teaching and research posts.[80]

The reversal of official policy didn't produce the intended positive effects. The economy continued to deteriorate at an alarming rate. Oddly, the effects of continued deterioration and partial recentralization were not as apparent in the everyday

life of Hungary. The standard of living didn't drop significantly and the appearance of what became known as "Goulash Communism" continued.[81] It appears that there was a lag between the time the central authorities reverted to more centralized control and its effects on the general population. Nonetheless, the Hungarian economy continued its downward spiral. GNP figures reflected the gradual decline, between 1963-67 (pre-NEM) GNP growth was +5.3%, (post-NEM) 1968-72 +5.8%.[82] Between 1972-75 it fell to +3.4% and only +2.3% between 1975-80. This was a far cry from the double digit figures anticipated by the Hungarian leadership at the start of NEM. Even more alarming was the rate at which Hungary kept accumulating hard currency debt which reached \$9.1 billion by 1980. In fact, the Kadar regime borrowed nearly \$20 billion between 1970 and 1980.[83] Most of these moneys went towards financing food stuffs, rent, and transportation. Kadar was able to maintain stability by temporarily shielding Hungary from the negative effects of recentralization and continued subsidization. Heavy subsidization of the economy led to Hungary's economic decline and insolvency crisis in 1982. Economic crisis in the early 1980's necessitated Kadar to reconsider his hitherto policy as signs of decline became more explicit and warranted genuine economic change. The subsequent decline and gradual rationalization of the economy questioned the credibility of Kadar and his regime which ended in collapse in 1989. Thus, the very policy which intended to enhance and maintain the credibility/legitimacy of the regime (the economic carrot) ended up being one of the chief factors in its decline!

Towards the end of the decade (1970), the effects of Hungary's foreign debts were felt much more strongly. Several Kadar advisors recognized the need for urgent action and subsequently warned Kadar of impending crisis. A change of heart in the Soviet leadership helped facilitate a gradual return to NEM principles by late 1978 and early 1979. It appears that the Soviets realized the apparent political harmlessness of NEM, and that its continuation would probably enhance stability. Moreover, the Soviet Union no longer displayed the same intense interest towards events in the Bloc. Perhaps, it no longer felt it had the solutions to the economic woes of its CMEA partners. The end result in Hungary was a gradual transition of economic decision making power to the party's financial and economic experts who delegated to the state bureaucracy.[84] Perhaps, the party listened to its critiques; Janos Kis, editor of "Beszelo", one of the first samizdat journals to appear in Hungary in 1981, felt that the the party could facilitate some rational economic activity by allowing even some of its planning experts to have genuine input in economic decisions.[85]

Decision makers were faced with a huge task, as several disturbing trends began to manifest themselves in Hungary. Most noticeably, huge hard currency debt continued to grow. Many enterprises still failed to respond to market signals. Shortages continued to be a problem especially in housing. Enterprises failed to see the importance of profitable investments and expeditious construction, while labor markets continued to be tight with high turnover rates and little progress made towards

down-sizing labor forces. Large state enterprises still thrived and consumed huge state subsidies which distorted prices and trade.[86] The leadership reacted by reinstating NEM principles and modifying them. The modifications did not come at once and were staggered over a number of years, between 1978 and 1988. The modifications seemed to be reactionary. New reforms were introduced only as conditions deteriorated. Planners were not motivated by rational anticipation of the future. Instead, they were motivated strictly by the unsustainability of the economic situation that had presented itself, which was Hungary's heavy indebtedness and the threat of insolvency which accompanied it. The reactions should have been two-fold, immediate steps should have been taken to reverse the two most negative trends in the economy which was overheated internal consumption and ailing exports. Secondly, steps should have been taken to prevent the cause of the exigence, which was the lack of institutional change in the political economic sphere.[87] As before, indirect central regulation persisted. Only incremental steps were taken towards genuine competitive market conditions. This hesitation by the leadership can be linked to the leadership's fear of a more rigorous implementation of NEM.

Despite the central leadership's unwillingness to implement a much more liberalized market mechanism, the Planning office did recognize the inherent side effects of bureaucratic intervention. It also recognized the need to reduce rapid quantitative progress in favor of qualitative progress. Quantitative progress exacerbated the chronic problem of low quality products and

technological backwardness.[88] At the 11th Party Congress, the party re-iterated its position on the economy. It called for improved efficiency of central control and higher standards of planning at the national level. The party maintained its position on political change by emphasizing the need to preserve the socialist system and by stressing the importance of central economic controls as a feature of the socialist political economy.[89] It did accept the need for greater linkage to foreign markets, instead of manipulating prices and wages through subsidies and taxation. It also recognized the need for more discipline in the labor force with better training, and organization. Greater flexibility and adaptation to changing conditions under the guidance of regulators was deemed necessary. Greater enterprise autonomy was seen as important too. The party's official position on further reforms could be summarized in four points. The party felt greater cooperation with planned economies was necessary. It recognized the need for continuous, but more flexible medium and long term plans. The party felt greater individual role and more cooperation between national planning organs and social organizations would be beneficial. Lastly, an improved information and supply processing system was also required.[90] Still, market regulators occupied a distant secondary role in the economy, however were expected to behave with the kind of efficiency, productivity and motivation as if under competitive conditions. The second wave of economic reforms like the first was not accompanied by any significant institutional or organizational change.[91] The institutional framework stayed intact until 1980, and under went only minor

cosmetic changes afterwards. If the reforms were to be more effective and representative of marketization, the party would have had no choice but to surrender its traditional role as chief director of the economy. This was not politically feasible to the HSWP or its Soviet counterparts. As a result, subsequent economic reforms did not create genuine market conditions. Instead a simulated market was established which was incapable of significant budgetary constraints. As a simulator it was open to central interference and could never foster the kind of entrepreneurial initiative common under genuine market conditions. Even as structural changes were recognized as necessary, political elites and their respective institutions remained unchanged.[92] The line between administrative regulation and market regulation was unclear.[93] There is an area of overlap. In order to maintain the integrity of the institutional and organizational structure, it appears the leadership in Hungary was content to foster extensive administrative control. This was reflected in the limited nature of the second wave of reforms introduced between 1978 and 1988.

Of particular interest in the changes introduced under the second wave of reform was the legalization of the second economy. Up to 16% of labor hours originated from this sector, and up to 40% of income originated from this sector. The legalization of the second economy was more able to accommodate the official policy of indirect regulation (primarily through taxation). The second economy was allowed to function freely [94]. It became especially strong in the agricultural sector where as much as

1/3 of agricultural production came from private plots on collectives. The "entrepreneurs" of this sector became particularly wealthy since they were able to function free of most regulation.[95] In some cases, these rural entrepreneurs implicitly engaged in direct competition with state enterprises. Private producers were able to provide a higher quality and selection of produce. On the other hand, the state controlled stores offered less selection and quality, but also lower prices. Though the state would never openly admit, it probably supported the idea of eventual total privatization of produce markets because this was a way to relieve itself of the financial burden of heavy food subsidization. The agricultural sector perhaps is one of the few cases of success under NEM. The problem was in the fact that it clearly benefited a single group in the economy. It created a small but very visible wealthy class. This class exploited NEM even under government supervision. Bribery for various oversights by state officials was not uncommon. This class was viewed by some with contempt, envy, and as products of an undesired reform system.

Pricing under the second wave of reform also underwent significant change. The first step taken to make pricing more rational and realistic was a reduction in subsidies and a subsequent increase in prices towards world market ones.[96] As a result, in 1979 the first major increase in prices for basic foodstuffs took effect. Prices went up by an average of 25%. [97] Taxes on luxury goods were raised by removing subsidies. The price of household energy also rose sharply, but because the

overall cost of import and producer prices rose, subsidies actually increased. Subsidies for services and transportation remained intact. Even though the competitive price system was abolished in 1987 to facilitate a further and more realistic link to actual import prices, central authorities continued to enforce import price constraints on various products; firms were expected to comply.[98] The competitive pricing system introduced in 1980 was in theory supposed to adjust to changing export and import prices. In reality, significant interference or indirect economic management continued which in turn distorted pricing.[99] Even more disturbing was that the population, at large did not recognize the danger of this practice and its negative long term effects on the economy.[100] People continued to take for granted the relative affordability of most essential items. The continued affordability and availability of such goods had many positive political "kickbacks" for the regime. The "political kickbacks" however came at tremendous cost. Hungary's debt grew to nearly \$13 billion dollars! Thus in 1982, Hungary was faced with a potential insolvency crisis. To ameliorate the situation, it applied for emergency IMF funding to cover its interest payments, and it also embarked on a campaign to increase hard currency exports and decrease hard currency imports.[101] In order to increase hard currency exports, more emphasis had to be placed on marketization This did not occur.[102] Producer prices still continued to be isolated from world prices because of the static economic structure which employed consistent industry by industry, firm by firm intervention.[103] Actual costs were

rarely reflected in pricing strategy, especially with CMEA partners. The Domestic pricing formula was even more complex, it took into consideration a firm's export performance on convertible currency markets, as well as the extent of competition a firms faced domestically and abroad as well as the actual and hypothetical price of identical or similar products.[104] The overriding concern of the leadership in the early 1980's was concerned with "stability". Despite informally recognizing the need for structural and institutional change, the leadership still chose political stability instead of further economic reform . This actually prevented further economic reform and subsequently increased the potential for destabilization.[105]

Several other modifications were made to the 1968 reforms. The selection of enterprise managers was liberalized so that firms with less than 500 employees could nominate and elect their own managers. However, firms which were deemed as key to fulfilling national plans remained under state regulation. Selected large firms, those with more than 500 employees were allowed a fifty/fifty composition of elected and appointed members for their boards. The central bureaucracy cut its personnel in half and merged three branch ministries: heavy industry, metallurgy and machine industry, and light industry into one ministry of industry.[106] There was some selective break-up of large producing units which resulted in 300 new firms.

Further changes were made in the area of private enterprise.

In fact, small business was encouraged. In many cases they replaced many of the sub-contracting functions performed by former large firms. Trade and competition between private firms and state owned ones was also encouraged. Officially, small enterprises were encouraged, but in reality bureaucratic and administrative regulations along with limited access to resources made it difficult for them to grow and compete effectively. Moreover, despite simplification of bookkeeping procedures, taxation, pricing, and other regulatory measures, small private firms continued to be plagued with a plethora of administrative restraints making competitive market behavior very difficult and limited.[107] Such was the case with firms attempting to trade amongst one another and with firms abroad.

In order to curb over-investment, new taxes were introduced, there was an attempt to stop the practice of firm-ministry bargaining. Subsidies, tax allowances, investment credits were sharply reduced even withdrawn by the central bank where deemed necessary by central authorities. In theory, this should have disciplined wasteful inefficient firms, but it achieved the opposite effect. The central authorities refused to accept bankruptcy or plant closings, but recognized the need to control unrestrained investment of state firms by slashing their resources. Those firms which should have been left to close or to go bankrupt were given further assistance in the form of new subsidies, credits, and tax breaks, while those which remained efficient and showed profitability were subject to increased taxes. As a result, profitable and efficient firms were

penalized while those which should have been eliminated or split up continued to draw subsidies on an already overdrawn system.[108] Attempts at contractualizing investment agreements in an effort force firms to keep completion dates and cost projections had little positive effect. It risked reducing overall investment. [109] Only fundamental structural change could have ameliorated the situation.

The last major modification to NEM produced similar results. The banking system in Hungary was partially decentralized starting in 1983 when a bond market was established. Like other reforms, the state retained disproportionate leverage in the market. In 1985, two new banks were created to stimulate more competition in bond issuance, deposits, and leasing agreements. In 1987, three commercial banks were created along with joint stock operations in which the state was the majority shareholder.[110]

Continued deterioration in the balance of payments caused the government to convene a general meeting in 1986 to discuss the prospects of the economy. It concluded that economic performance did not reach projected levels because consumption still outstripped production. Executive elements of the central committee and government were blamed. The harsh self-criticism and admission that the meeting took place wasn't publicly known until 1988. In 1987, a small group of researchers in the ministry of finance conducted an independent assessment of the state of the Hungarian economy. They concluded that there was no choice

but to overhaul the entire political-economic system. Party officials didn't take kindly to the suggestion and the individuals involved were disciplined. The study explicitly blamed the leadership for its negligence, hesitations, and poor decisions as the root cause of Hungary's economic problems. Despite public denouncement of the study, it appears the critiques had an effect on party officials. In July of 1987, a party sponsored economic workshop was organized. Its single most important suggestion was to reduce personal consumption. However, for the first time, topics which were hitherto taboo were discussed as well. The very viability of market socialism was questioned. It recognized many of the contradictions between central regulation and marketization. However, The official party statement was much more cautious. It recognized the need for greater flexibility in regulations and promotion of a less restrained market mechanism. It was careful to avoid the presumption that an overhaul of the entire economy was really required.[111] As a result, even though 6 committees were formed by early 1988 to formulate further reforms, practically no new steps were taken. This was directly attributable to the political instability of the party and the implicit knowledge of its impending collapse.[112]

Further deregulation and liberalization occurred with the introduction of a unified tax system. Wage regulation was set for complete removal by 1989, instead institutionalized collective bargaining would take its place. Administrative price restrictions were to be further reduced and import laws were to

be liberalized allowing for devaluation of the Hungarian Forint to increase exports and reduce export subsidies. Also, more liberalized entry of high technology products was permitted and deemed necessary. The ultimate goal was to lead towards convertibility.[113]

The Grosz regime called for fundamental restructuring of the economy towards market regulation. It intended to reverse budgetary deficits, and external debts while speeding the pace of restructuring and simultaneously minimizing social dislocation. The Grosz proposals to say the least were unrealistic and hence lacked credibility. All too often, the Grosz regime resorted to mudslinging the former regime and the architects of NEM in order to free themselves of blame for the dire economic situation.[114] In reality, political currents for reform were beginning to emerge. The prospect of democracy in the not too distant future forced the party to scramble. It was clear that the existing political structure could not support a market regulated economy required to improve the Hungarian situation. The contradictions were too many. Thus, NEM effectively came to an end in late 1988 as opposition organizations and eventually parties began to emerge. Further attempts at socialist guided reform slowly fizzled out. Instead, attention focused on regaining political legitimacy which the party had lost through its failed reform attempts.

NEM and its subsequent reforms had two broad objectives: To gain political legitimacy through an improved standard of living and, to facilitate a more efficient and productive socialist

economy by introducing market principles and at the same time preserving the integrity of the traditional institutional and economic structures of the command economy. The fact that NEM was limited to the economic sphere of activity, accounts for its longevity.[115]

The NEM was to create political legitimacy and passive consent to the political status quo. This was particularly important to the Kadar, because of the tarnished image of the communist party after the 1956 Revolution. Self-legitimization took the form of economic reforms which would improve the the standard of living by increasing the food supply, housing, universalizing welfare services etc.[116] In Hungary this qualitative change to living conditions manifested itself primarily through NEM. The Hungarian leadership was clever because it didn't introduce NEM with all the slogans and "hoopla" associated with many communist countries. The regime was in fact quite elusive and avoided the use of explicit public relations tools to introduce and implement the reform. Instead, it chose wisely to to concentrate on the delivery of the "carrot." [117] Still the Kadar regime was very cautious, it made it absolutely clear that political reforms would not accompany economic reforms.[118]

The chief goal of NEM and subsequently its most distinguishing feature was the elimination of central directives. In the context of the period it was introduced, it was a radical departure from the orthodox command economy. Elimination of

directives was to allow the stimulation of market links between state owned firms, and firms and consumers. Lastly, it was believed that the resulting independence would facilitate greater initiative and motivation to more profitable and efficient economic behavior. In order to stimulate this sort of initiative and independence, it would have required some political reforms. yet this was not the case. The government made no provision for self-criticism which would have made the reforms more credible. Furthermore, no steps were taken to formally invite and incorporate individual opinion or initiative into the decision making process, not even through a quasi democratic institution. The government didn't even make any legislative commitment to the reform process. It was very clear that no matter what degree of marketization was implemented, regulatory and decision making power was completely in the hands of the central authorities. Central directives were replaced by more discrete indirect regulators. The political will of the central authorities permeated the economic sphere and really left no room for genuine participation by individuals in economic decisions. Therefore the reforms lacked a genuine authenticity.[119] Janos Kornai said, removal of central directives alone, does not constitute marketization.

The regulators in most cases manipulated the enterprises' financial environment. Like before, the introduction of NEM, the national plan didn't have any logical and rational basis for its objectives. It was politically motivated and determined. It had no effective method of measuring value, supply, and demand. Thus,

its decisions were quite arbitrary since it had no accurate method of gathering information. As understood under NEM, implementation of aspects of the market were to facilitate the planner's decisions in determining the national plan. However, the indirect regulators, which the planners implemented to guide the economy, foreclosed any possibility of getting accurate information. As a result, decisions were rarely rational and wise. In essence, a "catch 22" situation existed.[120]

The phenomenon of shortage persisted. Moreover, the Hungarian economy continued to be characterized as a seller's market and not as a buyer's market. Enterprise managers were effectively ordered to exercise entrepreneurship. As already, discussed, any such coerced market behavior simply does not work. Entrepreneurial initiative, or the entrepreneurial mystique only emerges under the uniquely spontaneous and dynamic self regulating market. The regulators were intended only to guide the economy but, they had such a profound effect on a firms viability, that many enterprise managers preferred to continue the bargaining practice which was of greater benefit to the firm than any market regulated behavior. The firms which escaped the regulators entirely, were the only ones with any motivation towards competitive market behavior. Two key objectives of the reforms were not met: Government intervention wasn't reduced sufficiently to allow independent investment decisions and the creation of competitive institutions. The indirect regulators bore far greater influence on economic activity than any market influences on wages, prices, and investment. Continued heavy

trade with Comecon partners also facilitated centralized economic behavior.

Reformers ended up compromising that which they intended to eliminate: bureaucratic overcentralization.[121] The former organizational system survived and continued to live.[122] The limited market which emerged was reminiscent of the Oskar Lange model of market socialism which depicted market implementation through trial and error. This was apparent in Hungary. In most cases the economy was not made more efficient and productive, instead "white elephants" continued to survive and lobby the state for preferential treatment through favorable regulators. No real market was established which was capable of budgetary constraints.[123] In fact, there was no evidence for genuine competition between firms, the fundamental mechanism of the market, supply and demand was not prevalent, and even more so, entry and exit of firms was non-existent.

The official party line was clearly contradictory, it advocated the free determination of supply and demand between buyers and sellers and consumers which would in turn encourage enterprises to operate more efficiently and productively towards profit, and ultimately towards the satisfaction of social interest.[124] Here too, the rhetoric becomes dangerously close to sounding like Adam Smith. The line between centralized bureaucratic control and market control is often difficult to perceive. The party line however continues by confirming its inherent right to influence the economy via financial regulators where it deems it necessary. Still, it confirms the idea of more

individual initiative and less bureaucratic prescriptions and restrictions.[125] Even in 1984, the party continued this contradictory stance, it called for further development of the relationship between macro-economic management and enterprises to facilitate the influence of both. It's difficult to surmise how this is to be done since the two obviously contradict each other.[126] Controls remained. Firms were forced to allocate profits into separate funds for wages, investment, and reserves; each were taxed differently. Large inefficient enterprises were the least profitable and the least likely to be able to accumulate sufficient funds for investments. Therefore, they were most likely to draw on state funds. The problem was further exacerbated by the fact that enterprises were often disallowed from discontinuing production of certain unprofitable commodities because they were considered essential by central authorities.[127] Even worse, profitable enterprises were taxed heavily to shoulder the burden of subsidization.

Both the state and enterprises continued to cultivate vertical links between one another. The state wanted them reduced, but its continuation of indirect controls and the significant influence they had on enterprises proliferated vertical relationships. Even though marketization was officially encouraged, the level of state interference didn't drop sufficiently to allow market oriented behavior to dominate. As a result, bureaucratic centralization continued to be a dominant feature of the Hungarian economy. Vertical links between state and enterprise remained. Horizontal market-mediated links were

sharply curtailed.[128] Ultimately much of the waste, inefficiency, irrationality, arbitrariness, and low productivity continued to plague the Hungarian economy even in the mid to late 1980's when the Hungarian leadership implicitly admitted the failure of the reforms, but chose not to act. The political inflexibility and the impossibility of combining market elements with socialist economic theory and practice, proved insurmountable.

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NEM in Practice: Some Case Studies

In order to illustrate some of the difficulties of the Hungarian reform process, it is useful to examine a number of case studies and examples. The examples used will only accentuate the hitherto arguments. Therefore, only the most relevant features of the case studies will be discussed.

Hungary's geography is conducive to agricultural production. Most of present day Hungary lies within the boundaries of two parallel river basins of the Danube and Tisza rivers. The land is very fertile and the climate is conducive to a broad range of agricultural production including fruit, livestock, vegetables and grain. The "lay of the land" is Hungary's single most important and ultimately valuable natural resource. Therefore, it is not difficult to realize why Agricultural production has always been a key feature of the Hungarian economy.

The Hungarian communist leadership attempted to reverse this historical tradition by trying to convert Hungary into a heavily industrialized country. The drive toward this end was particularly evident in the early to mid 1950's under the leadership of Matyas Rakosi, an advocate of Stalin. Industrialization was the most aggressive during these years. Simultaneously, Rakosi started the first wave of agricultural collectivization. The process utilized coercion. In part, this contributed to the October uprising in 1956. The broader ramifications of Rakosi's tactics was that he directed the Hungarian economy away from its area of natural advantage.

Firstly, the peasantry was hostile towards forced collectivization. Secondly, Hungary was not suited for heavy industry because it lacked most of the raw materials such as steel, iron, and various energy sources necessary for heavy industry. Hungary held very limited reserves of Uranium and a poor grade of Bauxite. Simply, Hungary held no natural advantage for heavy industry. The birth of Hungary's mammoth state enterprises can by be traced to this period.

The agricultural sector in Hungary was the sector in which the spirit of reform was perhaps the most tangible and noticeable. Still, like other sectors of the economy, it continued to be subjected to various forms of politically motivated state intervention. In hindsight, it can be argued that it was only the form of intervention which evolved. Nonetheless, Hungarian agriculture is a case of neglect and then moderate success.

Hungarian agriculture had to endure two waves of collectivization. The first was coerced, the second under Kadar was more conciliatory and, in fact voluntary. This was necessary to promote a sense reconciliation after the 1956 experience. In fact, it was part of Kadar's plan for gaining political legitimacy. This is why industrialization too, was more paced in the post 1956 period. Likewise, the agricultural sector was the first to realize the effects of Kadar's more moderate brand of leadership when the first significant reforms were introduced in 1966 after the completion of collectivization in 1961.[1] The only condition for the formation of the large cooperative farms

was that the necessary equipment and expertise had to complement their formation. The leadership hoped that well equipped farms would facilitate good yields and subsequently wealth for cooperative members. In addition, it was hoped that this would encourage more to join the cooperatives. By 1961, nearly all peasantry had joined the cooperatives.[2] Comparatively, the collectivization of Hungarian agriculture was slow, but intentional to avoid past mistakes attributable to rapid collectivization. In Bulgaria, collectivization was complete already in the fall of 1958, in Czechoslovakia, large scale farms occupied more than 75% of agricultural land.[3] Agricultural policy in the pre-reform period had some very important benefits. Cooperative members enjoyed the benefits of state subsidized health care and pensions, a very important feature for older peasants. State subsidies to the cooperatives accounted for nearly 50% of the cooperatives' income. Though, cooperatives were legally bound to paying rent for the land they occupied, but still remained the property of the peasant. Generally, expertise and equipment still lagged. Consistent with Kadar's conciliatory policy of the period, the state tolerated and later legalized household plots and family share farming. This method of farming would be the key feature of the reform even if it was not preconceived by the state. On the eve of the official introduction of NEM (1968), the income from household farming was higher than the income from the cooperatives. To the regime's credit, its toleration and legalization of this form of farming created a largely content and adequately fed population. The

biggest concern was still poor expertise and, even more so poor mechanization and subsequently the target of allocation of millions of dollars.[4] Kadar was very pragmatic in his approach towards agriculture, especially in light of the mass desertions from the post 1945 collectives in 1956. Mandatory deliveries were abolished and more reasonable pricing strategies were developed for agricultural contracts. The central feature of the post-56 agricultural policy was reconciliation. By allowing pragmatic and less than ideologically pure policies to permeate the agricultural sector, the peasant population was kept at bay. So long as they were allowed some freedom in subsistence agricultural production, and as long as non-coerced collectivization policy was pursued, the Kadar leadership was able to tentatively secure a quasi legitimacy, but more importantly stability in the peasant population.[5]

The introduction of NEM in 1968 bore with it a number of important reforms for the agricultural sector in Hungary. These reforms were the most explicit reflection of the intended effect of NEM. Under NEM, agricultural enterprises were free to choose and modify such activities as product patterns, quantity and quality, means of production, technology used, production processes, even the basis for decisions were to reflect demand for agrarian products, foodstuffs, and other types of product services. Secondly, production was to be motivated by the objective of increasing enterprise income. Lastly, enterprises were to enjoy the freedom of decision, required for successful operation. Ultimately, they could not be directly forced by

administrative measures to engage in activities determined to be outside the sphere of agricultural activity.[6] Agricultural enterprises could avoid state intervention if it ran contrary to the economic interests and success of the enterprise, in fact it could autonomously abandon any activity which it felt was a burden to it. In theory, enterprise survival and growth (loans for development, depreciation & return of costs) were to be determined by the market and limited by market prices. The reforms intended to stimulate a phenomenon known as "venturing" or more commonly: entrepreneurial behavior.[7] The reforms introduced for the agricultural sector were quite radical, and to most outside observers they seemed credible. However, as was always the case with any reform. Hidden agendas and motives existed. The first piece of evidence to confirm this was that the existing institutional structure did not change. Inversely, the reforms themselves were not institutionalized. Hence, the central leadership continued to hold extensive regulatory power. Only the nature of the regulation really changed. Mandatory commands ceased, but state control over factors such as pricing and subsidization allowed it to exercise its will over many "venturing" agricultural enterprises.

The reforms introduced in the agricultural sector, like other sectors of the economy were limited political agendas of the central leadership. They were not institutionalized in any way. Thus, arbitrary and often less than rational economic considerations prevailed over those which were motivated by "venturing". Specifically, the reforms were limited by the

maintenance of the monopoly and oligopoly structure of input and output sides (detectable change only occurred in the early 1980's). The market as a means of production materialized only in a very rudimentary form. Of even greater significance was the total lack of rational pricing. Selling prices for agricultural products fixed by authorities were disconnected from consumer prices. Cost returns and competitiveness were not consistently implemented principles in pricing.[8]

The recurring practice of linking credits and subsidies to production policies outlined in central plans also continued. Therefore, loans were granted on the basis of satisfying preferential objectives which had partial quotas linked to them.[9] Instead of offering credits based on the enterprise's credit worthiness, they were often awarded as part of fulfilling central plans. This resulted in a consistent flow of credit to even those firms which were chronically in debt and plagued by inefficiency and low productivity. Heavy indebtedness persisted and grew amongst these firms. Coercive attributes were much more prevalent.[10] The persistence of central intervention primarily through indirect regulators, mainly subsidies, encouraged many firms to pursue micro-economic policies concerning production processes and technologies which lacked modernization and innovation. The principle of "venturing" introduced under NEM and the autonomous decision making this was supposed to encourage was sharply curbed by the inherent link between receiving state subsidies and fulfillment of central policies.[11] Rezso Nyers, the architect of NEM, felt that it was possible to act like a

good businessman and fulfill, in a broad sense the national plan. He felt that micro economic autonomy in decision making and broad state regulations complimented each other.[12] He and many others failed to recognize that by linking state subsidies to fulfillment of central objectives, there was little motivation to embrace the venturing spirit even on a micro scale since fulfillment of central objectives was the sole measure of a firm's success and for that matter, its productivity and efficiency. The fact is that state subsidies made possible by massive foreign loans continued to flow into many state farms and cooperatives, and as will be seen, into many industrial enterprises.

The efficiency of labor also suffered from the contradictory position of agricultural enterprises. Enterprises often avoided optimizing income in order to avoid the sharply progressive wage tax. To avoid the penalizing taxes, enterprises resorted to hiring workers with minimal skills and low wages. Again, the negating effect of reform and regulation clearly exhibited itself.[13]

Pricing policy designed to keep food prices low was the most restrictive towards the agriculture sector. Until 1980, no steps were taken to raise the price of agricultural products. Even after 1980, increases did not bring prices in line with world price levels. Subsidization kept prices artificially low and made agriculture highly unprofitable compared to other sectors of the economy. The fixed pricing system resulted in much lower profit margins from agricultural products than industrial goods.[14]

The disparity between agricultural and industrial prices caused distortions in the value of output.[15] So much so that it was a key factor in the expansion of ancillary and the complimentary agro-industrial sector. As an indication of the level of disparity between agricultural prices and industrial prices, between 1985 and 1987, industrial prices increased 203% while agricultural prices increased by only 64%.[16] In order to achieve a rough parity of incomes between agriculture and industry, the operating surplus of farms relative to industrial enterprises were compressed. The profitability of the two sectors were roughly equalized through fiscal policy at about 1/3 value added. State subsidies to the agricultural sector assisted in various investments, energy use, other farm inputs, the promotion of exports and to farms operating at higher than average cost levels and lower yields (usually attributable to poor expertise and mechanization)[17]. Thus, agricultural pricing suffered not only from inequilibrium between world prices and prices determined by the Hungarian Ministry of Food and Agriculture, but also from distortions between the Agricultural and the Industrial Sector. The source of the distortions can be attributable to the centrally determined pricing system of the communist regime. Heavy subsidization to keep various agricultural products and foodstuffs cheap were to create a content and well fed population.

As in other sectors of the economy, there were no institutional changes in agriculture, specifically those reforms which were supposed to stimulate competitive behavior. The

hierarchical dependence of agricultural enterprises did not cease, only the extent of it was reduced. Even local and regional interference in daily matters was strong. The practice of appointing, evaluating, and ultimately arbitrarily replacing and instructing managers of state farms and cooperatives did not cease entirely. Despite reforms which allowed a degree of autonomous manager election in enterprises which was supposed to reduce state interference (cf. chapter 3), the manipulation of enterprise managers actually lead to the application of widespread state preferences and discrimination. For instance, proprietary functions were split between agricultural enterprises and the state regardless of ownership. The hierarchy of allocation gave the enterprises certain means, but their autonomy was still restricted in selecting and utilizing them.[18] Intervention wasn't always explicit. The most common method of manipulation was through subsidies. The agricultural enterprises were thus further restricted in their pursuit of "venturing" activity. The state encouraged, in fact it expected venturing behavior despite the obvious contradiction between continued informal regulation combined with expectations that the enterprises would behave as if they were operating under competitive conditions. The optimum structure of agriculture in a process of modernization could only be developed by an economically rational combination of means of production (ie. the creation of a land, labor and capital market). Very simply, the reforms introduced in 1966/68 and later in 1980 did not include a land, labor and capital market. Only very limited steps were

taken to increase the flow of capital by introducing less restrictive administrative measures. The variety of options necessary for venturing did not exist. The state expected enterprises to respond to administrative constraints profitably, even though abandoning unprofitable state sponsored behavior was considered taboo and contrary to national interest.[19] Despite all the administrative restrictions, agricultural enterprises seemed to exhibit the most sensitivity to profitability and subsequently production capacity which was flexible and more capable to rapidly adjust to changing demand unlike its industrial counter-parts, especially small scale private operations.[20] Ultimately, their formal autonomy was limited mostly by two factors, which was low agricultural producer prices and scarcity of capital goods. These weren't distributed according to any economic logic and financial rationality, but still subject to a plethora of administrative restraints. Non-economic political factors often influenced central and local government levels.[21]

Hungarian agricultural production was still the most successful compared to other East European Bloc countries. This was partly attributable to Hungary's long-standing tradition and experience as an agricultural producer, but more importantly it enjoyed a tremendous natural advantage in its climate and geography which was and is conducive to agricultural production. Hungary is a consistent exporter of various agricultural products. It exports many delicacies such as pears and peaches and other fruits. Its main crops are grain (mostly wheat), maize,

sugar beet, and oil seeds. Initially, these field crops were produced by three sectors within the agricultural sector, state farms, cooperatives and private farms.[22]

A combination of negative and positive factors produced two unique by products not present in any of the other sectors of the economy. The reforms did formally encourage venturing behavior, yet the informal regulations exercised by central authorities made it difficult to accumulate profit through agricultural production. Price margins and tax margins made agricultural production largely unprofitable. As a result, many large scale farms engaged in various forms of ancillary economic activity.

Small scale non-agricultural activity emerged as a compliment to the reforms, rather than a direct manifestation of them.[23] By 1978, up to 40% of large scale farms' income originated from non-agricultural activities. Characteristically, the most developed agricultural regions, particularly around the nation's capital, Budapest were involved in extensive non-agricultural activity. Most of the non-agricultural activity utilized only a small portion of an enterprise's resources. Typically, it utilized only 12-13% of the labor force and 8-9% of fixed assets.[24] The over-centralization of large scale enterprises created a favorable climate for small scale plants to produce various consumer goods. Small scale industry was typically more flexible to micro and special market demands than big enterprises.[25] Small scale farms were characterized by commodity and specialization. In fact, they had a very important

function. By employing economies of scale, they produced many products which were best produced by small scale operations. Small scale producers were oriented towards commodity production and income maximization. They had greater freedom to decide what to produce or when to stop and start commodity production, even better than private farmers or in many cases the parent state farm (parent in the sense that small scale firms often utilized the resources of large state farms). Market forces actually influenced the behavior of small scale operations. If price fell, production was adjusted accordingly. Likewise an increase in demand was reflected in an increase in production. What made it even more successful was that production capacity was maintained even during lulls in demand. During the lulls, capacity was maintained and often utilized to supply themselves.[26] This was the most successful aspect of small scale agro-industrial enterprises. It gave new alternatives and new life to an otherwise ailing and heavily regulated agricultural sector. The single biggest success of the reform was the diversification it allowed through the development of non-agricultural ancillary activity where the potential for profit and "venturing" behavior was much greater. Still, state intervention did exhibit itself. The Kadar leadership did not realize the degree to which small scale agro-industrial activity complimented the Kadar platform of economic compromise for stability. The relatively higher margin of profits along with the material benefits of the small scale operations made them a quasi "sacred cow". This was evident in 1975 when small scale agriculture enterprises were attacked by

conservative elements in the leadership. It resulted in shortages and threatened a drop in living standards. The central leadership quickly reconsidered its position.[27]

On the macro-economic level, Argro-industrial development helped to modernize an otherwise dated industrial structure. It was also a catalyst for regional development. A complimentary relationship formed between industry, agriculture, state farms, co-ops, and small-scale agro-industrial enterprises. One of the more popular ancillary activities of the small scale enterprises was food processing, its raw materials came from both the agricultural sector and the industrial sector. It successfully provided a market for both. Cooperation between state farms and cooperatives and the accompanying managerial freedom was reflected in a noticeable improvement in Hungary's agricultural production during the 1970's. New technologies were introduced largely because of joint ventures and greater managerial freedom. Independent initiative also facilitated agricultural enterprises to compete in non-agricultural activities. Ancillary activities grew from only 3.5% of gross output in the 1960's to 31% of gross output in 1987.[28] Food-processing, construction companies, retail stores, and restaurants are just a few of the ancillary activities. In larger cities, the diversity of large farms allowed them to operate ventures totally unrelated to agriculture, such as the manufacture of clothes, computer chips, precision engineering work sometimes in cooperation with western firms, even house renovations and exterminating. This type of activity was facilitated in large part by the introduction of

NEM in 1968. It expanded very rapidly in the latter half of the 1970's and provided well paid jobs to some 200,000 - 250,000 people by the mid 1980's. In some cases the cooperatives deliberately launched businesses to provide jobs for family and cooperative members. This also provided a legal framework with in which entrepreneurs could develop and implement their ideas. In return, they would allocate a portion of their profits to the cooperative. The most distinguishing feature of such entrepreneurial exercises and subsequent small and medium sized enterprises was that they relied entirely on the marketplace; if they were not profitable, they went out of business.[29] So, in a very convoluted fashion, the principle objective of NEM materialized. It was this by-product of agricultural reform which was initially tolerated and then legalized and most explicitly reflected the features of marketization which was sensitive to profitability, market demand, and actual entry and exit of firms from the market place. None of these features were really present in the much larger state sector. Unlike the state sector it was also an example of horizontal integration which was one of the major shortcomings of the reforms in the state sector.[30] Ideally, the reform direction taken by the agricultural sector should have been applied throughout and not just to areas where agriculture and industrial cooperation was possible. Central interference too, was not as explicit in the agro-industrial enterprises, but still the macro-economic policy of central planners exerted adverse affects on this sector. Namely, the disparity between agricultural pricing and industrial pricing produced many irreconcilable distortions. Still, ancillary small

scale non-agricultural industry was one of two sources of growth for agriculture overall. In 1978, Ancillary production (non-agricultural activity) accounted for 57 billion forints net income amongst co-ops and 18 billion forints for state farms. Even more impressive was the growth of net income between 1974-78, it grew by 64% in cooperatives and 39% in state farms compared to 30% for strictly agricultural activities.[31] The other major area of growth in the agricultural sector and also an off shoot of economic liberalization was the growth of private farming.

Private agricultural production was an explicit reflection of the second wave of economic reform in Hungary, starting in the late 1970's and carrying over to the early 1980's. Private agricultural production was an integral part of what was known as the second economy. Its legalization allowed it to grow rapidly in subsequent years and consequently earn the Hungarian economy the name: Goulash Communism. Its legalization was accompanied by a much more favorable attitude from cooperatives and the agricultural administration. The only restrictions placed on it was size, otherwise it was allowed to operate freely.[32] Private Agricultural production encompassed a very broad swath of the population. Only 26% of private producers were actually farmers and only 6% of them (approx. 50,000) were full-time professional farmers producing on plots provided by state farms. 28% of private producers were workers, 23% white collar workers, and 23% pensioners. Private plots involved almost 1.5 million families as well as an additional 700,000 who cultivated plots smaller than

1500 m2 which did not officially register as private plots. Approximately 50% of the Hungarian population was involved in private agricultural production. According to 1983-84 figures nearly 1/3 of agricultural produce came from the private sector: some particularly impressive figures, 50% of Hungarian pigs (11,000,000 total) and 90% of raspberries came from private producers.[33] Unlike most of its CMEA partners, Hungary's meat production was abundant. In fact, statistics showed that 144 kg of meat was produced per capita, which qualified for 4th best in the world. Hungarian meat exports earned as much \$100 million/year.[34]

Private plots helped increase the standard of living for most Hungarians by producing an abundant supply of many agricultural goods. Those farmers producing for sale on farmer's markets had the potential of earning high profits and affluent lifestyles. By 1984, a common problem began to emerge; the efficiency of many private plots diminished partly because of an aging population (45% of private plotters were over 60 years of age), but mostly because of an attitude of self-exploitation. Most private plots could use the facilities of state farms and collectives. In fact, cooperative farms were organized on a democratic basis. As a result, it allowed for the articulation of private plotter's interests most of whom were also members of cooperatives. Members would rarely vote against their own interests.[35] It was ironic that the sale of private producer goods was entirely uncontrolled, yet it relied heavily on the non-market sector for production. Regulation of the private

sector would have required the central planners to place further restraints on the already regulation ridden non-market sector. Also, by regulating the private sector directly, which would have been a mammoth task in itself. This would have diminished the utility of the non-market sector upon which the private sector so heavily relied. Practically, there was really no way of regulating this sector short of stopping it altogether; that is why an estimated 10-20% of national income escaped state control![36] By 1988, private agricultural production accounted for 36% of all agricultural production which occupied only 5.5% of the available arable land.[37] These figures clearly illustrate the poor state of the rest of the agricultural sector by the late 1980's.

A peculiar situation evolved in Hungary. Three distinct sub-sectors manifested themselves in the Agricultural Sector. The state sector which included state farms and cooperatives, the small scale ancillary agro-industrial sector, and lastly the private sector. The two latter sectors were the least regulated and in some cases not regulated at all. Lack of central intervention allowed them to exercise "venturing" behavior and thus earned Hungary the label: Goulash communism.[38] These two sectors helped maintain a relative high standard of living and gave wealth to a small minority of Hungarians. No other sector exhibited such relative success. Few realize that the Hungarian state indirectly subsidized both these sectors by allowing them to use the machines and facilities of state firms who in turn bargained for favorable taxes and subsidies. Under such

conditions no state firm could survive especially since a growing proportion of agricultural output was being produced by private producers who weren't subject to regulation and low prices. The state effectively financed the second economy and could have regulated it by reducing state subsidies and tax exemptions to state farms and cooperatives. In a sense, this happened.

Uniform "across the board" growth experienced in the Hungarian agriculture sector during the 1970's and in the early 1980's stopped. Negative macro-economic symptoms effected all economic sectors including agriculture. The root of these symptoms was Hungary's huge foreign debt which threatened insolvency in 1982. It was forced to reduce the level of state subsidization of the economy to avoid insolvency; this permeated the agricultural sector too. Decreasing industrial growth, and increasing foreign debt coupled with chronic bad investments all led to decreased agricultural investment as well. The reduction of state subsidies originating from foreign loans, and the simultaneous drop in agricultural production confirmed its reliance on the state and not genuine "venturing" ability. It also reflected the superficiality of growth (with some exceptions) even in the 1970's. Agricultural production dropped by nearly 20% in 1988 almost half (571) of state cooperatives were near or at insolvency.[39] The agricultural sector was plagued with a number of disturbing trends between 1984 and 1988. The work force was aging; it decreased overall by 8.5% and most importantly state purchasing enterprises had not raised prices relative to the increased cost of production in the cooperatives.

Even if they would have been adjusted to reflect increases in cost, they still would have been far from world market prices. Finally, investment in new farm equipment which had been hitherto dependent on state subsidies fell sharply, so that by 1986, 56.9% of agricultural machinery was amortized. Even more discouraging was the lack of modernization, which had been previously made possible by state subsidies.[40]

Even the Hungarian Leadership, specifically Istvan Szabo, Politburo member and Chairman of the National Council of Agricultural Producer Cooperatives, publicly admitted to stagnation in 1986 and subsequently decline in 1987 and 1988. Hungarian economists also warned that distribution and export patterns could not be sustained. They cited two reasons: the heavy subsidization of EC Agricultural production and the low uneven quality and sophistication of Hungarian processing.[41] Amongst the few positive developments in the Hungarian Agricultural sector was a record wheat harvest in 1988, but unfortunately higher wheat prices did not filter down to producers which left the financial situation of most cooperatives perilous. This situation was exacerbated further when fertilizer prices increased 26%, and subsequently orders for fertilizer fell by 50%. The newly created commercial banks offered short term loans at 20% interest, but many could not afford to harvest cooperative crops. Even formerly successful state farms like Babolna which was world renowned for their diversification into horse breeding decided to invest in the bond markets, where returns were much higher and more secure. Land could not be used

as collateral, it had no value under the existing system. In March 1988, the faltering communist regime made a last ditch effort to help revive the agriculture sector. Like previous reforms, it too was watered down significantly before it was actually implemented. The goal was to lift restrictions on cooperatives regarding decisions on suitable production patterns and also to allow more land to be transferred to household plots for non-agricultural activity.[42]

The political inflexibility of the communist leadership can be blamed for the ineffectiveness of the reforms introduced in the agricultural sector. Even though it was successful in stimulating more liberalized small scale agro-industrial industry which complimented state farms and cooperatives as well as providing a market for the industrial sector. The private agricultural sector, more commonly referred to as the second economy was legalized, and thus created a medium for entrepreneurial initiative. Participants in this sector were many and some became very wealthy because of the lack of restrictions imposed on them. Both of the aforementioned sectors relied on the facilities, resources and machinery of state farms and cooperatives. They relied indirectly on state subsidies to continue production. Inversely, the state was forced to continue subsidizing state farms and cooperatives to help keep the reform alive, and the benefits it produced. Cooperatives did not embrace "venturing" behavior because favorable regulators could only be ensured by satisfying the plan objectives of branch ministries and central authorities. By linking favorable financial

conditions to satisfaction of central objectives, it negated the reform's intended effect of stimulating even micro-economic "venturing" behavior. The cooperatives were forced to compromise between state interests and member interests which lead to a contradictory situation unfavorably affecting producer interests. The National Council of Agricultural Cooperatives (TOT), whose function was to participate in planning and developing of the regulatory system through representation of its founders/members was to advocate the interests of its members, and secondly to undertake the transmission of central objectives. These functions were often reversed, so that instead of representing the interests of the cooperatives, the council became powerfully integrated with the hierarchy of state control. It even encouraged coops not to give up loss making agricultural activities.[43]

The following recommendations were made by A.Sipos and P.Halmi, in the article Organization System and Economic Mechanism in Hungarian Agriculture, the recommendations for improving the Hungarian Agricultural Sector in 1988 actually serve to highlight its primary deficiencies: A stronger regulatory role for money had to be established. The autonomy of those enterprises pursuing long term profitability had to be institutionalized. The plethora of administrative hindrances to resource allocation had to be eliminated, and also capital labor markets, and land markets had to be created and institutionalized. Finally, competition and market relationships needed to be developed in the agro-industrial sphere which

included reducing the disparity between agricultural and industrial prices by restricting the role of budgetary redistribution, and enhancing the orienting function of prices overall.[44] Sipos should have taken it one step further by insisting restructuring of the political system to facilitate his recommendations.

In contrast to the agricultural sector, Hungary's industrial sector was characterized by heavy subsidization to support many money loosing state factories. Billions of forints, made available by foreign loans were spent during the 1970's. The effects of the reforms were very limited in large state enterprises. Their size and relative share in gross national output made even reform advocates hesitant to introduce significant reform since it would have inevitably produced shock waves throughout the economy. Reform would have required the dismantling of many large state enterprises and the shut down of many others. This would have caused massive unemployment, the most feared and most de-stabilizing side-effect of reform. Since, the Hungarian regime based much of its quasi legitimacy on providing employment and income to support a relative high standard of living, few steps were taken to split up, down-size, or even eliminate unprofitable enterprises in the industrial sector. The political weight of the large state enterprises would have and actually did sharply limit the ability of the leadership to take reforming steps.

The industrial sector best illustrated the waste and

inefficiency of large state enterprises discussed in Chapter 3. A number of specific examples outline many of the deficiencies of state enterprises.

Even on the eve of the Hungarian Communist Party's collapse, little institutional change had been implemented to facilitate the reforms introduced under the two waves of NEM. In practical terms this was reflected by the continued existence of huge money loosing state-run factories. By 1987, the situation was so critical, especially in terms of the government's fiscal deficit that admission to the problem was unavoidable, and action had to be taken. By this time, Kadar's successor, Karoly Grosz took over the function of 1st Secretary. Even though initially he appeared to support more radical and fundamental reforms especially in the context of state enterprises, it soon became evident that he too was unwilling to implement fundamental institutional change in the Hungarian Political-Economy. The result was that despite hints that a serious overhaul of state enterprises was imminent, only limited action was taken.

As of November 19, 1987 the Council of Ministers authorized the Ministry of Finance to disallow chronically insolvent enterprises to differ tax and other government and inter-enterprise payments. They also tried to curb the habitual practice of defaulting on delivery dates and completion of construction projects. Hungarian state enterprises were infamous for this. State funding would still continue, but it was made conditional on completion of contractual obligations. The HSWP Central Committee also published a resolution which bluntly

recognized the sad state of the Hungarian economy. It recognized the need to cut the production of shoddy and outdated goods of inefficient state enterprises by significantly reducing state subsidies in 1988.[45] They also encouraged more frequent application of the Bankruptcy Law enacted in 1986. Up to 1987, bankruptcy proceedings were initiated against only 55 enterprises of which only one was of any significance; the Veszprem County Construction Enterprise in Western Hungary; the others were only small cooperatives and small enterprise work cooperatives.[46]

The consistently poor performance of the economy encouraged further streamlining of state enterprises over the course of 1988. In 1987, state support to insolvent enterprises (this does not include solvent but still wasteful enterprises) amounted to 150 billion forints or approximately 23% (1/4) of the annual budget! This was a huge sum, especially when only 200 billion forints were usually allocated towards a reasonably good 5 year plan period. This resulted in a major drive to eliminate unprofitable enterprises which included new directives to ministries ordering, which ordered them to cut the 1988 budget for enterprise support by 45 billion forints. This change in policy led to significant streamlining and reorganizing of 6 major state enterprises starting already in the first week of December 1987. Among them was GANZ-MAVAG, LANG Machine Plant, the Iron Foundry in Soroksar, Tatabanya Coal Mines, and the Nitrogen Works in Pest.[47] Of these, the most significant was GANZ-MAVAG.

Ganz-Mavag was the Hungarian equivalent of General Electric

in the United States in terms of its role in the economy. It was one of the largest industrial works in Hungary in the 1930's. In 1986, it was Hungary's 30th largest undertaking. It was a very diversified undertaking which was actually composed of 5 enterprises: Ganz-Mavag, Ganz-Danubius, Ganz-Electric, Ganz-Instrument Works, and Ganz Switch and Equipment works. The company had been founded already in 1870 by a Swiss born entrepreneur Abraham Ganz and it enjoyed a very good reputation as one of Hungary's oldest and largest enterprises until it was nationalized in 1949. The company's flagship enterprise, Ganz-Mavag is the most recognized with in Hungary and in the international markets. It produced railroad carriages and locomotives (diesel and electric), and in addition to these traditional product lines, it produced nuclear fuel rod exchange systems, elevators, streetcars and other products. It had extensive foreign markets for many of these products. In fact in 1985, it was Hungary's 3rd largest hard currency exporter after RABA (tractor trailer manufacturer) and Tungsgram (electrical products owned today by General Electric of America). It enjoyed extensive markets in India, Greece, and Egypt.[48]

Complacency accompanied the nationalization of Ganz-Mavag. Ganz and Mavag were two separate companies until they were merged in 1959. Like other large state enterprises, Ganz-Mavag lacked managerial initiative and innovation. Product lines gradually turned outdated. The factory infrastructure remained practically unchanged since its construction in 1870. Only, certain departments such as nuclear research and development employed

any significant modern technological apparatus. Otherwise, old outdated and amortized equipment characterized the factory. It was highly labor intensive, but it too was characterized by redundancies with few incentives provided to employees to do better. Cost accounting was virtually non-existent, some units had no idea how much their production cost was! Falling revenues prompted officials to grant Ganz-Mavag special taxation status in 1972. The first reorganization occurred in 1976 under the tutelage of the National Planning Office which was also accompanied with a 12 billion forint infusion of funds, of which 7.2 billion had already been spent by 1982. Ganz-Mavag continued to operate with huge losses; for instance it sold forty-two, two car diesel trains to New Zealand and Tunisia at below cost in 1986. Similarly, it was consistently selling products at below cost to CMEA partners. The company unfortunately had little control over the prices it received for its products, since it was almost always unilaterally determined by central authorities.[49] This underlies one of the fundamental problems faced by enterprises, entrepreneurial activity simply could not function when one of the most basic variables of entrepreneurial activity, price had no link to enterprise operation. Simply, the institutions found in a market economy which facilitate such behavior were non-existent in Hungary. As a result, Hungarian enterprises such as Ganz-Mavag became more skilled at accommodating the supply side of the market and thus creating shortage situations. Instead, greater sensitivity should have been given to demand which would have placed emphasis on profitability.[50] However, the political leadership did not

permit the formation of those institutions which would actually facilitate independent initiative and market determined supply and demand leading to rational pricing. In the case of Ganz-Mavag, the quality of products fell sharply, so much so that even the Hungarian National Railroad refused to purchase Ganz-Mavag railroad equipment.[51]

In 1985, further steps were taken to reverse the negative trends. The Soroksar Iron Foundry was separated from its parent, Ganz-Mavag. This relieved it from 1.9 billion forints of debt. It received a further infusion of state funds, but poor management and engineering led to even lower productivity and greater debt. By 1987, Ganz-Mavag was effectively insolvent. Its debts amounted to 11.5 billion forints, its assets were only 9 billion. Still the state refused to allow market forces to shape the future of the enterprise. Seven new enterprises were created, the railroad component remained under direct state supervision apparently to ensure the fulfillment of international contracts. Debt repayment was also frozen which led to a 140 billion forint short fall for the Budapest Bank Ltd. Lastly, plans were made to liquidate some of the company's assets and to lay off up to 1500 workers.[52] Similar steps were taken in Ganz's other sister enterprises.

The Lang Machine Plant which had historically been a flagship of Hungarian enterprises in the 1930's when it enjoyed a licensing agreement with the Swiss based Brown Boveri Company, accumulated a 936 billion forint backlog of unpaid credits. An outside study determined that the causes were all internal.

Management was haphazard, cost benefit analysis and marketing too were non-existent. Products were outdated, prices high and there were huge stockpiles of unsold products.[53] Like its sister enterprise, Ganz-Mavag, the Lang Machine Plant was subject to state interference which contributed to its complacent management and ultimately its demise. Three such decisions had profound effects on the enterprise's viability. It lost a contract for four turbines to be used at Hungary's first Nuclear Power Plant at Paks when the Soviets, who were only supposed to supply the other components for the plant insisted that the whole plant be Soviet built. The second contributing factor was the slow down of Hungary's investment drive in the 1980's and thirdly, the interference of the National Planning Office which made poor business agreements with CMEA partners and forced Lang to produce products for transactions that often never materialized. One such transaction was the construction of industrial incinerators which subsequently weren't sold. It wasn't surprising when it became known that for fiscal year 1984, Lang's expenses were 244 million forints more than its income from sales. Such poor investment decisions were not unique to Lang or Ganz Mavag. The lack of foresight and rational planning which would consider all the possible variables (there will always be unforeseen ones) often determined the fate of state enterprises. In fact, the Planning Office most often failed to fulfill its primary function..... planning, particularly macro-long term planning as stipulated by NEM. For instance, in 1988, 9.5 billion forints were invested in a coal-cooking project started by the Danube Steel works. Planners failed to anticipate changes in demand

during construction and more importantly the coal to be coked was of much poorer quality than what was required. Similarly, 4.1 billion forints were invested in the Mecsek Uranium Mine in Southern Hungary; there too, planners failed to anticipate long term demand patterns. As a result, when the mine was finished with serious cost over-runs, demand was so low that its production was not required until 1990.[54] Poor planning, cost over-runs, lack of technology, and poor quality all characterized the deficit ridden state enterprise system. Nonetheless, anomalies did exist, there were a few state enterprises which despite mostly negative economic trends were very successful.

One such enterprise was RABA. It was one of the few cases where planners were able to exploit the potential of an enterprise effectively. It was placed strategically within its sector specifically to facilitate its links with Western markets. It achieved a relatively high level of modernization and innovation by absorbing various advanced techniques. It also helped facilitate horizontal integration in Hungary by producing and selling products for both domestic and foreign markets. RABA was the only Hungarian enterprise to own companies in the former West Germany. In fact, it had close business links with MAN of West Germany just as IKARUS bus industries of Hungary. RABA exercised an aggressive policy to win a position in the international division of labor, which increased its ability to receive Western credits. Of greatest significance was that RABA was one of the few cases where the company directors were technocrats who actually possessed the necessary expertise and

professional competence, unlike the majority of state enterprises where management appointments were the norm. Often, they had little regard for expertise or any entrepreneurial ability. In fact, RABA was considered one of the jewels of the state enterprise system; especially since it was the biggest hard currency exporter for Hungary. Ironically, RABA had very close ties with central authorities. In fact so much so, that they were able to avoid extensive central intervention![55]

Another success story was IKARUS bus industries which was actually closely linked with RABA. Producing nearly 15,000 units a year by 1982, it was considered one of the largest bus producers in the world. Nearly 2/3 of its production was sold to CMEA partners, though it also had extensive foreign markets especially in Middle Eastern countries like Egypt, and Far Eastern countries like China, even some limited sales in the United States and Canada. RABA provided most of IKARUS's engines which incidentally were produced by RABA under license from the West German company MAN. IKARUS's success in the West was limited by its narrow choice of models and its ability to meet quality requirements. Like many state enterprises, it suffered from inconsistent supplies of materials and lack of technical expertise and even equipment. Units destined for western markets often utilized a much higher proportion of Western components; sometimes entire chassis and engines. Moreover because of the higher quality standards in the West, export units were assembled off the assembly line. These units were assembled mostly in the traditional workshop environment which lacked many of the

advanced production technologies and resulted in a higher cost per unit.[56] Still, Ikarus was an important hard currency exporter with significant horizontal links with in Hungary and significant Western links with companies like MAN of West Germany and STYR bus industries of Austria.

Unlike most state enterprises, RABA was held close to the heart of central authorities because it was one of the few success stories in the state enterprise system. It was politically and economically advantageous to allow the company to operate as freely as possible with little or no interference. Politically, it proved to both domestic and foreign critiques in the Soviet Bloc and the international community that state enterprises could work. Ironically, its success was achieved and maintained through its close political links with the central leadership which allowed it to strategically avoid counter-productive central intervention. This was something that the reforms intended to introduce throughout the economy, but failed to achieve. In most cases, large state enterprises would use their political weight to protest liberalizing reforms and to earn more state subsidies. Quite the opposite happened with RABA. It used its political weight to secure more unrestricted market oriented economic activity. In a sense RABA was the epitome of the state enterprise and a jewel of the Hungarian socialist economy and at the same time an anomaly. Its success was really attributable to relatively little state intervention and more to competitive market oriented economic regulators. The case of RABA shows the arbitrariness of state leadership. Support to RABA was

not based on long term national plans. Instead it was based on its ability to earn much needed hard currency exports. The fact that it was profitable and competitive even on Western markets was a bonus, and the state authorized "carte blanche" to RABA. The political benefits far outweighed the obvious contradiction apparent in the situation. If only, the leadership adopted a similar stance towards other large state enterprise, perhaps it would have been more successful. Though applying the RABA case on a macro level would have required significantly reduced central intervention, but also indirect regulation which was the leadership's alternative to plan directives, and the reform's principle legitimizing feature which preserved the "central role" of the party. Nonetheless, the most distinguishing feature of the RABA case was its use of political influence and vertical links to avoid state intervention, so that it could operate more freely and competitively particularly in western markets. This was the type of behavior which NEM was supposed to foster, but typically state intervention through vertical links prevented this! Moreover, small and medium size enterprises which were the most receptive to the reform's objectives lacked the political weight to influence central authorities to decrease the level of central intervention. On the other hand, the large state enterprises especially the insolvent money losing ones used their influence to nurture vertical links and to maintain the status quo (state subsidies). They would even force reform advocates who feared instability and dislocation from reform, to compromise their positions. In other words, those who most benefited from the

reform, possessed the least political power, those who opposed the reform (large money losing state enterprises) who were at risk from a thorough implementation of NEM possessed the greatest political power and thus continued to impede the reform process and subsequently burden the economic system.[57] The state fell victim to the sector of the economy which it was trying to reform.

The reforms introduced in 1968 and later in 1980 achieved moderate success in both the Agricultural and Industrial sectors. In the agricultural sector, the reforms manifested themselves most explicitly through expansion and legalization of private plot production which produced up to 1/3 of Hungary's agricultural output. The reforms also stimulated ancillary non-agricultural industrial activity which provided a medium for some entrepreneurial initiative. Despite consistent growth throughout the 1970's, Agriculture suffered from the effects of state determined pricing which was almost always below cost. The inconsistency between Agricultural pricing and Industrial pricing caused severe distortions. Both sectors were restricted by state controlled regulators. The regulators which commonly took the form of subsidies were often made conditional upon the satisfaction of central plans. Thus, entrepreneurial initiative was encouraged in a very limited and restricted sense. It was easier not to try at all, and simply fulfill central objectives since it was the only measure of performance which rewarded the enterprise in the form of favorable regulators. Politically guided economic regulators distorted the effectiveness of the

reforms which were supposed to stimulate a more independent market oriented economy; only the market was missing. The successes were limited to areas where political-economic interference was minimal, like in agricultural private plots and in the most successful state enterprises such as RABA. The private plots could have been influenced by simply ordering cooperatives and state farms to restrict the use of state equipment and land (incidentally the private plot farmers found their limitations in low technical "know how" and in out-dated farm equipment). The state chose not to interfere mainly because the private plots had become such an important link in the food production chain. Also, they could be utilized as successful examples of the reform program, even though the government had practically no control over this sector (ie. party's guiding influence). Similarly, RABA was a case where government ties were so close and its successes so good, that RABA managers were able to avoid central interference. They operated almost solely in response to domestic and foreign markets. As a result, an anomalous situation occurred where a major state enterprise functioned almost entirely free of state intervention.

Unfortunately, the successes are limited and few. Both sectors suffered from the distorting effects of indirect regulators. Firms had to reconcile a plethora of regulations, just to function. Even if genuine entrepreneurial initiative existed, the (conditional) regulators more often than not discouraged it. The party's insistence to maintain its guiding role through this practice led to its own demise. State subsidies

especially to the mostly money loosing industrial sector continued to flow even on the eve of the party's collapse. The Hungarian economy simply could not sustain the level of accumulated foreign debt and the accompanying interest payments to fund an irrecoverable industrial sector. The total foreign debt in 1988 rose to \$18.4 billion.[58] The deficit ridden state enterprise system required significant restructuring. The change would force state enterprises to exercise cost benefit analysis, sensitivity to market demand, efficiency, productivity and ultimately profitability. This could only be achieved in a market governed atmosphere free of extensive government interference and where supply and demand would determine the viability of an enterprise and not conditional state subsidies. Simply, the possibility of failure had to exist in order to stimulate cost effective profitable enterprises. Reforms towards greater enterprise efficiency and productivity were enforced only to the extent that they did not endanger the existence of any economic units or employment positions. Any time a conflict of interest or some form of economic tension materialized, the chief concern of political authorities and regulatory agencies was how to maintain the existence of the affected economic unit; only later was there any concern towards profitability and efficiency. This was especially true in the mining industry.[59]

This would have been achieved only if the changes had been institutionalized. These changes did not materialize even as the entire global market place was institutionalizing radical structural changes towards the end of the 1970's. Many of these

changes were in response to the rapid pace of technological advance. As supply and demand adjusted to new conditions, the situation in Hungary remained static.

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Conclusion

The Hungarian reform advocates intended to develop a blend of market economy and command economy. The key objective in the Hungarian reform imperatives was to stimulate more individual initiative and enterprise independence. The hope was that it would create some level of entrepreneurial behavior where spontaneous and dynamic economic decisions could take place. Ultimately, the profit incentive and to a lesser degree personal gratification would in theory prompt more efficient and productive economic behavior.[1]

The contradiction in the whole concept lies in the fact that these measures were to take place under the supervision and guidance of a central authority. In other words, central directives which controlled wages, investment credits, export credits and so on, would cease to exist. However, the fundamental organizational structure remained in place. This organizational structure continued to advocate extensive central intervention in economic activity via branch ministries. This aspect of the organizational structure was a distinguishing feature of the system.

The market economy, specifically the concept of individual initiative requires independence from extensive state intervention, if it is to operate in the spontaneous and dynamic fashion which leads to profit oriented, efficient and productive economic decisions. Only a few firms under the Hungarian reforms were allowed to function "independently". Of course, there success was also limited by the fact that most firms around them

continued to nurture vertical relationships with central authorities and branch ministries.

The firms falling under this category did not necessarily make this choice out of their own personal freedom. In fact, vertical relationships were imposed upon them since the system of complex indirect regulators which replaced the system of plan directives had such a profound influence on their economic activity, especially the allocation of resources. So, profit incentives were really secondary in priority since they did not secure the necessary factors of production needed for the survival of the firm. Ironically, the central authorities actively promoted profit oriented market behavior to enhance efficiency and productivity. In reality, the real factors influencing the firm's economic activity was the strength of the vertical ties it maintained with branch ministries who facilitated profits through various credits and subsidies. A real market was never created.

Central planning is a futile exercise which will never be able encompass the literally limitless possibilities of a genuine market economy. Minor details which are often essential factors in the market mechanism would inevitably fall aside in a central plan. The Hungarian reformers intended to use partial marketization to help facilitate their decisions which would, as a result more accurately reflect the pulse of the economy. This type of partial marketization introduced in Hungary produced an inaccurate measure of the economy. The market cannot function to

its fullest potential under the persistence of regular and extensive central intervention, even the use of indirect regulators which arbitrarily alter key decisions regarding the allocation of resources and the function of supply and demand. Any information gathered from such a system will be grossly inaccurate.

The reform intentions failed also because the fundamental organizational structure of the Hungarian political economy remained intact. Flexible and dynamic political economic institutions did not materialize. Even in market economies of the same time period, stagflation produced restructuring, and technical advancement accompanied by graduated price hikes. The opposite occurred in Hungary.[2] The distinguishing feature of the existing organizational structure was the practice of central regulation. The nature of the regulation varied between the East European Bloc countries, but still shared the common objective of satisfying the national plan. Vertical relationships generated dependence and not independence. Horizontal relationships promoting competition and ultimately the function of supply and demand had to take priority. Firm entry and exit had to be allowed, even bankruptcy. Only such conditions would stimulate independent initiative, and entrepreneurial activity.

Since the existing organizational structure represented the epitome of what the communist political economy, changing the institutional structure would have required the leadership to consider fundamental reform or more likely, dissolution of itself. Clearly, this was a threshold beyond which the leadership

would not move beyond because its very existence would have been threatened. Moreover, the reforms intended to improve the economy in the context of the existing institutional and organization structure, but this structure was highly resistant to economic change. The organizational structure constituted the limits of conservative innovation. The party would have lost its identity and its power. By overstepping this threshold, it would have passed from the realm of mostly centralized bureaucratic control to decentralized and most likely democratic control. The two concepts cannot be combined successfully. They are in contradiction with one another. Hence the marketizing efforts in Hungary were limited by the inherent flexibility built into the institutional and organizational structure of communist one party rule. The deterioration of the Hungarian economy under the conflicting circumstances created by the combination of marketization and the plan economy forced the party to surrender itself to democratizing forces which could support genuine market competition. The limits of conservative innovation were embedded in the impossibility of reconciling genuine market activity with the planned economy. Changing the identity of the party, in late 1989, lead to changes in the organizational and institutional system in Hungary, which was followed by a wave of democratization. The party was not able to withstand the inevitable attack from emerging opposition forces. It had to realize and ultimately endure the reality that the political economic circumstances would be much worse before they would improve. The party, by this time did not have the necessary

support with in its ranks and from the Hungarian populace to consolodate any further reform attempts.[3]

Thus the Hungarian reform experiment was politically motivated. The Kadar regime's first priority in initiating the reforms was to create a comparatively high standard of living. By achieving this, he could consolidate his leadership and earn a form of pseudo legitimacy in the eyes of the Hungarian populace. However, as the discussion has shown, the first wave of reforms did not produce all the desired effects, particularly in the long term. The persistence of central intervention especially in the form of subsidies, distorted marketizing efforts and more importantly, augmented a growing debt. This debt was financed by foreign loans. As the debt grew and as it posed serious long term and short term concerns for the Hungarian economy, the reform efforts were taken more seriously and began to gradually employ more expertise. The government simply could not support heavy subsidization of grossly inefficient, unproductive, indebted state firms. Further proof that the Kadar leadership manipulated the economy to gain pseudo legitimacy was confirmed when the economy began its rapid decline in the late 1980's. As the the standard of living fell with the decline of the economy, so did the public's perception of the party. To compensate for the sharp decline in Hungary's standard of living, The Party was forced to ease restrictions on the media, reform advocates, even reformists such as Imre Pozsgay with in the HSWP. It had no choice in the matter, but by doing so, it also undermined itself because it opened the door of revelation, namely the bankruptcy and

corruption of the party. It would not recover from this, especially since by this time the HSWP had lost all external support, particularly the Soviet Union. This was confirmed by Gorbachev's 1987 visit to Budapest when he made it clear to the Hungarian regime that the Soviet Union would no longer lend its support to the HSWP, and that it was practically free to do what it felt best.[4] In fact, this was confirmation of the green light given to Hungarian reform agendas already in the early 1980's before Gorbachev came to power. As the economy collapsed, so did the legitimacy and ultimately the control of the party. The innovativeness of the reforms were to be found in the party itself. It was unable to sufficiently change the institutional and organizational structure of the Hungarian political economy to accommodate effective liberalizing reforms. In fact, it simply could not do so, without sacrificing its identity, and purpose for existence as understood in the context of a communist political economy. The party had the opportunity to save itself in its final years preceding its collapse in 1989. Though it could not redeem itself in the traditional sense, it could have surrendered its traditional monopoly over the economy in favor of radical market reforms. The HSWP was incapable of this, particularly because of conservative currents which were unable to accept the party's failure and the subsequent necessity for radical reforms.[5] The terms bankruptcy, unemployment, supply and demand continued to be ideals mentioned only in rhetoric but not practiced. As a result, the party lost its monopoly of power and it also squandered its chances as a viable candidate in the ensuing

elections of March 1990. The Hungarian Socialist Worker's Party ceased to exist as of October 1989.

In retrospect the Hungarian reform experiment can be viewed as the most thorough-going attempt to reform the traditional command economy in the post second world war era. Despite rigorous attempts to resolve the conflict between the combination of market and the plan, the Hungarian experiment failed. The failure reflected the inflexibility and obsolescence of the command economy. Still, modest successes were recorded and because the reforms were applied throughout the economy, many neighbouring bloc countries observed, studied and even tried to emulate the Hungarian experiment. This was especially true in the case of the former Soviet Union. It too, watched with great interest and perhaps in a sense of hope that perhaps the Hungarian experiment might offer a resolution to its economic woes too.

As it turns out, the Hungarian experiment failed and heralded the triumph of market forces. The failure of the reforms had broad implications throughout the communist world and for that matter, the western world. The experiment, for a time, was believed to be a potential resolution between market and plan. When it failed, it signalled failure for other communist bloc countries where reforms (if any) were much more modest. The failure of NEM in Hungary caused ripples throughout the communist world, even the Soviet Union. The disappointment of the Hungarian failure nulled any hope of alternative reform plans.

This modest study helps to pinpoint some of the reasons for the failure of communism. Among other things, it highlights the incompatibility between market and plan as the central problem. By using the case of Hungary to illustrate this incompatibility, the study also sheds some understanding on the broader implications of the failed experiment and how this effected reform throughout the communist world, particularly the former Eastern Bloc. By examining the Hungarian case one can obtain a better understanding of the some of the difficulties faced by former bloc countries today. In Hungary, conservative elements have a minimal effect on the reform agenda. Still, those sectors of the economy where stagnation continues are those where conservative tendencies are the strongest. Only time and dedication to the reform process will tell if the new Hungarian Political/Economic institutions and structures will survive.

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Appendix: Standard of Living

Table 1: The average annual increase in per-capita consumption between 1951-1978.

Hungary	2.6%
Poland	2.9%
CSSR	1.6%

USA	2.3%
UK	2.1%
Japan	6.5%

Table 2: Private Cars (per 1000)

	<u>1980</u>	<u>1987</u>
Hungary	86	157
Poland	64	111
CSSR	127	174
Romania	11	12

Holland	322	349
W.Germany	388	462
Austria	298	355
Italy	302	392

Table 3: Foodstuffs: Labor hours required to purchase 1 unit of product in 1988.

<u>Product</u>	<u>Qty</u>	<u>Hungary</u>	<u>CSSR</u>	<u>Poland</u>	<u>Bulgaria</u>

Beef	1kg	2.6	3.7	1.7	5.9
Egg	1pc.	2.6	3.8	6.6	5.5
Milk	1L	1.8	2.0	0.7	2.7
Bread	1kg	0.5	0.5	0.5	0.9
Wine	1L	2.8	5.8	10.6	2.9
Coffee	1kg	7.2	10.4	17.8	18.2
Butter	1kg	2.5	3.6	3.5	6.0
Beer	1L	2.7	2.0	7.0	3.8
Detergent	1kg	4.1	---	5.1	1.5
*Gasoline	1L	5.7	7.0	5.0	8.1
*Color TV	1	4.0	6.6	13.4	5.3
*Car	1	2.3	2.5	9.2	4.0

*Prorated figures

Source: Kornai, Janos. A Szocialista Rendszer. Budapest: HVG Kiado Rt., 1993. pp.326-329.

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