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HUNGARY: Major New Economic Reforms in Prospect

Summary

Budapest this year is inaugurating the first major modernization of an economic reform program that caught world-wide attention 15 years ago with its bold breakaway from the Stalinist-style centrally planned economy. New measures, long in the drafting and now proposed for gradual introduction in 1984-90, draw on the old ones of 1968 but seek even greater decentralization in enterprise management, pricing, wages, and the use of labor, capital, and credit. Although a broad outline for change has won Party support in principle, and some initial measures are being introduced this year, many of the specific and more path-breaking proposals are still under debate. Decisions by the Central Committee are not expected until sometime next year. [redacted] 25X1

This memorandum was prepared by [redacted] East European Division, Office of European Analysis. Comments and questions are welcome and should be addressed to [redacted] Acting Chief East European Division, EURA, [redacted]. 25X1 25X1 25X1

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We have seen two lengthy concept papers prepared primarily by economic professionals that outline the general thrust of government proposals for new reforms. In addition, Budapest's letter to the IMF last December requesting new standby credits contained a brief sketch of the proposals, and a Party plenum in mid-April called for reforms in "every aspect of management." Because these documents tend to be vague and elliptical, we offer here only a preliminary interpretation of what seem to be the most innovative highlights. Moreover, even when the Party consolidates its position, we are unlikely to learn for some time how much of the government's reform package was accepted, which specific proposals were rejected or tabled, or much about the timetable for implementation over the next several years. Nevertheless, allowing for some scaling down or delays, it is clear that Hungary's leaders find the need for radical changes imperative and are prepared once again to go much further than their CEMA allies in the common quest for a more efficient system of economic management. 25X1

The key question is how far the Kadar regime is willing to go.

- -- Some of the reforms could undermine, at least in the short run, the regime's commitment to improving living standards.
- -- They also are bound to encounter resistance from entrenched Party and government bureaucracies. 25X1

The reform proposals also risk negative reactions from the new Soviet leadership and other East European regimes. We already have seen signs that Budapest is fearful that the Western press will overplay "capitalist" aspects of the new measures and provoke criticism from Hungary's more orthodox allies. Indeed, Hungary was clearly the target of recent Czech and Soviet propaganda criticizing socialist countries that overestimate their own "model." 25X1

In our judgment, Hungary's leaders have no intention of abandoning their socialist system. Nothing we have seen suggests that the state is willing to relinquish ownership of the means of production, cede major power to workers over enterprise management, or embrace political pluralism at the national level. 25X1

Decentralization

Concepts for a "new phase" in economic reform have been circulating in Hungary's prolific professional think-tanks since 1977 when mounting balance-of-payments difficulties forced Party leaders to call for a fundamental review of economic strategy. New rules of the game were needed to make enterprise managers more profit-oriented and induce them to become entrepreneurial risk-takers assuming the lead in updating the country's increasingly outmoded structure of production. Proposals now under study spring essentially from a consensus that lack of effective competition for resources is the force holding back badly needed structural changes:

- -- too many large monopolistic enterprises are protected by vested hierarchial management institutions, restricting incentives to use resources efficiently; and
- -- too many products for export by Hungary's trade-sensitive economy are not price-competitive in hard-currency markets. 25X1

A key problem is that labor and capital stock are in short supply, yet continue to be misallocated in activities with small profits or even losses. By contrast, the availability of bank credit tends to be excessive, and institutions are lacking that could channel it use into activities yielding the highest returns. 25X1

Thus, reform proposals aim at establishing an elaborate new institutional framework that offers individual enterprises greater freedom to fix prices and wages while at the same time providing inducements to use labor, capital, and credit where the potential payoffs seem greatest. These are not new ideas, even in Hungary, but experts commissioned by the government now see a need to reach out in directions that have no precedents. They seek solutions through a more far-reaching decentralization of decisionmaking not only to the enterprise level but within the banking system as well. 25X1

Enterprise Management

At the core of the new reform concepts is the notion that central or middle-level state administrative agencies should possess only general supervisory authority and should be divested of their rights to interfere in the operational and investment decisions of enterprise managers. Implementation of this concept already was evident in 1980, with the merging of three central industrial ministries into one with diminished authority, and in the subsequent breaking up into smaller units of numerous trust organizations and other very large enterprises enjoying monopolistic market positions. Organizational decentralization along these lines is to continue. 25X1

Vetoed, at least for the 1984-90 period, is the creation of "holding companies," unique types of property management agencies long advocated by many prominent reform economists. The winning argument apparently was that holding companies, for all their potential merits in separating the state from the economy, could easily become ministry-like protective organizations that would serve to restrict rather than promote the development of profit-oriented entrepreneurial attitudes on the part of their subordinate enterprises. 25X1

Reform proposals envisage a much larger number of medium and small enterprises with independent rights to decide on their internal organization, planning, relations with other firms, and use of materials, labor, and capital. Several new "enterprise profiles" are suggested, depending on whether the reorganized firm is owned by the state or by a cooperative. In general, the reforms seek to create a "system of interests" in which new representational bodies allow managers and workers alike more say-so in how their firm is run and who runs it. Central authorities, however, will apparently retain a veto power over almost every aspect of management when actions conflict with their perception of national interest. Even the most ardent reformers emphasize that their proposals for decentralized decisionmaking at the enterprise level have little in common with Yugoslav self-management, which they contend has led to a spiraling of wages and prices that central authorities have been unable to contain. 25X1

Capital and Credit Markets

Among the most innovative of the new reform proposals are those directed at making better use of new and existing fixed assets and decentralizing the credit functions of the central bank. They may also be among the most politically sensitive because they imply closing down chronically unprofitable enterprises and reallocating not only their capital assets but also their labor forces to other enterprises--a prospect that many displaced managers and workers might find traumatic. 25X1

Reforms in these two areas are interrelated. They grew out of experiments begun in 1983 aimed ultimately at developing a Western-like capital market providing alternative types of financial assets marketable to both enterprises and the general public. What is contemplated in the years ahead goes considerably beyond the sale and trading of equity shares in domestic corporations and the issuance of government and enterprise bonds that occurred on a limited scale last year. 25X1

The new proposals would create a network of commercial banks, subject only to oversight by the central bank, that would accept and rediscount obligations of enterprises--something Hungarian bankers describe as a market for "commercial bills." In line with this, the central bank also would be empowered to adopt a "flexible interest rate policy" affecting deposits and loans of both enterprises and the public. The bank would be free to raise or lower domestic interest rates in line with shifts in the cost of obtaining foreign credit or in the real interest rate caused by domestic inflation. As far as we can tell, these proposals are still on the drawing board and are likely to be among the last adopted. Officials of the National Bank of Hungary naturally would like a greater voice in monetary policy, but they are reluctant to assume responsibility for it without full backing from the Ministry of Finance to which the Bank is subordinate. 25X1

Pricing and Enterprise Finance

Many other changes are embodied in the new reform concepts, mostly involving proposed tax reforms and other revisions in enterprise financial flows to and from the government budget. Potentially the most important measure here is the gradual introduction in much of the economy of what are being billed as "quasi-free market prices." 25X1

Further Price Reforms: Pricing rules to be introduced on a limited basis this year but rapidly extended thereafter will greatly modify the so-called "competitive price system"1/ implemented in 1980. Domestic producers' prices in the 1980 concept were considered competitive if they were linked to world markets either directly via exchange-rate conversions of actual export and import prices or indirectly by exchange-rate conversions modified by various compensational adjustments such as tax rebates. New prices based on these formulas were expected to provide enterprises with incentives to minimize costs of

1/ Since adoption of the New Economic Mechanism in 1968, reformers have looked on the economy as being composed of two broad sectors--the "competitive sphere" and the "non-competitive sphere." The competitive sphere consists of sectors where a potential exists for "self regulation" and includes the processing industries, the construction industry, and some services branches, together with domestic and foreign trade in products produced in these sectors. The concept implies a large number of producers and consumers of inputs and outputs competing with each other. The non-competitive sphere includes agriculture and most infrastructure sectors that, in the interest of social policy and other national considerations, must be managed by the state. 25X1 production and better adapt their product lines to demand in volatile export markets. In practice, the system quickly grew overly complicated, with widespread departures from the original principles, and it contributed little to cost-sensitivity or easing the country's current account imbalances. As some critics describe it:

> Our price mechanism presupposes the market mechanism, and much of our problems are due to this fact or to the situation that in practice we have a simulated rather than a real market. We can expect an appropriate solution only if steps are taken to establish a real market mechanism and competition. (Emphasis added) 25X1

The new pricing reforms start out cautiously with applicability confined in 1984 mainly to an informally-designated "club of elite enterprises" representing the star performers in the manufacturing sector of industry. Firms eligible for membership in the club have unprecedented freedom to set their own prices, the only constraint being that their domestic prices cannot exceed the equivalent forint price of similar products imported from convertible currency countries. The firms also enjoy greater freedom in granting wage increases. Whereas other enterprises must pay a long-standing and steeply progressive tax on profits if they increase wages more than this year's 5 percent limit, the more efficient "club" members are allowed to exceed substantially the 5 percent ceiling without having to pay the tax. 25X1

To be eligible for adopting the freer-pricing procedures, firms must be major exporters operating at a profit, and the demand and supply for their products must be subject to "adequate" competition in domestic markets. Requirements that the firms not hold monopolistic positions and that their products not be in short supply apparently are to forestall unjustified price hikes.

In 1984, some 60 to 100 enterprises accounting for about a fourth of sales in manufacturing are expected to adopt the new pricing formula. But the group of participating enterprises is expected to expand rapidly, with the freer pricing and wage-setting scheme to become the general one in 1985 throughout much of industry, the construction trades, and a large part of the services sector 2/. 25X1

<u>Other Related Measures</u>: A major goal of the 1980 price reforms carried over in the new proposals is the establishment of a more rational relationship between producer and consumer prices. Reducing the former and increasing the latter would reduce the burden on the state budget of financing enormously costly price subsidies. 25X1

Solutions in this area require, in the first instance, a more frequent adjustment of the exchange rate based on fluctuations in international currency markets because producer prices are based on world market prices. The National Bank of

2/ Domestic prices of fuels and basic industrial materials will continue to be established according to the rules adopted in 1980; they are linked to the forint equivalent of import or export prices depending on whether Hungary is an importer to or exporter from the convertible currency area of the particular commodity. Prices of most other goods and services will remain under central determination, including basic consumer supplies, most agricultural procurement, and major areas of infrastructure such as housing and public health. 25X1

Hungary already adjusts the exchange rate of the forint on a weekly basis; the proposal is to make adjustments daily. This, in conjunction with enterprises' responsibility for making product mix and prices more competitive, will require that managers have access to more market-related information. 25X1

No radical changes are contemplated in the determination of consumer prices, but the government plans to continue selective increases in prices of consumer goods and services. These increases will be constrained only by the desire to maintain present living standards. Elimination of subsidies for certain essentials has been ruled out even over the longer term as being an unacceptable policy for a socialist state. 25X1

The goal of reducing producer prices is complicated by the desire also to rationalize the relative input costs to enterprises of labor, materials, and capital. This would be accomplished primarily by increasing the costs to producers of hoarding labor. To encourage managers to get rid of redundant labor, enterprise contributions to the social security system will be increased. In addition, enterprises are to receive greater tax relief in return for trimming their workforce, with the savings to be used to raise wages of the remaining workers. This latter proposal arouses concern, however, that enterprise managers will resort to the longstanding practice of passing on any increased costs in the form of higher producer prices. The freer price-setting scheme and more flexible interest rate policy being introduced this year should help make the costs of materials and capital more realistic. 25X1

Taxation

As in any country with a complex legal system, tax reform in Hungary is highly controversial because of its impact on the morale and work ethic of all elements of society. Thus, it is not surprising that reform proposals in this area seem the most tentative (see box). Their general goal is to lessen the burden on enterprises subject to heavy profits taxes while broadening the base of taxes paid by individuals. The issue apparently turns on the question of whether tax reform should be shaped more in the direction of the West European system, requiring introduction of an indirect value-added tax, or the American system of direct taxes on enterprise and personal incomes. In either case new tax schedules would be structured so as to provide greater differentiation in enterprise profits and individual earnings based on productivity. 25X1

Timetable and Obstacles

In essence, the reform proposals aim at considerably expanded use of market signals by providing more flexible formation of all price instruments--prices of goods, labor, capital, and credit. This would not accomplish full-fledged "market socialism" but it could propel the economic mechanism substantially further in that direction. Much remains to be done, however, in working out details and a more specific timetable for implementation. 25X1

Even if government experts succeed in getting a revised

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BOX

Tax Reform

Under existing regulations, most producer enterprises pay a flat but stiff tax on profits to the state budget and a smaller one to local governments. They also are subject to a progressive tax on wage increases above a prescribed limit and a payroll tax to help fund social security. Trade and other firms that sell directly to the public pay additional consumer turnover taxes. The system has been changed several times since 1968, but still is cumbersome and complex. New proposals, still to be agreed upon, would reduce enterprise profits taxes by gradually eliminating the progressive tax and shifting more of the general incidence of the flat tax from primary and intermediate products to final goods. Adoption of a value-added tax, it is thought, would accomplish the latter goal and have the extra benefit of promoting exports in a way that would be acceptable to GATT and other international financial institutions. (C)

At present, the only direct tax on personal incomes in Hungary is paid by private craftsmen and merchants, self-employed professionals, and persons working private farm plots or renting out private housing, with different tax schedules for each group. Employees of state enterprises and cooperatives pay only a pension contribution to the social security system administered through the state budget. This lack of uniformity--plus the growth of "second economy" workers enjoying untaxed incomes from part-time, after-work jobs, and the recent authorization of small-scale private and semiprivate enterprises--has led to a proposal for an integrated progressive tax that applies to all individual earnings from whatever source. For both technical and political reasons, however, the proposal is vague and states that even if a new type of personal income tax is accepted it can only be introduced gradually. 25X1

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outline approved by the Central Committee, expected to be convened for this purpose sometime next year, debates over details are bound to continue. As the proposals now stand, relatively small changes are planned for 1984-85, with the greater part of the package scheduled for introduction by stages during the next five-year plan (1986-90). 25X1

A recent sampling of views among the experts involved suggests that the major thrust through 1985 will be on reforms in enterprise management, pricing, and wages but that major changes in banking and taxation must wait until 1986-90. And, we must keep in mind that reforms actually implemented down the line may differ markedly from what is agreed to in the short-run. As of now, it appears that the New Economic Mechanism is passing through a new watershed that promises to keep it the most attractive model for significant evolutionary change in Eastern Europe. 25X1

The key question is how far the Hungarian leadership is willing to go. For one thing, the proposals we have seen have the potential for upsetting the Kadar regime's commitment to improving living standards for the Hungarian people. They also would force change on entrenched Party and government bureaucracies. While the leadership believes Hungary must maintain credit flows from the West, these bureaucracies are still reluctant to take the kinds of risks essential to making Hungary competitive in hard currency markets. 25X1

Finally, the reform proposals risk negative reactions not only from the new Soviet leadership but also from other East

European governments, which are already wary of the demonstration effect of Hungary's higher living standards and are concerned that Hungary is moving too much on its own to improve relations with the West. Perhaps most worrisome for Hungary's CEMA partners is the fact that in the minds of many Hungarians the economic reforms are only the prelude to more fundamental changes. Budapest's economic proposals have been worked on not only by economists but also by sociologists, jurists, and historians who believe that an efficiently functioning market-oriented economy cannot succeed without significant political liberalization. Thinly veiled criticism of Hungary has already surfaced in Czech and Soviet news media chastising socialist countries that overestimate their own "model" and seek unilateral advantages from the West. Possibly in reaction to this kind of criticism, a Hungarian banker claiming to speak for Party and government leaders has stressed to US Embassy officials the hope that Western officials and press commentary will not overplay the new reforms. Indeed, we would not be surprised if Budapest becomes very cautious in publicizing the details simply to avoid the problems with its Bloc neighbors that the Western press has helped create. 25X1

In our judgment, Hungary is not going and does not intend to "go capitalist," as the Western media like to suggest. This would imply that the Communist Party is willing to abdicate its control over economic policy, enterprise behavior, and public welfare. Despite the novel and evolutionary nature of Hungary's economic policies, nothing we have seen suggests that the state is willing to relinquish ownership of the means of production, to cede real power to workers over enterprise management, or to embrace political pluralism at the national level. 25X1

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