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## Changes in the Economic Mechanism in Hungary

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In the seventies Hungary's national economy reached a development stage in which only a development of basically intensive character is possible. This is because, considering the development of the national economy, there are two phenomena of particular importance rising above the changes of the past one decade and a half. On the one hand, resources which had served as a basis for a relatively rapid growth in the previous decades practically ceased to be available in the seventies, i. e. neither increasing the employment nor obtaining cheap sources of raw materials are possible today. On the other hand, the national economy has to face a considerably different scale of values in the world economy from what prevailed before, as a result of which Hungary suffered a loss in terms of trade amounting to the national income of one year during the past 10 years. As offsetting this loss was not possible in the short run, its considerable part was financed through running into debts. By the end of the seventies Hungary's external and internal equilibrium had been upset, and the improvement of the balance needed substantial change in economic policy. Priorities of the economic policy were changed, special government programs were elaborated aiming at savings in energy and raw materials as well as at re-exploiting waste materials, an extremely strict restriction of domestic demand was introduced leading to a considerable decline in the investments in real terms, while real wages were reduced as well. As a consequence of the economic policy pursued in the past four years, Hungary's external balance has considerably improved, and, in spite of the relatively high debt service, net indebtedness has declined.

The balance situation of the early eighties created such an atmosphere in which it became quite natural that further development of the economic mechanism was given an impetus again. Between 1981 and 1984 a government program was elaborated for a comprehensive analysis of the economic management system, 15 years' activity of the economic management system was evaluated, and key issues were defined in which, in order to be able to achieve economic policy objectives scheduled in the second half of the eighties, it

was necessary to bring about changes.

The result of this work lasting for about 3 to 4 years was that the government was able to determine guidelines for the changes to be carried out in the economic mechanism and approved the proposed program for the expected introduction of the various elements.

The concept aiming at the development of the economic management system stipulates that:

—the conceptional reform of the price system started in 1980 should (may) be completed, and adequate economic conditions for a real market price system should (may) be established;

—in the second half of the eighties substantial taxation reform should be implemented, including the taxation of different personal incomes on a uniform basis as well as substantial changes in the system of turnover taxes;

—it is necessary to continue the establishment of instruments for flow of capital and assets, and, to the necessary extent, adequate organizational conditions should be created for the functioning of capital market;

—the enterprise management system should be modified in such a direction that the decision-making possibilities of an enterprising behaviour be more favourable than today.

The external connections of Hungary's economy, compared to the domestic market, are so significant that virtually any sector of the economy should practically follow international market requirements. The intended changes in the economic management system seem to be able to mobilize new energies in the interestedness relations of the economy and to promote successful performance in the international markets. The development guidelines of the economic mechanism need the application of such concrete instruments and methods which accelerate the spreading of enterprising behaviour in the economy. These guidelines make it obvious that market effects (of both the external and the domestic market) should be intermediated towards the economic agents. This requires such a system of rules in the frameworks of which enterprises perceive, at the same time, both the economic incentives and the pressure for keeping pace with progress.

It is important to emphasize that the development of the economic mechanism takes place in such frameworks in which central planning of the economic development continues to be maintained since central planning can ensure that policy objectives and the set of instruments necessary to achieve them be in consistency. The basis of the special role played by macro-level planning is that the most important purposes and directions of the reproduction, as a comprehensive social process, are determined by economic policy, and it is the central planning which holds this comprehensive process in hand. Central planning makes preparatory works for comprehensive policy decisions, elaborates macro-level government programs, and controls macro-level consistency between objectives and instruments. At the same time, the development process of the economic mechanism unambiguously reflects the conviction of the economic management that there is a permanent need to intermediate national economic objectives towards economic agents basically through the instruments of price policy, monetary policy, budget policy, taxation policy and credit policy. If these instruments are able to intermediate market effects towards enterprises, then macro-level planning can sufficiently take into consideration interestedness relations

and market effects in forming the objectives.

In respect of the introduction of the various economic policy proposals several points of views were considered, among which especially two deserve notice:

—In a part of the proposals adequate conditions for their introduction were established in 1985, thus these proposals were elaborated in details in 1984. The respective changes have already been carried out or will be carried out during 1985. The other part of the proposals needs such sort of changes the conditions of which can only be established by several years' hard work so these changes are to be introduced in the second half of the eighties.

—As the changes as a whole result in substantial change but individual elements are introduced in different points of time, special care is taken of safeguarding the uniform concept of the development of the economic management system. At the same time, efforts are made to avoid such changes which would imply abrupt and large redistribution of incomes in the economy since, according to experiences, it is also a condition of success that the economy and the society be adaptive to subsequent changes in income relations. In an opposite case economic agents would have to face impracticable requirements which would adversely effect both these economic agents and the economic management.

Further on in this paper a summary is given on the characteristic elements in the change of Hungary's economic management system, first of all on the measures introduced in 1985, but brief references are made on the modifications to be introduced in the coming years and included in the concept as well.<sup>1)</sup>

### **The Structure of the Price System**

The changes implemented in the price system in 1985 have not modified the character of the price system prevailing since 1980. The steps which have been taken in the price system since 1980 are fully in line with the program aiming at restoring equilibrium in foreign trade as soon as possible and at increasing efficiency of the economy. The theoretical construction of producer prices in industry, in agriculture and in the sector of services differ in character from each other.

The development of industrial producer prices have been linked to that of the foreign trade prices since 1980. The basis of this is that considerable part of the production relies, either through import or through export, directly and to large extent upon external markets. Hungary is poor in raw materials and has to import some 70 percent of her total consumption of basic materials. Under such circumstances domestic prices also have to reflect changes prevailing in external markets.

Foreign trade relative prices are represented in domestic prices differently in case of energy, industrial raw materials and semi-finished products utilized in large volumes on the one hand, and in case of manufactured products on the other hand:

1) Economic management applies very comprehensive instruments and institutions. Giving a full survey is obviously impossible within the frameworks of a short study. What makes the problem even more difficult is that the reader could actually get a real picture on changes in the economic mechanism only if he could compare the shifts concerned with the system having been in force before. This paper, however, disregards the presentation of rules removed at end-1984, hoping that, in spite of this, the reader can still form a brief but comprehensive notion on the character of Hungary's economic mechanism.



—Prices of energy and raw materials are generally determined on the basis of market prices in the West expressed in convertible currency. The basis of domestic prices of energy is, as from 1980, the price of Saudi-Arabian oil, and prices of energy from domestic sources are determined on the basis of utility value comparison with Saudi-Arabian oil. Prices of metallurgic products, of basic materials of wood industry and clothing industry, of intermediers, etc. are usually determined on the basis of actual import prices from Western markets. Domestic prices of raw materials follow steady development of foreign trade market prices. According to the price formation guidelines, prices either being in effect or contracted with foreign partners for 3 to 4 months or more should be qualified as steady. As a consequence, domestic prices of energy and materials change relatively frequently if justified by trends of world market price movements.

—In manufacturing industry the adjustment of domestic prices to foreign trade prices is realized in a very peculiar system. As from January 1, 1985, the price formation concerning manufactured products includes two general rules. These rules practically function as administrative prescriptions which have to be observed by enterprises in inter-enterprise connections even if, as seller and buyer, they fix prices freely. One of the rules is that a given enterprise of the manufacturing industry should not increase price level of its products to be sold in the domestic market—considering all such products—faster than the price level increase in forint terms of its total exports in Western markets. The other general rule is that domestic producer prices should not exceed prices, in forint terms, of products imported from convertible area, provided that utility features and conditions of price application are similar. This latter principle is the so-called import price constraint according to which in the price of an imported product in forint terms, beside the price in foreign currency, costs of trade, transportation, packing and others may also be included. This rule, unlike that mentioned previously, relates to a given individual product. In Hungary in the production of certain products or product groups relatively few large enterprises play decisive role. These enterprises account for the majority of exports as well. Adjustment of domestic prices to foreign trade prices has to be ensured, first of all, in case of these enterprises. Since in the domestic market they are the price-makers, price regulations stipulate for other enterprises producing similar products to proportion prices of their products, while taking into consideration utility features, conditions of sale, packing, etc., to those formed by enterprises following export prices.

Within the construction of the industrial producer price system shown above one may view the price formation relating to products of manufacturing enterprise as a strange element. As a matter of fact, conditions of an external market are intended partly to be adopted by this regulation of domestic prices. The opinion in Hungary is that in line with the development of market conditions it is possible to gradually create such circumstances under which, concerning the vast majority of consumer goods, a stable market equilibrium can be achieved, in other words, either domestic producers or imports create such a situation in which demand can be dynamically met. At present such conditions exist only in case of food and some half of industrial consumer goods. As much as the improvement of domestic market conditions can advance (which needs investments, foundation of new enterprises, new import possibilities etc. in some fields), linking of the domestic price level



to export prices can be eliminated as well.

Foreign trade prices have to be converted to the domestic currency at the current exchange rate at any time. As a consequence, exchange rate policy plays an active role also in the general determination of the price level. As for convertible currencies, exchange rate policy is based on the principle that individual exchange rates of the forint (the Hungarian currency) follow the development of cross rates in international foreign exchange markets. These changes usually do not affect the level of the exchange rate, i. e. the value of the currency basket in terms of forint. Exchange rate level (i. e. revaluation or devaluation of the forint) should follow changes in the general efficiency of the economy, as reflected in the judgement of external markets. National Bank of Hungary is authorised to implement, moreover, such exchange rate adjustments which revalue or devalue the forint by no more than 1 percent p. a. Changes exceeding this limit are decided upon by the government.

The link between domestic prices and foreign prices are influenced, beside the exchange rate, also by financial bridges:

—Customs duties are levied on imports. Hungary, as a GATT-member, has formed duties in line with GATT rules. Level of duties is to be reduced by 15 percent of that at present by 1987 (the nominal level of duties was reduced by 25 percent between 1979–1985);

—In case of exports the state rebates the turnover tax paid in previous phases. Such turnover tax is levied, for example, on crude oil, some basic materials of wood and paper industry as well as on products the prices of which, due to adoption of prices in dollar terms, are much higher than domestic production costs or prices of imports from the rouble area;

—In the foreign trade with socialist countries foreign trade prices change on the basis of price principles applied within the Comecon and they are considerably different from domestic prices. This difference is offset by several types of financial instruments, for example, in case of import of energy and raw materials from socialist countries, the difference between import prices and actual domestic prices is paid in, as turnover tax, into the state budget by importer enterprises.

The specific features of the agricultural price system stem from the biological determination, from the highly differentiated demand for labour by different branches, from the co-existence of state, cooperative and private sectors, and from the fact that many large plants and farmers are involved in similar activities. Prices of agriculture, in spite of significant connections with external markets, are based on domestic average costs, and basic agricultural products are subject to administrative price determination. A more intensive responsiveness to market price changes is a requirement also in this sector but a flexible price system has several preconditions, and the harmonization between food-processing costs and consumer price policy as well as price changes of machines and materials of industrial origin have to be taken into consideration. The Hungarian agriculture has reached a development level on which price policy should stimulate, first of all, not the quantitative increase of production but it should rather prefer qualitative factors. Thus the differentiation of prices according to quality will continuously alter relative prices. In line with international practice, in this sector prices are necessarily completed by a given system of subsidies and various financial allowances since, as it is generally experienced,

beside costs determined by the average quality of soil, cultivation of lands of lower quality is in social interest as well. On these lands yields are low, costs exceed prices and this difference is offset by subsidies or tax allowances. One of the essential endeavours of procurement price policy is that interestedness of producers be safeguarded also by state protective prices or subsidies provided for individual aims but, beside this, the price system makes it possible that connections between producers and buyers be organized on the basis of common and direct interests of enterprises.

In the fields of the infrastructure several types of price formation are in effect. In construction industry, for example, the so-called undertaking price system is gradually extended in which tenders are invited for given building and constructing works, and customers (investors) can choose the most favourable among the tenders. In choosing the most favourable tender one of the most important criteria is the price. The applications of undertaking price system has two essential conditions: on the one hand, the customer (investor) should be definitely interested in paying only a realistic price for the performance in the construction activity and not simply the costs incurred, on the other hand, in the implementation of a given project choosing among several undertakers should be possible. At the beginning of the eighties an administrative price system, and within this fixed or maximized prices, was in effect almost in all parts of the construction industry. At present some 30 percent of building and constructing activity is covered by the undertaking price system.

In other sectors of infrastructure, such as transportation and trade, administrative rules in price formation are substantially reduced from 1985. But in these sectors the application of administrative guidelines for prices and profit margins is characteristically maintained even today. These constraints can be viewed as being on half-way between former administrative prices and free market prices.

In the development of the consumer price system the general endeavour is that consumer prices reflect the actual production costs and react upon the structure of production (supply). Deviations between producer and consumer relative prices are directed by intentions of central authorities. In the framework of these intentions:

— In the interest of expressing permanent social preferences, subsidization of pharmaceuticals, public transport, communal services, cultural and health services is maintained. At irregular intervals prices of these goods and services are changed as well in order, at least, to give signals to consumers about changes in costs through consumer prices. For the time being, meat, dairy-products and a part of children's clothing are still subsidized but, according to the intentions, at these products preferences will gradually be expressed by zero turnover tax. The elimination of price subsidies is obviously possible only through consumer price increases;

— At some products, partly to limit consumption, partly owing to other social interests, consumer prices are deviated from producer prices by considerable tax rates. Above ordinary turnover tax, excise tax is included in the prices of alcoholic beverages, tobacco goods, personal cars and other luxury products.

Consumer price policy is closely linked to producer price policy and, beside the two types of product groups (preferred or dispreferred), definite efforts are made to link consumer prices and producer prices by a relatively uniform, involving very few tax rates,

turnover tax system. The development of this turnover tax system is the task of the coming years, considering that, as of today, the number of turnover tax rates is rather great and, as a consequence, relative prices are unjustifiably divergent. In the 1981-1985 period the consumer price level increased by some 40 percent. This means 6, 8 percent increase p. a. on the average and within this, above increases in producer and import prices, there were also such price increases which either reduced prevailing subsidies of foodstuffs and household energy or increased turnover tax revenues levied on some consumer goods.

As for the formation of domestic prices, the fact that at the end of 1984 Hungary's parliament enacted a law on the prohibition of unfair economic activity resulted in substantial changes. This law, as a matter of fact, summarizes the rules relating to economic competition and, among others, defines cases when prices or price formation should be regarded as unlawful. For example, no commodity is allowed to be withdrawn from circulation with the aim of achieving price increase. Deceit of consumers in respect of the quality and usability of the commodity, tie-in of commodities as well as making agreements of price cartel character are forbidden. On the basis of the law a separate resolution defines those cases when the applied price should be regarded as unfair, consequently, unlawful, independently from the entity by which it has been determined. (For example, the case when economic agents violate the rules relating to the linking of domestic prices to foreign trade prices is subject to this resolution.)

Prior to 1985 it was compulsory to prepare such price calculations for domestic producer and consumer prices which were based on the detailed compilation of production costs, on general costs to be charged on individual products according to determined principles as well as on profit margin. This calculation was the subject of administrative price control. As from 1985 the obligation for preparing this type of price calculations is generally removed in the group of industrial products. The lawfulness of price formation and the documentation of information for price control are constituted by the observations of rules, mentioned above, relating to the adjustment to foreign trade prices. However, the obligation for preparing price calculations continues to be maintained in some fields where market relations are not developed enough to serve as basis of price formation.

### **Changes in the System of Taxation**

The guidelines designed to improve the tax system include significant changes, the modification to be introduced mean, in fact, a tax reform. The changes will cover taxation of enterprises as well as uniform taxation of personal incomes of the population from different sources.

The characteristic features of the tax system in effect today Hungary are as follows:

- Due to specific features of the price system, the vast majority of taxes are paid by enterprises and, apart from social security contributions, very low level of taxes burdens incomes of the population. Though personal income tax exists today, it relates only to those involved in private activities, to artists, to independent intellectual activities, accordingly, covers only small part of both the workable population and the activities.
- Until 1985 within enterprise taxes the taxation of depreciation as well as of profit played significant role.
- Turnover taxes levied on private consumption are lower than the average tax level



in OECD countries, furthermore, due to traditional reasons, considerable price subsidies are provided in a part of the consumption by the state budget. As a consequence, balance of turnover taxes and price subsidies is rather low both within total revenues and relative to GDP.

It has been deemed that it is expedient to implement such changes in Hungary's tax system through which, on the one hand, it is possible to reduce the share of taxes paid by enterprises within the total tax revenues and it is possible, in turn, to increase the role of turnover taxes realized in private consumption. On the other hand, guidelines express the endeavour that, in the course of the transformation of enterprise taxation, the present proportions between taxes on capital and on labour be shifted, accordingly, taxes on development resources i. e. taxes charged on "capital" be reduced while taxes burdening labour increase. In the framework of the program the introduction of a general taxation system of personal incomes has also been scheduled.

The directions in the transformation of the tax system mentioned above imply that both net income proportions and relative prices will be modified rather significantly. Taking into consideration that, in the short run, it is expedient to avoid major restructurings in income positions, the development program of the tax system is treated as a longer term task. In 1985 such changes were implemented which altered proportions between taxes on capital and on labour within enterprise taxation and which somewhat increased the weight of turnover taxation. The introduction of personal income taxation as well as the development of normative rates in turnover taxation are to be carried out later, in two or three years.

Changes in the tax burdens of capital and of labour were practically implemented in the following way:

—As from January 1, 1985, the taxation of depreciation is eliminated (previously industrial enterprises had to pay in 40 percent of depreciation as a tax). Furthermore, those individual taxes which were introduced in the past three years in order to safeguard that purchasing power for investments be kept within strict limits are removed as well;

—Considering that, due to the objectives of the economy to improve balance as well as limitation of consumer price changes justified by other considerations, overall tax level burdening enterprises could not be reduced in 1985. The income surplus, which could have been generated in enterprises as a result of tax reductions mentioned above, is taxed away by three new taxes: first, a 10 percent wage tax has been introduced, second, enterprises have to pay a 3 percent tax on their assets, third, expenditure on investments in a given year is burdened by a tax of business-cycle-regulatory character the rate of which in 1985 is 18 percent and which may, according to plans, be reduced in the next year.

The new general scheme of enterprise profit taxation is as follows:

—Enterprises may form reserves in optional amount out of their profit for protecting themselves against various risks emerging in the course of their activity. Prior to 1985 formation of enterprise reserves had a differentiated system, i. e. enterprises had to form several reserve funds separately depending on what purposes each fund served for. There existed separately the reserve fund against price risks which had been designed to moderate cyclical fluctuations in import prices, the reserve fund against price risks in

export sales, the compulsory general reserve fund, etc. These funds, despite all of them could practically be formed by enterprises out of profit, could not be reallocated among each other. As from January 1, 1985, the several separated reserve funds are removed, enterprises may, instead, optional share of their profit, on their own decision, for protecting themselves against business risks.

—Out of profit decreased by reserves enterprises pay municipal contribution to local councils the rate of which is 15 percent of the profit.

—On enterprise wage payments and on other payments of personal income character 10 percent wage tax is to be paid.

—The amount remaining after tax obligations mentioned above is put into such an interestedness fund which includes, beside after-tax profit, depreciation generated at enterprises and other minor allowances as well. Out of this interestedness fund enterprises pay, as presented above, tax on assets (the rate of which, again, 3 percent on enterprise assets) and a business-cycle-regulatory investment tax (the rate of which is 18 percent on investment outlays in 1985). Allowances are granted, in respect of investment tax payments, for investment programs promoted and preferred by the government, such as separate investments for savings in energy and raw materials or investments implemented with the assistance of World Bank loan.

—The regulation which sets extra limits, also by the tax system, to the increase of personal incomes paid to employees has been a specific element of Hungary's tax system since long ago. As from 1985 progressive tax has to be paid, depending on annual individual earnings, on earnings paid to employees which burdens the interestedness fund mentioned above as well.

One of the special aims of the modification of enterprise tax system in 1985 was that tax burdens of enterprises operating in different fields and different sectors of the economy become closer to each other. This could only be achieved by unambiguously separating those economic sectors which operate on the basis of profit motives from those sectors where the general profit interests, owing to objective reasons, cannot function. Enterprises belonging to this latter group are usually public utility companies where profit interests appear, first of all, in rational cost management. Thus these are such organizations which are obliged to operate and to provide services, and to meet demands does not depend, first of all, on economic considerations. In this sphere prices are usually low, and in most cases there is no such organization which could supply alternative goods or provide alternative services. Organizations involved in this type of activities are communal, public utility companies (performing activities in real estate maintenance, water economy, heat supply, undertaking, etc.), public transport enterprises, a part of institutions providing health and cultural services as well as, regarding traditional services, the post.

These public utility companies are granted several tax allowances compared to the general scheme: they do not pay municipal contribution (considering that activities of these enterprises are financed mainly by councils), they, furthermore, do not pay either tax on enterprise assets or investment tax, and the rate of the general profit tax is only 10 percent.

### Changes in the Instruments of Monetary Policy and Financial Intermediation

During the past years in the mechanism promoting the flow of financial resources among enterprises several such changes happened in Hungary which provide favourable conditions for establishing or spreading the initial elements of capital market. Among the changes the possibility is remarkable according to which enterprises may, temporarily or finally, lend their available financial resources, otherwise destined for their own investment, to other enterprises either inside or outside the frameworks of various associations. For about three years such a mechanism has been in effect which makes both the lender and the borrower be interested in reallocation as interest rates may be subject to inter-enterprise agreement; lending of capital may take place against rent as well; there is a possibility for the lender to receive share from the profit of a business involved capital transfer.

For nearly three years there has been possibility to issue bonds which have, so far, contributed to the obtainment of financial resources necessary for investments first of all in the communal sphere. Bonds issued to finance investments aiming at meeting public communal demands (e. g. gas supply, construction of watermains, telephone network) may be purchased by the population. Bonds issued by productive enterprises may not be subscribed by individuals. The state, in the form of capital allocation, may take part, also directly, in financing investments, first of all in those fields where the investment is in the interest of the national economy but the enterprise which would implement it is not creditworthy. (Capital allocation may make the enterprise concerned creditworthy.) Such fields may be, for example, coal mining, building of power stations, etc.

As in Hungary the most important instrument of capital reallocation is credit, analyses of the economic management have been directed, first of all, to how the credit system can further be improved. The assumption is that the credit system will function, in the future, under such conditions in which commodity and money relations will play greater role in the control of economic activities. It is also assumed that, in line with the development of the set of monetary instruments, financial and credit policy may have greater and more autonomous scope of activity in the future. Both banks and enterprises will have greater possibilities in the organization and arrangement of capital flows aiming at profitable investments. According to plans, central bank regulation will strengthen in the control of money supply and credit granting on business principles may gradually develop, and banking system may change accordingly.

The credit system remained basically unchanged in January, 1985, but during the year the introduction of such changes is expected which represent important steps for accelerating the implementation of the elaborated concept.

One of these changes is the introduction of commercial credit and, as its instrument, of commercial bills. This is because prevailing commercial crediting has proved to be rigid, involved superfluous cash flows and loosened financial discipline. Application of commercial credit makes it possible that enterprises, cooperatives and individuals performing economic activity, having mutual connections, may grant commercial credit to each other on the charge of any available financial resources. The source of commercial credit, thus, may be any financial resources arranged in a lawful way. The refinancing bank judges whether the guarantee to repay the commercial credit is sufficient or not, in other words,



refinancing depends on the creditworthiness of the borrower organization.

It is obvious that the interest charged on refinancing will regulate the interest rate applied between the participants. The regulation of commercial bills is based on the internationally accepted strict rules of commercial bill legislation. Application of commercial bills is further encouraged by a rule according to which the enterprise draws some 0.5 percent interest benefit if the commercial bill is purchased by the bank, compared to the case when it takes refinancing credit to refinance commercial credit it has granted.

The so-called current account crediting is to be introduced in Hungary in this year as well. Experiences prove that economic activities cannot be arranged in a way that revenues and expenditures be in equilibrium at any time even in well-organized enterprises. Therefore enterprises need a minimal financial (liquidity) reserve in order that short term but inevitable inequilibrium of revenues and expenditures can be bridged. This task has also been treated by short-term crediting up to now but the proposed current account crediting is more flexible and planful. It means that for perfectly creditworthy enterprises the bank provides, on the basis of credit agreement, such a current account credit within the limits of which enterprises are allowed to effect payments falling due without applying for individual loan at the bank. Thus, current account credit, up to the contracted amount and within the contracted term, may be used and repaid variably from day to day. This possibility ensures that the actual credit stock of an enterprise is, at any time, in line with its demand for money, provided, of course, that creditworthiness of the given enterprise is not questioned in the meantime. Agreement on current account credit can be made for a period not exceeding one year and, if there is no change in creditworthiness, it can be renewed. After the prevailing debt the interest to be paid equals that charged on other short-term debts.

The declared concept of the further development of the economic management system takes into consideration that increasing the role of monetary policy necessarily implies the development of the banking system. The development of the banking system is a gradual process. In the first step the departments performing issuing bank functions and commercial bank functions will be separately organized within the organizational frameworks of the National Bank of Hungary and, in line with this, the central bank regulation and control of the other existing financial institutions will be developed. (This plan is to be realized within 2 years.)

Objectives of the central bank regulation will be interpreted by the credit policy guidelines approved by the government in the future as well. These guidelines contain obligatory rules for the National Bank of Hungary which have to be enforced through the regulation of the operations of both its own commercial banking departments and the other financial institutions. Central bank rules should regulate the issue of purchasing power realized through crediting. Instruments of central bank regulation will be interest rate policy, refinancing policy as well as the system of compulsory reserves.

### **The Development in Direction and Management of State Enterprises**

Analyses of the economic management system have proved that the idea which treats the uniform management in relation to the planning system, the economic regulatory system (i. e. price, monetary and fiscal regulation) as well as the organizational structure

of enterprises is appropriate from a theoretical point of view.

In the agriculture the organizational structure and the management system of the economic units have substantially be transformed for the last two decades. Modern management and organizational forms have been developed which can serve as a basis for the integration and intensive development of the Hungarian agriculture. At the same time, a conceptional problem has remained in industry and in construction industry the solution of which is planned in the second half of the eighties. The basic situation, namely, is as follows: In the direction up till now the capital concentration process required by adequate enterprise operation has been necessarily accompanied by changes resulting in the centralization of the enterprise organization. This was due to several reasons: on the one hand, there were no adequate instruments to create sufficient interestedness in capital flows among enterprises, on the other hand, it was recognized only in the recent past that if enterprises want to maintain their position in international markets, then the concrete development of the enterprise organization should be supported by adequate capital flows as well as by such an organizational structure which provides comparative advantages and which, consequently, results in optimal unit size.

As mentioned earlier, initial forms and instruments of inter-enterprise capital flows have been developed and, in line with this, such new enterprise forms have been established in the economy (affiliates, small-scale enterprises, joint ventures, etc.) which attempt to adjust organizational frameworks to the rational operation. In spite of these developments, enterprise structure in several branches of industry and construction industry is characterized by excessive organizational centralization even today.

The proposed changes, as from 1985, modify the connections between economic management institutions (basically branch ministries) and enterprise management in order to solve the conceptional problem mentioned above and, on the other hand, bring about changes in enterprise management structure in order that enterprise management disposes of all such rights which are necessary to make venture-like decisions. As proposals stipulate, in the so-called competitive sector covering the vast majority of enterprises such new enterprise management forms are to be developed in which the so-called "owner's decision-making" relating to the administration of state property (which is to become the responsibility of the enterprise management) will be unambiguously separated from the activities to be performed by state economic management. As from 1985, in the state enterprise category the majority of enterprises are to be transformed, within about two years, to one of the following two new enterprise management forms:

1. In the majority of enterprises so-called enterprise councils will be formed and these councils will be those collective bodies which make strategic decisions for the enterprises. In the councils the representatives of the enterprise management and the elected delegates of the employees will take part. Enterprise managing directors are also members in the councils but employer's rights over them are exercised by the enterprise council. (Earlier this task was performed by the branch minister.) The enterprise managing director continuously directs the enterprise on behalf of the enterprise council, and making of operative decisions necessary to realize the enterprise plan will be the right and responsibility of the managing director in the future as well. The number of staff in enterprise council as well as proportions of representation is determined by the organizational and operational rules

of the given enterprise but legislation specifies some compulsory rules relating to the principles. Such a rule is, for example, that the upper limit of enterprise council staff is 50, 50 percent of the members should be elected from representatives of the employees, and one third of those represent the enterprise management may be nominated by the managing director.

The scope of decision-making authority of the enterprise council is as follows:

- the determination of the enterprise plan;
- the statement of the enterprise balance sheet, and the approval of the record on profit;
- the making of major decisions concerning investments, borrowings, bond-issues as well as lending or taking over of organizational units of the enterprise;
- decision-makings concerning the transformation of an enterprise unit to an independent enterprise, the foundation of an affiliate as well as the participation in joint venture or in association; decisions concerning the splitting of the enterprise or the cooperation with other enterprises;
- the determination of the organizational and operational rules of the enterprise;
- the determination of principles concerning the distribution of enterprise incomes;
- the nomination or dismissal of the managing director as well as the appraisal of his performance.

(Enterprise council meetings are chaired by a president elected from the council members. The enterprise managing director cannot be elected for presidency of the council.)

2. In case of smaller enterprises such a new form will be developed in which a self-management system, existing already in cooperatives, is practically applied. In the framework of this, legislation delegates the right of general enterprise management to the collective as a whole and, as a matter of fact, it is the general assembly which exercises strategic decision-making presented above in connection with enterprise councils. Legislation does not define exact staff limits in the application of this form of enterprise management but experiences so far suggest that those smaller enterprises can be efficiently managed in this form where the enterprise activity as a whole can be overviewed by the majority of the collective and the inner organization and management system of the enterprise make it possible that employees can directly take part in the enterprise management. The assembly elects a board as well, and the regulation of the board's operation and scope of activity in details is also determined by the assembly. However, the assembly may not delegate the most important decision rights to the board but the board disposes of all those operative decision rights which are necessary for the continuous operation of the enterprise.

In a part of state enterprises the existing enterprise direction and management forms will continue to be maintained. In such large enterprises or trusts which dispose of several plants and employ some thousands (or some ten thousands) of workers strategic decision-making is basically the authority of a managing board usually consisting of managing directors of the enterprises of plants which belong to the given large enterprise or trust. Over managing directors of trusts or large enterprises maintained in their original forms the so-called employer's rights are exercised by the branch minister in the future as well.

In this enterprise category the present supervisory system of enterprises will virtually remain unchanged which provides possibility, on the basis of "owner's right," for the



founder to influence enterprise operation concerning both the changing of basic profile and the organizational transformation of the enterprise. The intervention of the founder institution (ministry or local council) into the enterprise operation depends on what sort of activity the given enterprise performs. It is obvious that in the category of public utility companies as well as in case of mining and energy-producing enterprises being of special importance from the point of view of the whole national economy the scope of profit-oriented operation is limited, thus in these enterprises the stricter control of the authorities is justified. In those enterprises which belong to the traditional management form further on as well but, otherwise, perform market-oriented activities, founder institutions do not intervene into the business and market policy of the enterprise but employer's rights over the managing director are reserved by them, and in case of organizational changes founder institutions have veto right and right of opinion.

The changes in the enterprise management system, characterized briefly above, limit the directive licences of the central authorities against the enterprises. The intention is that definitely more favourable conditions be created in this way for independent, market-oriented enterprise operation. In line with the establishment of the new enterprise management forms, the central management and supervision is to be maintained in the following way:

1. Over state enterprises ministries or local councils exercise a so-called legality supervision. Through the legality supervision authorities control whether the operation of enterprises and the resolutions of enterprise councils are in line with legal rules or not. Accordingly, the legality supervision does not include the examination and control of economic decisions or the enterprise management. If, in the framework of legality supervision, it is recognized that decisions of the enterprise are unlawful, then the legality supervisory organ first requests enterprise management bodies to modify their unlawful resolutions but ultimately it is authorised to suspend the managing director as well, furthermore, it may make proposal of the abolition of the enterprise in the prevailing form. Against the resolution of the legality supervisory organ the enterprise may, in line with legal rules of administrative procedures, resort to legal redress or, provided that the organizational and operational rules of the enterprise were deemed unlawful by the legality supervisory organ, it may turn to court for having them revised.

2. In respect of enterprises functioning under the system of the traditional central management, the supervision and control performed by the founder institution are maintained further on. In the framework of these the founder institution controls the implementation of government resolutions relating to the given sphere, comprehensively appraises and controls the activities of enterprises and those of managing directors.

3. In the last decade one of the key problems of the enterprise operation was that in certain cases central authorities were authorised to give orders to enterprises for particular activities. In the new situation this question is particularly important. The following principles are to be enforced:

—It is not consistent with a venture-like independent enterprise operation, if authorities intervene into the operational process in a way that the risk of their decisions and the subsequent responsibility are borne not by the authorities but by the enterprises;

—On the other hand, the state has to reserve, in the future as well, the possibility to intervene into the enterprise operation also through individual orders, with regard to

national economic interests, in exceptional cases, in order to divert serious market disturbances.

Taking into consideration this double requirement, rules stipulate that state enterprises may be given orders for certain activities in the following cases:

—In case of serious market disturbances stemming from unforeseeable events individual order may be given to enterprises for the production of certain products. Similarly, individual order may be given for meeting the demands of certain consumers, for keeping the level of stocks at minimum, in order that disturbances can be diverted as soon, and at as low cost, as possible;

—The head of the founder institution is authorised to give individual orders to any enterprise for solving tasks in defence;

—Individual order may also be given for the fulfilment of international contracts.

The execution of orders aiming at certain economic activities implies, in most cases, financial losses in respect of enterprises concerned. Legal rules stipulate that these losses have to be compensated compulsorily by the institution having issued the order. This obligation is not valid only in that case when, with regard to the significance of the exceptional situation, the issue of order has been commanded by the Council of Ministers. The compensation covers the depreciation in enterprise assets, the lost benefit as well as all expenses needed for the elimination of damages.

As it was pointed out in the previous sections of this paper, the conceptional development of the economic mechanism consists of the set of such measures which are to be introduced in the 1985–1988 period. In some fields the intended changes are of such character which can be arranged as continuous modifications, for example, the market price system will be spread depending on the success of the improvement of demand and supply conditions in connection with the external balance of the economy. Another part of the proposals necessarily represents such changes by which new elements get into the instrument set of the economic mechanism. These can be the new elements of financial intermediation but, for example, the introduction of personal income taxation is considered in a similar way as well.

The transformation of the banking system as well as the organization of enterprises will need some years, too. The changes are intended to be implemented in such a way that the organizational transformation lead to no break in the operation of the economy but, at the same time, those selection criteria which are applicable as general norms in the control of money supply of the economy as well as in business-like crediting start functioning, and an up-to-date enterprise management and organizational structure be gradually developed.

(National Office for Materials and Prices, Hungary)