

Facts and Lessons of Ten Years of System Transformation  
In Central European Countries

**Presented to the ICSEAD Workshop on Transition Economies:  
Comparison of Transition in Central-Eastern Europe and East Asia**

By

Tsuneo MORITA

Nomura Research Institute

Budapest

International Center for the Study of East Asian Development  
30-31<sup>st</sup> March, 2000, Kitakyushu City, Japan

The views expressed in this paper are those of the author and not those of the institution to which the author belongs.

Ten years have passed since the start of system transformation in Central Europe. This provides a very good opportunity to examine the history of these years and establish typical facts and learn lessons from in depth deliberate examinations. So long as the transformation concerns the whole of society, our argumentation encompasses the economic system, the political system and social norms. In order to obtain comprehensive understanding of system transformation, we need to draw from a wide range of analysis, and therefore the approach should be that of political economy.

## **1. Transformation or Transition? : From Where to Where?**

### **1.1 Transformation or Transition?**

There does not seem to be an essential difference in meaning between transformation and transition. However, while transition suggests a movement or a slide from one state to another state, transformation implies a fundamental change in system and paradigm to change itself into an essentially different substance. The usage of the word itself shows the way of approaching the problem concerned, irrespective of whether the actual movement or change is difficult or not. If one takes the movement or change not to be as fundamental, then one may use the word transition, and if one takes it as fundamental, then one may use the word transformation.

The contemporary change of the social system has been brought about a very fundamental change of society, which cannot be described as a simple movement from one state to another. This is why I prefer the term transformation to transition.

### **1.2 From Where to Where?**

#### **A. from Socialism to Capitalism?**

In some sense yes, but not for society as a whole. Many people take it for granted that the transformation or transition simply means a switch from socialist economy to capitalist economy. However, this is too much of a simplified and superficial viewpoint when observing contemporary system transformation. As was also the case under socialist economy, there has never been a genuine capitalist economy in the world for more than the two hundred years of its history. Indeed, there are many mixed economies with various high redistribution ratios in Europe. In some sense the welfare states of the United Kingdom and the Scandinavian countries possess more socialist features than those in former socialist countries. This is an irony of history.

If we believe that the transformation is towards capitalism, then we ought to look at what kind of capitalism has been constructed in these countries.

Do you think that the Russian economy in its present form is capitalist or another type of economy?

Do you think that a voucher-privatized economy is in itself already a market economy?

It may make sense to use the term “capitalist” in a symbolic sense so as to describe the emergence of capitalistic spirit in the economy, but it does not necessarily mean that the economy to be transformed will become a capitalist one.

### **B. From Socialist to Market?**

Some authors use this type of expression. However, the two concepts compared are not part of the same dimension, and therefore are not close enough for comparison and contrast. It may help to show the ideological distortion in so-called socialist economies, and thus, the contrast shows the transformation from politically distorted economy to non-politically organized economy. However, the contrast itself is not precise in an analytical sense.

### **C. From Planning to Market?**

Although this contrast is right in the sense that the two concepts are in the same dimension, and are therefore properly used in publications of international organizations, nevertheless we should recognize that any workable planning systems did not exist in ex-socialist economies. Therefore, this pair of concepts is not sufficient to describe the essence of the transformation. Besides, it is important to understand that the pair contrasted show more of an institutional working of economy, and less of fundamental economic activity.

### **D. From Redistribution to Exchange?**

As I propose in the book *Economics of System Transformation* (published in Japanese, 1994), we must understand the contemporary transformation more deeply. The two concepts I propose in system transformation are from redistribution to exchange. While the planning to market approach shows the institutional working of the economy, redistribution to exchange represents the essential change in the most fundamental economic activity. If we understand the contemporary transformation as the fundamental movement of human economic activity from the 20<sup>th</sup> century and 21<sup>st</sup> century, then we ought to deeply reconsider what essential changes are going on regarding human economic activities. In this sense redistribution and exchange provide us deep understanding of the transformation in our age.

## **2. The Need for Fundamental Conceptualization of Transformation**

### **2.1 Asymmetry of Transformation**

Many economists considered early in the 1990's that "market revolution" could be achieved in a relatively short period as was the "socialist revolution". There was and has been widespread misunderstanding of transformation in our age. The two transformations are entirely asymmetrical both in terms of time span and complexity.

The historical socialist revolutions were first and foremost political movements and therefore accomplished in a relatively short period of time as far as political control of society is concerned. They resulted in political regulation and control of national economy, which was placed under the name of planning, but as a matter of fact was just simplification of economic functioning. In this sense every socialist revolution resulted in a simplification of economic control by means of the direct redistribution of economic goods. Therefore, I have described the transformation from complexity to simplicity, which can really be done in a relatively short time.

Compared to this, transformation from direct control to market control needs a tremendous amount of time for economic participants to adapt to it, and cannot be accomplished within a short period. Natural law tells us that evolution from a simple state to a complex state takes a great deal of time, but a degeneration or an inverse movement can come about in a relatively short time by losing its adaptation power and endeavor for promotion and development.

Thus, the asymmetry of the two types of transformation is essential for understanding contemporary transformation. I have to say that there is no miracle path or road to revolutionarily shorten the long-lasting process of the transformation. This is the main reason for my rejection to the contrast between shock therapy and gradualism, which I will discuss later.

### **2.2 Social Moments of Exchange and Redistribution**

Complexity and simplicity in economic and social behavior depends on the social moments of fundamental human activity. The redistribution activity of socialist economies has resulted in continuing degeneration of human activities and finally destroyed the whole of society itself. The self-destruction, as a result of the long-term degeneration process, can be attributed to its fundamental economic activity, i.e. redistribution.

On the other hand, where exchange activity is vital to the economy and society, even where the state redistribution ratio is high, the economy and society shows dynamic development and vitality, which are entirely lost in redistribution society.

Therefore, we should examine why the two different activities bring about a totally different result in society and economy. The summary of the comparison is shown in the Table 1.

First, while exchange is a dual and bilateral activity, redistribution is almost a one-way and unilateral activity. From these characteristics the nature of communication is also entirely different. The communication involved in exchange is informational and anonymous, information of which can be transmitted as an universal message equally to all participants. On the contrary, communication involved in redistribution is physical and transmitted through personal channels to a specified organ or person via a specified physical unit.

**Table 1 Comparison of Social Moments between the Two Activities**

Social Moments	Basic Economic Activity	
	Exchange	Redistribution
1. Nature of communication	Informational and bilateral	Physical and unilateral
2. Institutionalization	self-organizing market system	Bureaucratization
3. Personal relationship	Depersonalization-civilization	Personalization-decivilization
4. Organization	openness and transparency	Closeness and secret
5. Social behavior	Independence and self-responsibility	Dependence on authority
6. Complexity	Continuously increasing	Degeneration into simplicity
7. Self-development	Autonomic and continuous	Destructing and –deteriorating

**Notes:** (1) A moment is a driving factor for autonomous developments in a positive or a negative direction which exists at each stage of basic exchange and redistribution behavior.  
 (2) Nowadays, every national economy consists of the two main economic activities: exchange and redistribution. The question is how the mixture of the two is composed in a given economy. The socialist economies were exclusively organized based on the redistribution principle, where almost 70-80 % of GDP was centrally redistributed. On the contrary, so-called capitalist economies largely introduced the redistribution principle after the Second World War, and thus various mixtures of the two combinations have been experimented with, which leads to the success of the further Development of national economies. The self-collapse of the socialist economy can be explained by its inner moments which degenerate and destruct economy and society.

Second, while exchange autonomously organizes market equipment, redistribution needs bureaucratic organization. The autonomous market organization can change itself and adapt to new surroundings for further development. However, bureaucratic organization cannot flexibly adjust to new environments.

Third, while exchange liberates personal interdependence due to the universality of information, redistribution presupposes some kind of subjective personal obedience to organization.

Depersonalization under exchange has resulted in civilization, and personalization in redistribution resulting in maintaining feudalistic human relationship and de-civilization.

Fourth, a market constitution is easily changed if it does not succeed in developing exchange activity. The rules of exchange are transparent and open to all participants. On the other hand, bureaucracy aims to maintain its organization at any cost and is very closed to the outside world; information is not fully open and available to participants.

Five, while exchange promotes independent personal activity with self-responsibility, redistribution enforces obedience and dependence on the authority which results in loss of self-responsibility.

Six, exchange increases complexity of activity through many-fold autonomous developments. On the other hand, redistribution tends to be more and more simple, thus decreasing the complexity of human activity itself.

Seven, exchange promotes the continuous development of organization and individuals through autonomous adaptations. On the other hand, redistribution limits the development of organizations and individuals, or rather degenerates human possibilities, and therefore it is self-destructing.

### **2.3 Why did the Redistribution-Dominated System collapse?**

#### **A. The Initial Moment: “Political decisions surpassed rationality”**

As has already been described, where the redistribution system dominates, economic decisions are carried out not on the basis of rational economic calculation, but on the basis of political judgements and decisions. It is a well-known fact that the leaders of the communist party possessed stronger decision making power within companies than managers. Not only in the micro economy, but also in the macro economy, the superiority of politics over economically rational considerations prevailed as the fundamental rule in the former socialist countries.

Economic rationality was always subordinated to political decisions, which heavily distorted the rational development and the structure of national economy, and the distortions accumulated during its long history caused the self-inflicted collapse of the system.

#### **B. The Second Consequence: “Subordination to the authorities suppressed individual initiatives”**

Redistribution stimulates and strengthens the vertical relationship of companies to the authorities, and it was also in the interests of the authorities to severely limit voluntary exchange for the sake of keeping their own power intact. Thus, voluntary and individual initiatives for promoting horizontal relationships among companies were punished and banned, resulting in the entire contraction of exchange activities. The contraction of the activity level of people, which was accelerated by political suppression, continuously decreased the level of activity of the national economy and kept it in long-term stagnation.

### **C. The Inevitable Result: “Simplicity overcame complexity, leading to degeneration”**

The planning of redistribution demands intense calculation which cannot be accomplished by even the most advanced of computer systems. Nevertheless, the Soviet Union attempted to plan the activity of its national economy by using manual calculations, which soon degenerated to merely setting routine rules of distribution of materials and products. Furthermore, the planning of the national economy never actually existed in the strictest sense in any of the so-called planned economies, and what really existed were routine rules and political decisions affecting redistribution, which made it possible to simplify the planning process into mere routine work. Thus, the impossibility of planning makes inevitable the simplification of the planning process: simplicity overcame complexity. Divergence from complexity to simplicity began, which continuously degenerated the people and society concerned.

### **D. The Final Consequence: “Degeneration of the society resulted in divergence from civilization, and the divergence finally brought about the self-inflicted collapse of society”**

Excluding rationality, obedience to the authorities and the simplification of economic rules continuously degenerated society from civilization. The degeneration of society prevailed in every form of social activity from economic activity through the legal framework to social normative. People handed all decision making power over to the authorities, and people as the “guided mass” simply obeyed the authorities by giving up their individual initiatives. For the majority, it may be easy to simply obey the authorities and adjust to a passive way of life providing daily life is guaranteed. This in turn has continuous effect of making people lazier and more ignorant, thus further degenerating people and diverging society from civilization.

## **2.4 The Transformation Task:Reconfirmation**

The task of transformation is to work out how it is possible to transform an economy from redistribution dominated to exchange dominated. This is the fundamental and deeply-rooted problem facing transforming countries. Although the task is executed through the liberation of human power and individual initiatives, which were suppressed in the previous regime, the establishment of a civilized exchange-based society is by no means straightforward.

When we observe GDP redistribution data, it could be said that Central European countries are already becoming exchange-based economies, at least in a macro-economic sense. Redistribution as a percentage of GDP in Central European countries has been continuously decreasing since the beginning of transformation, and 1998’s rate was already well below the average of the EU 15. The rate appears to

be decreasing further when we take into account the tendencies of the lesser developed EU countries such as Portugal and Greece, since transforming countries require a more deeply cultivated domestic market for expansion and this makes necessary the lowering of tax burdens.

**Table 2 Comparison of Tax Structure and Size of Redistribution(Percent of GDP,1998)**

	A. Direct Tax	B. Indirect Tax	C. Contribution to Social Security	A+B+C Redistribution Rate
Hungary	10.1	14.9	14.1	39.1
Poland	13.1	14.0	12.9	40.0
Czech Re.	9.5	12.0	16.9	38.4
CE average	10.9	13.6	14.6	39.2
Germany	10.2	12.6	19.6	42.4
Sweden	24.1	16.6	15.1	55.8
Great Britain	16.6	14.9	7.8	39.3
Portugal	10.3	14.8	12.1	37.2
Greece	8.3	15.0	12.8	36.1
Ireland	13.6	14.1	4.0	31.7
EU 15 average	13.7	14.4	15.2	43.3
USA	14.8	6.8	9.1	30.7
Japan	9.1	8.3	11.0	28.4

Source: Based on OECD data.

In spite of the macro-economic facts, the actual deepening of the market economy is a long way from being accomplished. When we observe the micro-economic process, for example by focusing on the income redistribution of inhabitants, an entirely different picture is depicted.

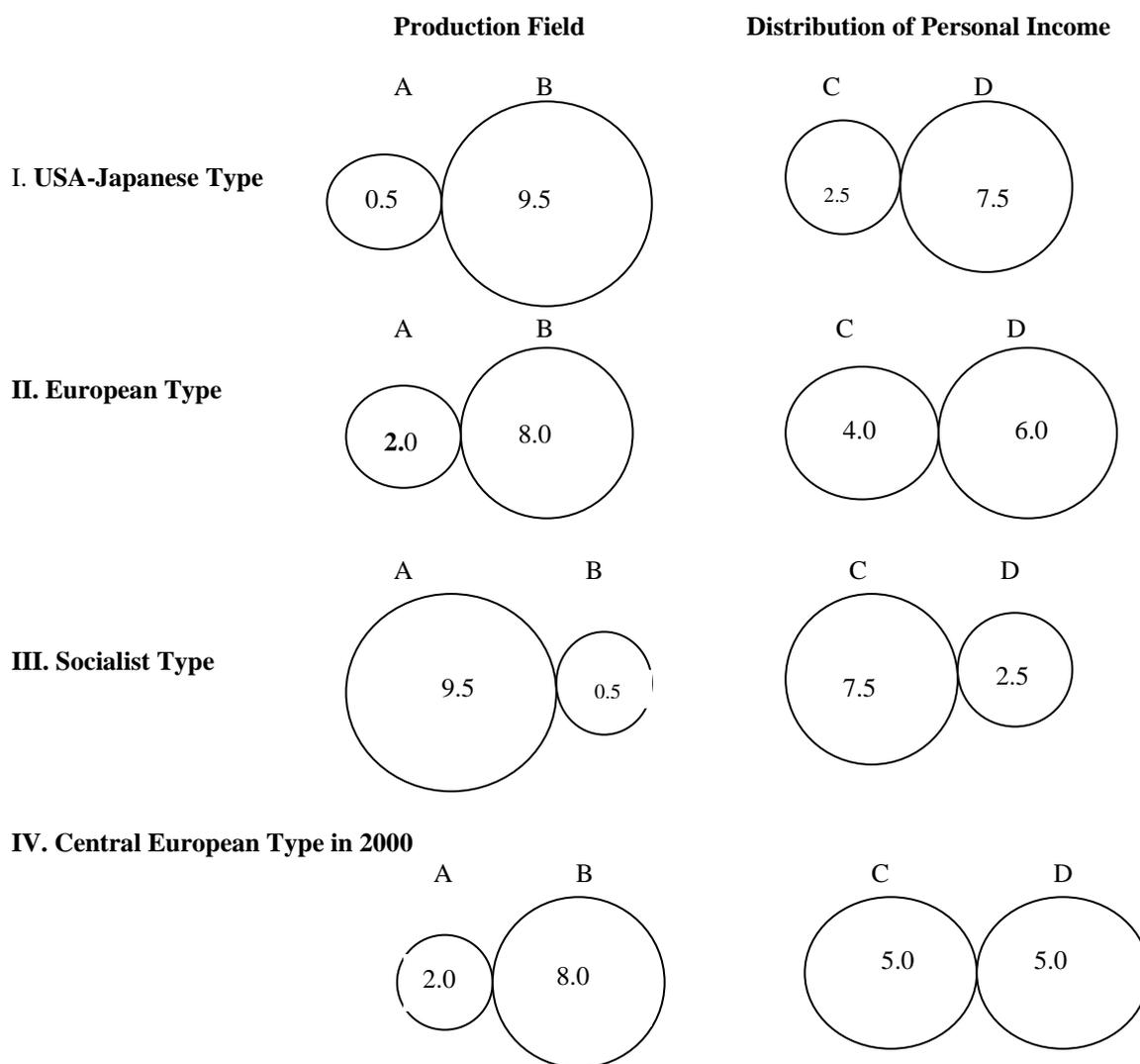
One might expect that the tax burden of personal income is very low in Central European countries, as is shown in Table 3, which seems to accurately describe the decreasing tendency of the income redistribution rate in Table 2. If the highest rate of income tax is only 40%, it is in fact very low when compared to developed countries. If this is the case, then the Central European countries are already at the level of developed market economy, with respect to income redistribution.

However, if the highest tax rate is applied to almost all incomes, then the tax burden is actually very heavy ( as it was under the socialist regime). In Hungary, 20% income tax must be paid by those earning the minimum wage and almost everyone except unskilled workers soon reaches the highest rate if they earn 4000 US dollars annually (not monthly). On top of this, inhabitants have to pay 25% VAT and local government tax out of the remaining income. Thus, roughly calculating, the total tax burden for inhabitants in Central European countries exceeds 50% of their personal income.

**Table 3 Tax Rates in Central Europe in 1999 (%)**

	Hungary	Poland	Czech Republic
Standard Rate of VAT	25	22	22
Corporate Tax	18	34	35
The Highest Rate of Personal Income Tax	42	40	40

Source: Based on OECD data.



**Figure 1 Comparison of Structures in Production and Income Distribution**

Remarks: A and B represent the weight of state-public enterprise and private enterprise respectively. C and D show the distribution of personal income between the portion paid to the public budget and the remaining portion available to inhabitants.

The paradox between the heavy tax burden of inhabitants and the low redistribution rate measured by GDP can be put down to the inefficient collection of corporation tax, which has resulted in the distorted income and tax structure. The paradox can be universally observed in the transforming countries after ten years of transformation. At the same time, it explains the slowness in domestic market expansion. Figure 1 illustrates a rough comparison in the structure of production and income distribution among the main types of economic systems.

The heavy tax burden on inhabitants in transforming countries is explained by the fact that many state and public institutions still operate without any fundamental reforms having been implemented even after ten years of system transformation. A huge amount of money is wasted maintaining inefficient public

services, which is also a waste of human resources, and this leads to the irrational tax burden on inhabitants and stagnation in deepening and expanding the market economy.

If the analysis described so far is correct, then the task for the second stage of transformation in the next decade will be to carry out fundamental reforms in the state and public services, which require a change in the structure of tax and income of inhabitants. From the standpoint of economic development, the transformation to exchange-dominated economy has so far been half achieved.

Moreover we should not forget that the transformation is not confined to just an economic sense. As described, the transformation task encompasses everything from the economic system to the social normative, the latter of which calls for the recovery or creation of civilized civil rules and behavior, which were isolated and neglected under the old regime. It takes at least one generation to establish a civilized social normative: social discipline, social justice and working moral.

### **3. False Criterion: Shock Therapy VS Gradualism**

In the first half of the 1990's, especially soon after the separation of Czecho-Slovakia, IMF economists praised the voucher privatization in the Czech Republic as a radical policy following Polish shock therapy in early 1990. At the same time, they criticized Hungarian privatization as being slow gradualism which was showed its reluctance to radical reforms towards market economy. Thereafter, the comparison between thock therapy and gradualism has been a popular criterion in judging the advancement of economic reform for the marketization of the economy in transforming countries.

As is widely known, Polish shock therapy was introduced to drastically bring down the hyper-inflation caused by shocks from the collapse of the old system. In this sense the Polish case was relevant only for a country which encountered the same type of transformation shocks in the early stages of the transformation. However, the Polish case is not relevant in the case of Hungary and even not for Czecho- Slovakia where the initial shock of the transformation was mild compared to other countries.

Radical policy followers misunderstand the nature of contemporary transformation, i.e. the asymmetry of the transformations. You can set up laws institutionally necessary for the working of a market economy without the existence of workable market economy. Legal legislation in itself does not produce market economy. \*

\* One example of this; in Hungary you have to obtain a green card to use a personal car which verifies the level of gas emission. However, in certain places you can receive it even without the car being tested, and that explains the continued use of environmentally damaging cars. But, if the government severely enforces the legal rule, then many cars are forced off the road. This example teaches us that legal rules by themselves do not have the power to change reality.

The transformation from redistribution to exchange is that from simplicity to complexity, which takes a tremendous amount of time for its completion, the change itself is evolution and not just movement from one platform to another platform. It is impossible to change the economy of redistribution to the economy of exchange in a short time. I would say it will take a generation at least, and there exists no royal short-cut to the transformation.

Nowadays discussion about shock therapy and gradualism has been subsiding, because the praised Czech approach of voucher privatization has been showing signs of failure which clearly verifies my theories described above.

#### **4. Voucher was Virtual: no “Royal Road” to Privatization**

After appraisal and recommendation by international organizations and also due to necessity, which I will explain below, almost all transforming countries have been trying to follow the Czech and Slovak’s miracle of voucher privatization. However, there has been no miracle anywhere at all.

There are two ways to carry out privatization in terms of capital origin: one is by domestic capital and the other by foreign capital. Except in the case of the Czech Republic, there was not enough domestic capital accumulation for domestic privatization in transforming countries in the early 90’s. Therefore, there was actually no choice regarding the privatization methods, when insufficient foreign capital inflow was expected, but just to distribute national assets among domestic people and wait for emerging new domestic entrepreneurs to emerge. This explains the widespread use of voucher privatization.

Here we should consider what privatization actually is? IMF has urged that any kind of privatization is preferable to state ownership, and was an active supporter of voucher privatization. However, this has the same problem as the green card in Hungary. Voucher methods possess no magic at all. An elaborate framework does not substitute for reality and substance.

By privatization we expect essential changes to capital power, management and technology. The change of management may push a first step towards reform of company and if the new managers are capable enough, then they can manage to accumulate capital and thus, to bring new technologies to a company. This is a very ideal view of privatization. The question is where you can find competent managers from the old regime, and from where and how you can obtain capital to develop your company with the introduction of new technology?

This is the *aporia*(unsolvable contradiction) of privatization. As long as you cannot break through the *aporia*, there is no miracle at all in voucher privatization.

Even the Czech Republic, where the conditions for self-privatization were favorable, is suffering from an awfully distorted market system, which resulted from voucher privatization. Czechs are now reprivatizing companies which were once privatized through voucher methods. Then, what was voucher privatization? The answer should be that it was virtual. The Czech miracle has faded away.

The Czech example shows us clearly that there is no “royal road” or short-cut to system transformation from redistribution to exchange, because evolution is really a historical process which no one can jump through in a moment.

**Table 4 Mass Privatization Programs in Central and Eastern Europe and the CIS Countries**

Country	Year voucher distribution began	All shares issued in waves or continuously?	Are vouchers bearer, tradable or nontradable?	Is investment in funds allowed, encouraged or compulsory?
Albania	1995	Continuously	Bearer	Encouraged <sup>1</sup>
Armenia	1994	Continuously	Bearer	Allowed <sup>2</sup>
Bulgaria	1995	Waves	Nontradable	Encouraged
Czech Rep.	1992	Waves	Nontradable	Encouraged
Estonia	1993	Continuously	Tradable <sup>4</sup>	Allowed <sup>5</sup>
Georgia	1995	Continuously	Tradable	Allowed <sup>2</sup>
Kazakhstan	1994	Waves	Nontradable	Compulsory
Kyrgyzstan	1994	Continuously	Bearer	Allowed <sup>6</sup>
Latvia	1994	Continuously	Tradable	Allowed <sup>5</sup>
Lithuania	1993	Continuously	Nontradable	Allowed <sup>5</sup>
Moldova	1994	Waves <sup>7</sup>	Nontradable	Encouraged
Poland	1995	Waves	Tradable	Compulsory
Romania <sup>8</sup>	1992	Continuously	Bearer	Compulsory <sup>9</sup>
Romania	1995	Waves	Nontradable <sup>10</sup>	Allowed
Russia	1992	Continuously	Bearer	Encouraged
Slovakia	1992	Waves	Nontradable	Encouraged
Slovenia	1994	Continuously	Nontradable	Allowed
Ukraine	1995	Continuously	Nontradable	Allowed

**Note:**

<sup>1</sup> By July 1996 only one or two funds had applied to receive vouchers.

<sup>2</sup> Although a legal entitlement exists to invest vouchers in funds, in practice this option was limited.

<sup>3</sup> The results of the first voucher auction were cancelled in March 1995, and fund licenses were suspended from then until August 1996.

<sup>4</sup> Vouchers were nontradable at the outset of the programme, but cash trading was legalised in the spring of 1994.

<sup>5</sup> Citizens could also exchange vouchers for other things such as apartments or land.

<sup>6</sup> Citizens could invest their vouchers in housing as well as here. They can sell their vouchers to funds, but no formal mechanism exists for them to subscribe to funds.

<sup>7</sup> Although the design of the Moldavian program was based on the offer of companies in waves, the waves were small in the early stages, and thus had many of the characteristics of a continuous issue.

<sup>8</sup> In 1991 Romania introduced a scheme based on the distribution of certificates of ownership in five private ownership funds. In 1995 a supplementary mass privatisation programme was introduced involving the distribution of coupons that could be exchanged for company shares or fund shares, after which the funds are to be transformed into financial investment companies.

<sup>9</sup> Under certain circumstances certificates of ownership in funds could be exchanged for company shares.

<sup>10</sup> Certificates of Ownership were bearers, coupons were registered and nontradable.

**Source:** Saul Estrin, "Some Reflections on Privatisation in Belarus", *Economic Trends Quarterly Issue Belarus*, July-September 1999.

## **5. Klaus's Failure**

### **5.1 Overvaluation of Domestic Technology and Under-valuation of FDI**

There were very ambiguous attitudes toward FDI (foreign direct investment) in Poland and the Czech Republic in the early 1990's. Only Hungary has been active throughout the whole period in receiving capital from abroad. Poland was very cautious towards foreign capital because of default of external debts, and the Czechs were very proud of their competence in industries, which they thought did not need foreign capital and technology.

Then, firstly Poland changed its mind as it realized that there would be no economic progress without sufficient capital and advanced technology. On the contrary, the Czech government even abolished preferential conditions for FDI after its separation from Slovakia in 1993.

It was just after the currency crisis in 1997 that the Czech government seriously began to reconsider the importance of FDI, simply because it recognized that Czech industry had been lagging more than one generation behind the rest of the industrialized world in terms of technology. However, the movement for inviting FDI is still characterized by the reluctance of admitting its weakness, the typical attitude shown by Charisma Klaus, ex-Prime Minister.

### **5.2 Misunderstanding the Policy of Foreign Exchange**

When Nomura Research Institute Europe at the end of 1995 saw the prospect of the Czech Crown being devalued, by as much as 20%, after the general election in 1996, Prime Minister Klaus became angry. He said in a press interview that “Nomura's forecasts have always been wrong and it is mere commonsense that Czech Crown can only be appreciated in future and never devalued, because the Czech Crown is in deeply under-valued”. He thought that an undervalued currency such as the Czech Crown with a strong industrial background would be continuously appreciated in the long run. The point was that he confused the nominal exchange rate with the real exchange rate.

Under inflationary circumstances exchange rate policy is not as straightforward as Klaus thought. If you appreciate the nominal exchange rate by 10 % when you have annual 10% inflation, then roughly speaking the real exchange rate will be appreciated by 20%. It is impossible for transforming economies experiencing various difficulties that their currencies in real terms are annually appreciated by 20% or more, which actually happened under the Klaus regime.

More sophisticated currency policy is necessary for an economy in transformation under inflationary circumstances. The nominal exchange rate should be devalued if the inflation rate is high enough, but the

real exchange rate should be kept to be appreciated exchange rate to some extent, providing the currency is considered to be highly under-valued. What is a proper rate of real appreciation? This is not a political question, but is monetary policy judged by measuring growth potentiality in the short-run and the long run.

### **5.3 Manipulation of Data**

Economists representing international organizations were deceived by tricks manipulating macro-economic indicators in the Czech Republic. One is the rate of unemployment and the other is the state budget deficit. Almost all forms of macro data in the Czech Republic were incomparable to other transforming countries during the early years of transformation: there was no inflation, no unemployment, no state budget deficit, no large deficit in current balance of payments, etc.. This really seemed to be a miracle.

Nowadays, it is widely known that the low rate of unemployment can be explained by lagged restructuring of quasi-privatized companies, and recently the rate has been increasing as restructuring proceeds. It was about 9.5% at the end of last year, which already passes that of Hungary.

The World Bank with the cooperation of the Ministry of Finance in the Czech Republic has recently compiled correct and accurate data on the deficit of the state budget (Table 4). The difference between the official data and the corrected data is the hidden deficits which have been put out of the official budget. The hidden deficits consist mainly of non-performing loans of commercial banks which have been concentrated and accumulated in the Bank of Consolidation (KoB, Konsolidacni Banka) as the asset of the bank. As long as the Bank of consolidation exists, the accumulated bad loans are not treated as state deficits in a legal sense. However, you cannot transfer the losses to the third organization forever.

Recently, a similar type of data manipulation can be observed in FDI data in Poland. As is widely known, two organizations publish FDI data in Poland: the one is the National Bank of Poland, and the other is PAIZ, a state organization for investment promotion. In the previous two years the discrepancy of data between the two organizations roughly amounts to 10 billion dollars, which gives a confusing picture to economists. As PAIZ admits, as long as it is a promotion organ for inviting foreign investment and not a statistical unit for Poland, we should not treat its data as official. FDI data from the National Bank of Poland is based on balance of payments as an international exercise; therefore we should use the data for comparison with other countries, all of which are based on the data of balance of payments.

**Table 5-A Government Implicit Fiscal Deficit, 1993-98 (percent of GDP)**

	1993	1994	1995	1996	1997	1998
Reported state budget fiscal deficit	-0.5	-1.3	0.3	0.5	1.1	1.4
“Hidden” fiscal deficit in transformation institutions (KoB, CI, CF and NPF)	3.2	1.9	1.0	0.5	1.0	2.0
“Hidden” fiscal deficit in guarantees net hidden subsidy (risk-adjusted)	0.0	0.0	0.1	1.0	3.1	1.5
<b>Implicit fiscal deficit</b> (including trans-formation institutions and guarantee net hidden subsidy)	<b>2.7</b>	<b>0.6</b>	<b>1.4</b>	<b>2.0</b>	<b>5.2</b>	<b>4.9</b>

**Table 5-B Sources of “Hidden” Fiscal Deficit, 1993-98 (CZK billion)**

	1993	1994	1995	1996	1997	1998
Konsolidacni Banka (KoB) <sup>1</sup> Net public expenditures	7.7	7.3	4.5	0.9	10.6	28.8
Ceska Inkasni (CI) net public expenditures	20.1	6.6	4.9	4.8	3.1	2.7
Ceska Financi (CF) net public expenditures					0.6 <sup>2</sup>	1.8 <sup>2</sup>
National Property Fund (NPF) net public expenditures (excluding KoB, CI)	4.2	8.2	4.3	1.9	2.0	2.6
State guarantees Net hidden subsidy (risk-adjusted)	0.1	-0.4	1.3	14.9	51.5	26.7

**Note:**1.Activities of KoB include credit to finance Stabilization Program of CF. Therefore, the table includes only interest payments by CF (which are then reported as interest income of KoB)

2.These figures are interest payments to KoB on credit taken by CF from KoB to finance Stabilization Program. In addition, CF paid interest CZK 0.8 billion and CZK 2.8 billion in 1997 and 1998, respectively, to Czech National Bank on its credit from Czech National Bank to finance Consolidation Program.

**Source:** World Bank, *Czech Republic*, Sept .1999.

## 6. Market Functionalism VS Industrial Policy

A usual means of comparison for the advancement of reforms in transforming countries are those criteria of market functioning such as privatization, liberalization of trade and prices, the banking system and liberalization of the capital market. These are conditions and infrastructure for market functioning, and I do not deny the importance of creating the conditions for market economy. Forming a framework either in a legal sense or in an institutional sense may be a necessary condition for market economy. However, it is not sufficient in itself. We cannot artificially create the content of the framework. The content is the activity of people themselves, whose level is dependent on the internal and external deepening of market economy and absolute level of income. Here is the point. The activity level of people cannot be increased by providing frameworks, and only by increasing real economic activities, which should be intentionally assisted by the industrial policy of the country in question.

So called international advisers are inclined to only make proposals within frameworks, because it is a rather universal task and not difficult to do for any country irrespective of its absolute level of economic development. Here exists the fallacy of market functionalism.

A more difficult task is industrial policy for the long-term development of the economy concerned. It needs more thorough knowledge of industrial situations and resources available in a given economy, and also needs a long-term strategic perspective from policy makers. However, this kind of task is usually neglected by international advisers, sometimes with the excuse that industrial policy is an old form of state intervention into the economy.

What the Russian crisis in 1998 showed is how vulnerable an economy which is supported only by market functionalism, without proper industrial policy, can be. Market functionalism is very compatible with financial liberalism, which can bring with it the superficial development of the capital market even without a strong real economy.

I have to say that the failure of international advisers regarding the Russian economy can be explained by the fallacy of market functionalism, which sees only frameworks of market economy and neglects strengthening real economy by accumulating capital and restructuring companies. Thus far, spontaneous privatization has not automatically brought about restructuring of companies and effective capital accumulation, which shows us the necessity of proper industrial strategy and government policy.

## **7. Who Governs the Quasi-Privatized Companies? : “The New Holy Trinity”**

### **7.1 Quasi-Privatization**

A voucher-privatized company is a so-called quasi-privatized company and cannot be considered as a real private company. Nevertheless, international organizations have recognized quasi-privatized companies as private as long as the state stake held in it is below 50%. However, it is a rather mechanical judgement which only pays attention to the legal form of a company.

This explains why the share of the private sector is high in those countries where voucher privatization is applied. The rate itself is extremely high as can be seen in Table 6. How is it possible to change the national economy from state ownership over to private ownership in a very short period? What does Table 6 show us? Is it a real picture or just an inflated picture by voucher “magic”?

**Table 6 Private Sector Share of GDP in %(rough EBRD estimate)**

	1995	1996	1997	1998	1999
Czech Republic	70	75	75	75	80
Hungary	60	70	70	80	80
Poland	60	60	65	65	65
Slovak Republic	60	70	75	75	75
Russian Federation	55	60	70	70	70

**Note:** rough estimate of EBRD at the middle of 1999.

**Source:** EBRD, *Transition Report*, 1995,1996,1997,1998,1999.

**Table 7 Ownership Structure of Voucher-Privatized Commercial Banks in Czech Republic (1994)**

	Ownership Structure(%)			
	Voucher	foreign capital	National Property Fund	others
Ceska sportelna	37	0	40	23
Investicni banka	52	0	45	3
Komercni banka	53	0	44	3

**Note:** Already Investicni banka is privatized. The another two banks are now under re-privatization process.

As shown in Table 7 the large Czech banks were considered as private when they were voucher-privatized in 1994, only because state ownership was decreased to below 50%. Thus, almost all voucher-privatized companies with minority state ownership were judged to be private and the weight of private sector zoomed up.

As has been already described, the voucher-privatized Czech banks are under a re-privatization process which is seeking a true ownership and management. This example clearly tells us that a voucher-privatized company is still not private, but just quasi-private, and surely needs re-privatization in future.

## **7.2 Reallocation of National Assets by the “New Holy Trinity”**

To date, voucher privatization itself has brought with it a reallocation of existing national assets among national players, and this is only the first round of privatization which should be followed by successive privatization in a more proper way. As long as a company remains quasi-private, it is only a “state monopolized” capitalist-type company in which competent bureaucrats of the old regime, reform-oriented managers and influential politicians have *de facto* control over it. Thus, a new type of “Holy Trinity” among bureaucrats, managers and politicians has been established in many quasi-privatized companies.

The new “Holy Trinity” forms and expands its own power group by including other companies and establishing its own banks and media as typically observed in Russia. How can we characterize this type of industrial group?

## **7.3 Patterns of Primitive Accumulation**

### **A. Russian Case: Enclosure of National Assets**

The enclosure of national assets by the new “Holy Trinity” in Russia seems to be none other than the primitive accumulation of capital typically observed in the early stage of capitalistic development as K. Marx described in *Capital*. This new type of capital accumulation is generally observed in ex-Soviet Union countries, where natural resources are rich, old political power is still relatively strong, and market economy development is weak.

In the course of enclosure it is also a well-known tactic to establish various types of subsidiaries around key companies and make money flows very complex and non-transparent. Thus, even if the key companies remain in the form of quasi-privatized companies, managers can easily acquire individual wealth by leaking money through subsidiaries to their own nominally existing companies.

Otherwise, it is impossible for managers to afford luxurious lives by their official salaries alone. The subsidiary tactic is widely utilized in Central European countries as well. Of the 120 billion Ft loss of Postabank in Hungary, it is said that a large amount of money was distributed to politicians, managers and others with various ostensible payment naming through various subsidiaries of the bank which also have their own subsidiaries with cross-ownership.

### **B. Czech Case: Insider Transaction**

In a more civilized society where market development is far more visible than in Russia, different methods of original capital accumulation are taking place. The Czech Republic, the pioneer of voucher-privatization, shows another way of accumulating capital by fully utilizing insider transactions.

Thanks to rapid privatization, almost all state owned companies have now been transformed into joint stock companies and their shares are freely traded among investment funds, where frequent insider transactions are observed due to the lack of strict transaction rules and disclosure requirements. Consequently, many unidentifiable investor groups could have acquired enough stakes in large companies, even in big banks, and suddenly have appeared as powerful investors in the business world.

In the Czech Republic, politicians have also tried to have good relationship with quasi privatized commercial banks and large companies to maintain their economic and political influences. Donations from large banks and companies were the main sources of election campaigns for the ruling Party, ODS, and the president of the largest Czech commercial bank, Komerčni Bank, was until recently a famous senator of the ODS and a colleague of Mr. Klaus. Not only Komerčni, but IPB, the fourth largest bank was also a major creditor in the 1995 election campaign.

The delay in the real privatization of the big banks in the Czech Republic has caused several serious problems in the banking sector. The Klaus government did not take effective measures to consolidate accumulated bad loans and instead continued the easy option of bailing-out companies. Consequently, large banks have kept past business routines with strong holdings of non-financial business companies, regardless of their profitability which has further worsened the situations of banks and has left semi-privatized non-financial companies not restructured.

All of these were mutually beneficial both for the Czech ruling party, ODS, and the managers of large banks and companies, because they could maintain their positions and political-economic benefits by their co-operation.

The direct cause of the resignation of Prime Minister Klaus in Dec. 1997 was the disclosure of a secret party bank account in Switzerland, to where not only foreign companies transferred lobbying fees in connection with privatization deals, but also secret donors in the Czech Republic transferred money. The hasty privatization in the Czech Republic has deeply upset market disciplines and rules, however Mr. Klaus self-praised the course as real liberal capitalism, all of which brought out chaotic business situations especially in the banking sector and in the capital market. Today's recession of the Czech economy can be attributed to the hasty voucher privatization, which had been greatly praised as a radical step towards the market economy by international organizations and economists in 1993-94.

Anyway, through voucher privatization and insider transactions, the Czech style reorganization and redistribution of national assets has been established, and this characterizes the method of original capital accumulation in the Czech Republic.

### **C. Hungarian Case: Dependence on Foreign Capital**

Where neither natural resources are available nor domestic capital is sufficient, the only way to accumulate capital is by importing. Direct investment by foreign strategic investors can pave the way for original capital accumulation in a given national economy. However, not every country can rely on imported capital, because it is not a given country's decision, but it is an investor's decision of where to invest.

Fortunately enough, Hungary has succeeded in attracting foreign capital and therefore so far accumulates sufficient capital in the national economy, partly by selling state companies to strategic investors and partly by inviting green-field investments.

Privatization by foreign capital is of one round and does not require re-privatization like voucher methods do. The question of how domestic entrepreneurs can grow up in these circumstances and what consequences will follow in future does remain.

### **D. Polish Case: Mixed Type of Latecomer**

Compared to the above mentioned three countries, the Polish case cannot be decisively characterized by the typical methods of capital accumulation. As is well known, trade unions hold strong powers and

represent an independent social power which largely contributes to political democracy, though they put limitations on the privatization process.

Thus, Polish privatization process has been delayed in spite of several attempts to quicken the process due to the lack of social consensus. Finally, as the latest user of voucher methods, Poland tried to introduce uniquely revised voucher privatization, i.e. NIF(National Investment Fund). By inviting foreign investment banks and consulting companies to manage voucher-privatized companies the Polish government tried to avoid the typical weakness of the voucher methods experienced in the Czech Republic.

However, the revised methods do not seem to be revolutionary and miracle bringers. The result so far may be a little better than voucher methods without experienced management company, but does not show any remarkable merits, which again teaches us that there is no “royal road” to privatization.

The recent rush of foreign capital into Poland shows us that individual direct sales of companies are successfully proceeding, mainly thanks to the large domestic market, not to the success of NIF.

In this sense, too, the Polish way to privatization is of mixed type.

## **8. Opportunism and Corruption :Legacy of the Old System**

In these ten years of transformation tremendous public money and wealth has been slipping into “hands” of individuals and private companies through legal and illegal channels. As already written in my paper, “Pretense of Market Economy and Legacy of the Old Regime”, there are typical ways of making wealth in the transformation period.

The first channel is privatization. Politicians of a governing party can get insider information about privatization plans, and not only intermediate matters, but also they themselves can participate in relatively minor matters and collect small benefits. Of course, the direct participation of politicians in almost all cases is not possible, but the participation of their family members and co-operators are not illegal. If the matter in question is an international tender, then the amount of the success fee for lobbying would be tremendous.

Secondly, not only bureaucrats but many politicians have also been appointed as supervisory board members of quasi privatized and fully privatized companies. The amount of each honorarium may not be large, but one can collect enough money to buy cars and flats from many nominal supervisory jobs offered by company managers who are looking for political and governmental connections.

Thirdly, the ruling party has decision power in distributing the state budget. Here again, politicians can get insider information on where money flows, and by proposing and suggesting ways of expanding budgets and where money should be expended, they can get earnings through intriguing channels.

Interestingly enough there are no concepts like abuse of status, insider transaction and bribery in transforming countries. Illegal activities in developed societies are not necessarily considered as illegal in transforming countries. There seems to be no social normative which regulates ethics of social behaviors and keeps social justice.

It is also very interesting to see that almost no legal accusations have been made by prosecutors in connection with bribery and corruption in transforming countries. One can say that the prosecution system is also under construction, because there was no prosecution system independent of the communist party in the old regime. In this sense, the spread of corruption without legal punishment is the direct result of the old regime, and the transforming societies are still living in the legacy of the old regime.

## **9. The Lost of Ideals, but Since When?**

In the general election of 1998 the so-called center right-wing FIDESZ coalition won in Hungary, and the so-called left-wing social democrats won in the Czech Republic. Do the two results show an opposite political tendency in the two countries? No, not at all. Both political movements are exactly the same in the sense that voters chose policies oriented towards social policies which have been neglected by previous governments. It sounds strange that the central right-wing party in Hungary follows social policies, however, in fact FIDESZ proclaimed that the party can realize social policies which were neglected by the socialist party.

It is quite interesting that stereotypical classifications of political parties are already irrelevant for today's analysis of political situations in Central Europe, where the old left are strongly pursuing a market economy and the old right are orienting towards more social policies. Thus, earlier descriptions of political parties should be inverted by exactly 180 degrees; left became right and right became left.

As seen in Table 8, the classification shows a typical old-fashioned and obsolete analysis of political maps in ex-socialist countries. It is already invalid to analyze the political situation in this region by a pair concept of right and left.

**Table 8 An Old Fashioned Political Map**

	First Post-communist Government	Next	Most recent
Bulgaria	Right	Left	Right
Czech Republic	Right	Right	Centre-left
Estonia	Right	Mixed	Right
Hungary	Right	Left	Right
Latvia	Right	Mixed	Mixed
Lithuania	Right	Left	Right
Poland	right	Left	Right
Romania	Left	Left	Right
Slovakia	Right	Left	Left
Slovenia	Left	Left	Mixed

**Source :** *The Economist*, May 30 - June 5, 1998.

It is also very interesting to hear from the new leader of the Hungarian Socialist Party, László Kovács, who was elected as the new leader after they lost the general election, that the party strongly opposes the taxation plan on real estate and interest on bank deposits. When I heard and read this news, I could not believe my ears. Since when did the Socialist Party become a capitalist party in Hungary? Something is eating away the ideals and conscience of the Hungarian Socialists who seem to have enjoyed political power and economic benefit too much in the previous ruling period.

There is a proverb in Japan: Fine manners need a full stomach. However, what we can observe in Hungary is: a full stomach makes a man throw over his original ideals, and makes a man more and more snobbish and vulgar. Otherwise, we cannot understand the change of behaviors in the socialists.

But, do you think that the degeneration of socialists happened just recently? I do not think so. The degeneration of socialists or the system itself has a long history, because as described in the Table 2 redistribution system does not have any moments for developing civilized relationships in society. Not only in an economic sense, but also in the sense of social morality, the old regime had already lost its legitimacy a long time ago and maintained mere formal legitimacy for the reign of communist party. Even the formal legitimacy itself was lost in the collapse of the old regime. Since then, socialists, including reformers have been losing their ideals and legitimacy both as a political party and as individuals, simply because they do not know themselves what a socialist and a party should represent in the transformation era.

## 10. How Is It Possible to Restore Social Justice?

By introducing taxation on accumulated wealth in the form of real estate and financial assets it is urgent and essential to restore social justice in transforming society, because sources of valuable real estate and other liquid assets are nothing but various types of incomes which evade taxation.

It is surprising to discover that no type of effective taxation on real estate actually exists not only in Hungary, but also in other Central European countries, and the state budget depends on a very high level of taxation of personal income and on VAT, the general rate of which is 25% in Hungary. The prevailing system of taxation in Central European countries is heavily dependent on current incomes and expenditures which unproportionally burden the poor and favor the rich. As observed in developed countries, small income earners do not have any ways of escaping taxation, on the contrary, large income earners do have various ways of evading taxation and thus tax evaded incomes are transformed into real estate and financial assets exempt from taxation. Contemporary Central Europe seems to be a paradise for the rich.

Why are socialists so strongly against real estate taxation? If it is because many socialist MPs constructed houses during their political ruling period, then it is quite sure that socialists cannot restore social justice in Hungary.

Almost every general election in Central European countries since the beginning of the transformation has so far resulted in changes of governments. Thanks to the changes, most major parties have already enjoyed a ruling period and have known where channels of money flow connected with privatization and state budget distribution exist, which, interestingly enough, has brought out *de facto* mutual surveillance systems for extraordinary abuse of status among politicians. In this sense public votes have so far played an important social role by giving its judgement to the ruling of government parties on behalf of unreliable and incompetent prosecutors.

Here I would like to add one comment. In spite of the fact that the Hungarian Socialist Party did not take any responsibility for the Tocsik scandal,\* the party got the largest support in the latest election, though the party did not succeed in keeping power. In the same way, in the Czech Republic Prime Minister Klaus was forced to resign via a secret bank account, surprisingly voters still supported the ODS and parties split from the ODS.

\* A lawyer named Tocsik got an enormous success fee from the Hungarian State Property Agency and transferred half of the money to the bank accounts of the treasurers of the two ruling parties.

These are very interesting phenomena when we study social and political normative in Central European countries in the sense that political scandal itself does not cause fatal damage for the parties concerned. We can say people are tolerant enough of political scandals.

Although foreign investors do not like frequent changes of governments, so far only the changes in political power have brought about the cleansing of the quasi bribery activities of politicians, bureaucrats and managers, and thus societies have barely maintained minimum social justice where the prosecution system does not work at all.

The disclosure system of individual assets of MPs has already been introduced in Hungary, but no one believes the seriousness of the self-declarations of MPs, most of which are so laughable that no form of media has anything to do with the declarations. This might be so, partly because the media itself does not work as a social checking and critical power in Hungary, and partly because people are very tolerant and quiet about bribery and government corruption. This can be explained by the long time period of silence of the people against any type of government and party corruption under the old regime, when protests by people against them were strictly punished.

However, the time has come for politicians to get a hold on themselves and make political life correct in the line of social justice. That is the message and expectation of people who voted for FIDESZ, the Young Democrats of Hungary who are considered to be still immune from corruption.

As described, people in Central European countries, except in Poland, are tolerable, obedient and silent regarding social injustice and corruption concerning government and parties. These societies are actually in some sense similar to European societies where the acceptance of the status quo in society is rather strong among people: people conform to current structures of social class and strata, those of wealth between the rich and the poor, and the relationship between authority and non-authority.

The level of social activity in Asian countries is far higher than that in Europe, for the opportunity exists for Asian people to move and step up from one social class and status to another by their own efforts. This possibility has produced tremendous energy among people who are struggling for social promotion, and at the same time has brought every type of corruption to ruling government and parties.

Thus, we can characterize Asian society as one of high level activity, a strong social struggle, political antagonism, large scale corruption, high demand for social disciplines and ethics due to the lack of them, a strong and independent prosecution system for maintaining minimum social order, and high ideals for social justice as integrating objectives.

On the contrary, European society can be characterized as one of a low level of activity, mild social struggle, peaceful political dialogue, small scale corruption, established social disciplines and ethics, a prosecution system highly dependent on government, and a quiet voice of social justice, partly because a social welfare system is already established.

In this respect Central European society is also different from Western European society. Central Europe is in somewhat of a mixed position in every aspect of the social comparisons described above. That is: the level of social activities is low, political struggle is less antagonistic, corruption is widespread, social disciplines and ethics are low, and demand for social justice is also weak.

To Japanese eyes Central European countries and societies need more energy and power to promote themselves to a higher level of social and economic progress, and at the same time social disciplines and ethics should be restored for lessening *de facto* bribes and corruption spread around government and semi-privatized institutions.

Therefore, Central European governments should motivate people to play a more active role in business and social life not only by encouraging economic measures, but also by establishing rightful social normative in public life. That is, by showing the social disciplines required for a developed and civilized society the public can learn new social normative and fight powerfully against corruption and social injustice, and against corruption in social and business organizations. The fighting power itself shows the activity level of a society, and the reverse is also true that the activity level of society remains low as long as people are afraid of fighting corruption and social injustice.

## References

EBRD, *Transition Report*, London(1994-1999).

*The Economist*, May 30-June 5, 1998.

Estrin, Saul, "Some Reflections on Privatisation in Belarus", *Economic Trends Quarterly Issue Belarus*, July-September 1999.

Morita, Tsuneo, *Taiseitenkan no keizaigaku*(Economics of System Transformation, in Japanese), Shinseisha Publisher, Tokyo, 1994.

WIIW, *Countries in Transition 2000*, Vienna, 2000.

World Bank, *Hungary*, Washington, 1999.

World Bank, *Czech Republic*, Washington, 1999.