

NEW TENDENCIES IN THE HUNGARIAN ECONOMY

Editor-in-Chief

Géza Kilényi

Editor

Vanda Lamm



Akadémiai Kiadó, Budapest

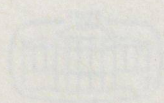
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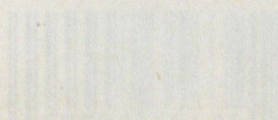
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Vanda László



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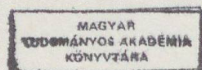


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Translated by

Mihály Kocsis

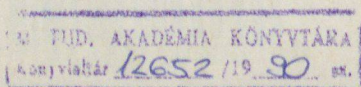


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List of contributors

Géza Kilényi	Professor Member of the Constitutional Court (Editor-in-Chief)
Miklós Király	Assistant Eötvös Loránd University, Budapest (Chapter Four)
Vanda Lamm	Professor Institute for Legal and Administrative Sciences of the Hungarian Academy of Sciences (Editor)
Ferenc Mádl	Professor Eötvös Loránd University, Budapest (Chapter Four)
Iván Pető	Historian Hungarian National Archives (Chapter One)
Tamás Sárközy	Professor University of Economics, Budapest (Chapter Two)
Gábor Török	Senior Research Fellow Institute for Legal and Administrative Sciences of the Hungarian Academy of Sciences (Chapter Three)

Distinctive Features of the Hungarian Economy. Changes in its Workings from 1945 Onwards

Introduction

The year 1945 marked not only the close of World War Two in Hungary, but also a change in the country's social, economic and political system. True, the period of the multi-party system and coalition government formally existing from the end of 1944 to 1948 or the first months of 1949 (practically the last months of 1947 or the beginning of 1948) showed little similarity to the following four decades, the Hungarian economy of today still contains several elements which evolved during that period, and hence its operation is perhaps not easily understandable without a brief review of those years. Even though the political forces which came to power in 1945 declared their intention to build a new Hungary, it has rested on the Hungarian statehood with a history of more than 1,000 years. While a short discussion of long centuries can be dispensed within this context, it appears inevitable to highlight a few basic facts of the pre-1945 period. Accordingly, Section 1 covers, with some hints at antecedents, the so-called transitional period of 1945–48, when the Soviet-type planned economy, which was to determine the following decades, emerged on the basis of an economic management reminiscent of times of the war.

Section 2 deals with the period of planned economy that may be called “classical”, a period of two decades lasting until the introduction of the 1968 economic reform in Hungary.

Several features of the Hungarian economy of the 1980s naturally have their roots in this period, not only and primarily because the contemporary developments significantly restructured the economy, with the plants built during that time still in operation, but because the workings of the economy, despite all the shifts to be discussed later, are still governed in several decisive aspects by the same methods employed during those 20 years.

Hungary was the first among the countries in East-Central Europe, not counting Yugoslavia, where the truly “classical” system of planned economy, a strictly centralized one of detailed plan instructions as devised in the Soviet Union, began to be eroded from as early as 1953–54. While several elements of the reform concepts about combining the advantages of market automatisms and a conscious economic management had been formulated during 1954–57, the new economic mechanism incorporating those elements was not introduced until 1968.

Section 3, on the one hand, tries to explain why a gradual removal of essential

elements of the Stalinist system, which was basically typical of a war-time economy, was undertaken by the cautious Hungarian leadership, Hungary being for a long time the first and only country among the CMEA member states to embark on that path (whith only Poland following suit even today). On the other hand, it discusses the characteristics of a reformed Hungarian economy, including the causes of the reforms losing momentum and the manner in which the economic policy shifts were effected as decided in 1978.

As it appears from the foregoing, the past period of nearly four and a half decades will be discussed mainly in chronological order, but, considering that important features of the current workings of the economy have been present for decades, these features will be addressed, with occasional glances at the future, in dealing with the 1950s and the 1960s.

One more preliminary remark is to be made: this review will be one of economic history which, in presenting an economic system determined first and foremost politically and ideologically, with its essential aspects still delimited by the political and ideological spheres. So it will necessarily give little or no coverage of the basic elements of operational mechanisms. Nor will it provide a technical description of the economic mechanisms, given its historical approach and the limitations of space; although a detailed exposition would be required for an understanding of the details of the operation of Hungary's economic system, since the institutions like enterprise, ministry, local state administration, party or price, wage, capital, etc. function in East-Central Europe quite differently from other countries, not to mention the difficulties of orientation arising from the institutionalized role of informal instruments (such as campaign, bargaining, directives, communications, instructions, guidelines, verbally expressed expectations) which are complements to and at times substitutes for the formalized system of institutions.

I. National Endowments, Controlled Economy, State Management of the Economy. Establishment of the National Endowments

The peace treaties closing World War One created a radically new situation for all East-Central Europe, including Hungary. The decades that followed revealed many similarities between the economic problems the new countries of East-Central Europe had to face and stemmed from their inherited structural patterns, relative backwardness of varying degrees and geopolitical situations. While the economic conditions for political independence had also emerged in the small countries of Western and Northern Europe over the centuries, that was not the case in the countries of East-Central Europe except for Czechoslovakia (practically in its Czech and Moravian territories). The new borders separated the economies, formerly linked to large united markets, from a large part of their selling and buying partners, and the political need to strengthen state sovereignty set the main task of creating economic basis for independence rather than trying to ensure the continuity of pre-existing economic relations. The loss of earlier markets in the

1920s entailed radical cuts in exports in nearly all the countries involved, while economic development, or industrialization policies pursued to substitute imports and to secure self-sustain led to grave foreign-trade imbalances and debts, with matters made worse by the world economic crisis of 1929 — 33.

In the second half of the 1930s it was only with great difficulties that the countries of the region, irrespective of the political endeavours of their majority, managed to overcome indebtedness by trying themselves ever more strongly to the German market. Relevant literature has shown that this process had started well before Hitler came to power, so it cannot be associated with the expansionist policy of the Third Reich. Of course, the post-1933 economic motives were coupled with the direct political and military designs of Germany and with deliberate efforts at the limitation of political independence in some countries of East-Central Europe, until it came to be suppressed at periods varying by country, from 1938 onwards. After World War Two, political independence was reestablished within largely limited frameworks, except in Yugoslavia, and the countries of the region, in accordance with the formal and informal agreements of the victorious great powers, forged their very close links, both politically and economically, with a new great power.

The end of World War One meant independent statehood created (Czechoslovakia, Baltic States), reestablished (Poland) or reorganized on territories enlarged by orders of magnitude (Yugoslavia, Romania), namely, it meant the realization of a national dream for the overwhelming majority of countries in East-Central Europe, but a trauma for Hungary, most of whose society was very slow to recover from the impact of the war.

As is well-known, under the Peace Treaty closing World War One, Hungary saw its territory reduced to one-third, with 40 percent of its population retained within the new borders and with the number of both Hungarians and members of other ethnic groups, equal to nearly 50 percent of the population in the reduced territory, remaining in the neighbouring countries. Although Hungary retained its economically most advanced territories (49 percent of industrial establishments, 56 percent of the production value of the manufacturing industry, 51 percent of those employed in industry, namely a higher ratio by comparison to the size of territory), it lost most of its natural resources (keeping 20 percent of its iron ore deposits, none of copper ore, little less than 15 percent of forests, etc.), with the well-heads of its major rivers also remaining outside the new borders. Thus the country ceased possessing any significant raw materials, apart from its considerable bauxite resources, which were gradually explored only after the 1930s, and from its brown coal of rather poor quality. Of course, the new borders cut off part of the existing road and rail networks, with a not negligible number of the remaining settlements also losing their previous zones of attraction or centres of pull.

The policies of the Hungarian governments in the interwar period were essentially determined not by readjustment to the new borders but by a desire to revise the borders which were held to be unnatural. Thus, on the one hand, the country came, almost perforce, to build close political links with Italy and Germany, which were interested in revising the peace treaty framed at Trianon, and, on the other hand, came to be on bad terms with the neighbouring smaller countries fearing a Hungarian revision. The peace treaty played no small part in that the successive governments failed to effect structural changes within the existing borders and

that a conservative social and economic order, containing no insignificant feudal elements, established itself.

The most pressing problems, which stemmed not so much from the general characteristics of post-World War One East-Central Europe as rather from the policies of the groups in power, were present in the agriculture. A small-scale land reform left land tenure with a rather unfavourable pattern in Hungary, with nearly 30 percent of arable land held by 1,070 farms of over 1,000 cadastral yokes each and with nearly 20 percent by 12,000 large private estates of 100 to 1,000 cadastral yokes. At the other extreme were than 1.4 million small and dwarfholdings suitable at most for family subsistence farming, but by no means of commodity production, and accounting for 20 percent of total land (1.2 million farms of 5 to 10 cadastral yokes held little less than 10 percent of total land against little over 10 percent held by 200,000 farms of less than 5 cadastral yokes), while the percentage of all area was 5 for holdings of 100 to 200 cadastral yokes and one-third for estates of 10 to 100 cadastral yokes. Also, owing to the rather slow rate of expansion of other spheres of the economy (national income rose at an average annual rate of 1.8 percent during the interwar period), the occupational structure of the population was changing slightly, with the ratio of persons living from agriculture falling below 50 percent of the total population as late as the Second World War. Consequently, in an agriculture based on masses of cheap labour, up-to-date and efficient farming was naturally an exceptional phenomenon.

While some products of the Hungarian industry (manufactures of Tungsram Ltd., machines of Ganz Factories and Weiss Manfred Works, some food products and other articles of the light industry, etc.) met world standards of the time, the lack of boom and capital left a relatively narrow scope for modern mass production, cooperation between plants and even small-scale production turning out labour-intensive and marketable products. The formerly dominant food industry, relying on the huge market of the Austro-Hungarian Monarchy, declined rapidly, and surging forward was not modern processing industries (machine building, electric engineering, chemical industry), but the light industry capable of absorbing unskilled labour, requiring relatively less capital and relying mostly on the internal market as well as on the less demanding markets of Eastern and Southern Europe. (The output ratio of the heavy industry to the total output of the manufacturing industry fell from 38 percent in 1913 to 33 percent in 1929, remaining as low as 36 percent even in 1938, whereas the ratio of the food industry for the same years was 42 and 36 percent, respectively, finally falling to 29 percent, and the ratio of the light industry rose from 15 to 26 percent.)

The extremely high ratio of small-scale industrial production and its rather slow rate of decline were added features of the Hungarian industry. The ratio of workers employed in small-scale industry was nearly half (49 percent of all industrial workers in 1920), was still 43 percent ten years later, and remained as high as 40 percent even in 1938, before the outbreak of the war.

The wartime boom set in motion an extremely rapid process of change in the Hungarian economy, with the role of agriculture declining and that of industry notably increasing. The number of workers in the manufacturing industry increased by 100,000 or some one-fifth within the post-World War One borders alone during five years after 1938, whereas the value of output rose at an even higher rate (37.5 percent), meaning that the economic structure of Hungary in the

early 1940s was growing similar, though as a result of war economy, to that of the advanced countries of Western Europe: the industry accounted for 27 to 30 percent of national income from the mid-1920s to the mid-1930s, with this ratio surpassing 40 percent by 1943, and the share of agriculture fell from between 37 and 40 percent to 28 percent during the same period. However, the occupational structure still reflected the traditional pattern: the ratio of people living from agriculture to the total population was 55.7 percent in 1920, 51.8 percent in 1930 and 48.7 percent in 1941, whereas that of miners and industrial workers for the same years was 20.6, 23.0 and 25.4 percent, respectively; the ratios of the population engaged in trade and credit business were 5.1, 5.4 and 5.5 percent and, in transport, 4.4, 3.9 and 4.0 percent, whereas the ratio of staffs in the state apparatus, the military and the judiciary as well as their families to the total population rose from 14.2 percent in 1920 to 15.9 percent ten years later and reached 16.4 percent at the beginning of the war.

In terms of level of development Hungary ranked among the more advanced countries of the world prior to World War One, but lagged far behind the most advanced ones of Western Europe and North America, while considerably outstripping Southern Europe except for Italy. Estimated at 120 dollars in 1937, its *per capita* national income amounted to less than one-fifth that of the United States (\$670), little more than one-fourth that of Great Britain (\$440), slightly over one-third these of Denmark and Germany (\$430), and was nearly 50 percent less than that of Czechoslovakia (\$170). It was roughly at the same level with Italy (\$135), but was one-fifth ahead of Poland (\$100), nearly one-third of Spain (\$95), Portugal (\$93) and Greece (\$92), one-half of Romania (\$81), Yugoslavia (\$80) and Bulgaria (\$75).

Notable reserves for further development were represented in principle by some elements of Hungary's infrastructure being more developed than the economy as a whole. Reference can be made primarily to the system of education, since 8-class primary schooling was made compulsory as early as the threshold of war, illiteracy was virtually eliminated during the 1930s, and secondary and higher education can be said to have been at a rather high level. Health care was close to the standard of the more advanced countries and social insurance coverage was also significantly general, although the agrarian population, which made up nearly half of the total, was extremely underprivileged in this respect.

New goals and new realities

The common programme proclaimed at the end of 1944 by the four-party coalition (consisting of two peasant parties, the Social Democratic Party and the Communist Party), which came to power after the war, was committed to a market economy subject to limited state intervention and seeking possible remedies to earlier social ills. It promised land distribution, rights to strike and unionism, legally regulated working time, nationalization of mineral resources and electricity works, state control of cartels and big banks and, emphasizing the importance of private initiative, abolition of such war-time institutions as delivery of agricultural produce and bureaus for the distribution of industrial raw and primary materials, which served to restrict such initiative.

With the war still raging in the western part of the country and with the regular forces of Hungary supporting the German army, the new power organizing itself in Eastern Hungary declared in March 1945 a radical land reform which, under the circumstances, was motivated mainly by social and political and, to a lesser extent, economic considerations. The estates of more than 1,000 cadastral yokes held by companies and institutions (including the Catholic Church) as well as by persons guilty of war crimes and crimes against the people were expropriated; in the case of estates of less than 1,000 cadastral yokes, compensation was promised for peasant holdings in excess of 200 cadastral yokes and for gentry estates in excess of 100 cadastral yokes. The new smallholders were allotted areas of little more than 5 cadastral yokes on average. The land reform significantly increased the number of holdings of less than 5 cadastral yokes hardly capable of commodity production (more than 10 percent of the active population was farming land of that size) and reinforced the attachment of the agrarian population to agriculture (in 1949 nearly 50 percent of the population lived from agriculture, with more than 40 percent of their families holding land).

The following three years saw no other radical change of a scale similar to the land reform, but the operation of the economy gradually underwent a deeply penetrating transformation in the period 1945–47. The shifts were effected by employing two, mutually reinforcing means: partly by wider restrictions on the market, or economic automatisms, partly by nationalizations.

There were several contributing factors to the emergence, not of a market economy operating with a limited role reserved for the state as envisaged in the common programme proclaimed by the coalition parties at the end of 1944, but of an economic activity subjected to more control and more intervention by the state. Large masses of society sympathized with the levelling of incomes, the abridgement of acquired rights and the reduction of property-related advantages, namely the realization of some of the socialist ideas. Though the parties in power differed widely by ideology, each of them was, for different reasons, traditionally opposed to the proprietary strata of the banking business and the manufacturing industry, the post-war situation of Hungary (which was, until 1947, supervised by the Allied Control Commission under Soviet influence) did not allow any meaningful oppositional organisation to be expressed to their line of action. At any rate, no one could advise other means than the economic involvement of the state to meet the fundamental economic problems, to deal with war damage, inflation and war damage compensation, and to ensure public supplies. (Greater economic damage than that of Hungary was suffered only by Poland, the Soviet Union, Yugoslavia and Germany among the European powers at war. The damage caused by the war amounted to five times the national income for 1938. Hungary had the highest rate of inflation in the post-war world. From the summer of 1945, price increases had to be measured daily, the price index rose several thousand and then ten thousand times the prewar level by the autumn, and prices and the dollar rate of exchange were expressed in astronomical figures reaching quadrillion *pengős* per unit before the currency reform of August 1, 1946. War reparation was valued at one-third of the national income, which fell heavily between 1945 and 1948, and called for more and more goods most needed for the Hungarian economy itself.)

Under the prevailing circumstances, the process of restricting market mecha-

nisms and replacing them with state direction was started as early as 1945, initially and primarily by resorting to occasional regulations and, from 1946, changing it into an overall system. At the time, however, the involvement of the state apparatus in economic management was justified by invoking the pressure of the situation rather than the idea of building a new system. Thus, on the one hand, the state was vested with powers to raise and draw from budgetary funds, the budget being a traditional tool of governments, and, on the other, authorized to exercise exceptional powers intended to be transitory and rejected in principle, but adopted in practice and strongly resembling war economy, while reliance was placed on entirely new inter-party relations side-stepping the hierarchy of state and private institutions and exploited mostly by the Communist Party, which was among the first to come out consistently for direct economic management.

The Enabling Act, which was adopted at the end of 1945 and prolonged time and again the following years, created a set of conditions for governance by decree and left rather wide scope for the state apparatus to change the operational system of the economy. During a few weeks at the end of 1945, economic decision-making passed into the hands of the Supreme Economic Council, which, in restricting the market as dictated by the pressure of the situation, was clearly guided by an intention to have private property steadily limited and gradually abolished.

From as early as 1945, the material management bureaus as typical institutions of war-time economy were reestablished to collect and distribute, by administrative means, the most important raw and primary materials. The real money and capital market was virtually eliminated before the currency reform of August 1, 1946 as, with the inflation galloping, it would only have been able to operate in stable foreign currency, but such operation was prohibited. While the war-time system of collection of agricultural produce and livestock was formally abolished, it was replaced by a new and increasingly stringent one, for taxes levied in money losing value had no more sense and hence it was taxation *in natura* and even barter that came into general use. Moreover, the problems of supply and the demands of war damage compensation prompted the government to collect produce, since it was unable to finance state orders and contractual procurement, while the lack of sufficient revenues led it to accumulate huge debts both to agricultural producers and the industry. With the inflation breaking loose from early 1946, wages in industry were paid mostly in kind and barter became the form of food supply for the industry.

The proprietors' scope of action was narrowed by regulations restrictive of the market, on the one hand, and by socially motivated constraints and institutions, on the other. Shop committees were set up in factories to control business and exercised strong political pressure on enterprise management to realize their ideas. The trade unions, the direction of whose majority was taken over by the Communists from the Social Democrats, were invested with broad rights after 25 years of repressive measures by a conservative and right-wing regime following upon World War One. Although in the subsequent national assemblies they did not retain the separate mandates which their representatives had obtained in the Provisional National Assembly functioning until November 1945, they were enabled by the government's strong pro-worker position to push through their concepts. They narrowed the proprietors' scope of action mainly in exercise of their right to conclude occupational collective agreements, but they took hold also of the institu-

tion of employment service and, though on behalf of a joint national effort, they were opposed to strikes, often resorted to political pressure.

Of course, the currency reform and stabilization from August 1, 1946 added up to a comprehensive economic reform rather than being confined to a simple replacement of the old currency, which had become completely devaluated. Trained in modern, elaborate West European theories, specialists devised a monetary and a price system capable of allowing scope for sharp restrictions and vigorous interventions by the state. At the same time, they ignored the political situation, the key positions which the Communist Party had gained in economic management from early 1946, and were consequently unaware that antiliberal tools were likely to serve not only a national economy in general, but also an economic policy which embraced an anticapitalist ideology and were likely to be employed not only in a situation of pressure which was considered transitory, but also in a longer term.

The price system introduced from August 1, 1946 was completely detached from world market prices on the assumption that agricultural prices were liable to regulation by government decisions in view of the fact that agricultural production now on a small scale had no direct contact with external markets. Agricultural prices and taxes as well as the retained compulsory delivery quotas were fixed in such a way as to sharply increase government revenues for financing other areas through central redistribution. Agricultural prices were 40 to 50 percent below industrial prices as compared to prewar levels. While they increased nearly 50 percent during the following years until 1949, industrial prices also rose by about 20 percent, so the gap between agricultural and industrial prices was only narrowed rather than closed.

The wage system framed in the course of stabilization also retained several of its elements for a long time. Wages and money incomes were planned to equal 50 percent of the prewar levels in general. (Industrial workers could expect to have 50 percent wages in real terms for 75 percent their prewar performance.) On the other hand, by way of compensation, rents and charges for communal services were fixed at extremely low levels. In addition, the income differentials of various groups of workers and employees were greatly reduced at a general low level.

For lack of investment resources, low wages made staff increase the main source of output expansion even though the wage taxes payable by employers were drastically increased. (Whereas such taxes amounted to less than 10 percent of the wages paid in 1938, they were close to 50 percent in 1946—47.)

The price and tax systems introduced in the course of stabilization reduced entrepreneurial profit to a minimum in the manufacturing industry and even caused production to go into the red in most areas. The amount of capital invested in industry was used up in one year and the resources available for replacing the machine park were depleted.

With stabilization, banking and credit business practically came to an end, for the government made all major financial operations a prerogative of the central bank of issue with a view to controlling the extremely limited supply of money and credit. Applications for credit were considered by the state apparatus, more specifically by the Communist-controlled Supreme Economic Council, and allocations of funds, particularly for agriculture, were made subject to extremely strict conditions.

All of these restrictive economic policy measures and tools were coupled with

the government's decision that claims against the state and its plants should not be amenable to court action. Since the decision affected the products destined for war damage compensation as well as the industries nationalized or brought under state control in the meantime, but the state and its enterprises collected their claims, the larger part of the private economy came to the verge of insolvency, not to mention the other obstacles to capital formation.

The methods institutionalized in the course of stabilization were employed with minor changes until 1948 and, in a few years, brought about a situation in which the overwhelming majority of industrial and commercial sectors in agriculture were unable to secure their operation except through the state-controlled credit system, while peasant farms maintained themselves almost exclusively from natural growth. (This method, intended to ensure the primacy of state economic policy, is called "dry" nationalization as distinct from formal nationalization, which was also gathering speed.)

Nationalizations as proclaimed under the programme of the coalition started with the nationalization of coal mining. The mines were brought under state control in December 1945 and taken into state ownership in May 1946, but with retroactive effect to January 1. Although the original idea of Communists demanding the expropriation of all mining enterprises was not realized, for it would have implied nationalization of a considerable part of the economy in view of the interpenetration of industrial with bank capital, the state took over, not coal deposits as had been suggested by the Smallholders' Party, the majority party of the coalition, but the units of enterprises concerned with mining and the mines, thus cutting across the coherent vertical spectrum of enterprises and also nationalizing the larger part of electricity works extraneous to mining. Moreover, while expropriation was to be with compensation, financial settlement was postponed from time to time on plea the "momentary" budgetary situation until it was finally shelved after 1948.

The Communist Party proposed that the five largest plants of the heavy industry which were producing for war damage compensation, i.e. on state orders, and supplied with state credits should be brought under state control as part of the government programme of stabilization. In December 1946, after lengthy debates in the coalition, state control was to be nominally upheld for the period of war damage compensation, but culminated into state ownership with subsequent nationalizations.

Before the war the state owned only a few smaller enterprises and a large industrial plant along with public utility works (railways, post, electricity works, urban transport, etc.). At the end of 1946, as a result of nationalizations and state control, over 40 percent of industrial workers and miners were employed at state enterprises, 20 percent of them at the five large ones placed under state control.

At the end of 1946, the Communist Party proposed the elaboration of a three-year economic plan, which, though by no means a Soviet-type one, was practically a large-scale state investment programme geared to a market economy. Yet, no small political pressure had to be put on the coalition parties to adopt it as a joint move of the Social Democratic and the Communist Party. The plan period finally started in August 1947. Much remained to be done to create sources of finance for the plan, which envisaged results surpassing somewhat the 1938 levels in respect of living standards and industrial output, but in May 1947 the Communist Party

started to emphasize the need to nationalize the largest banks as an indispensable condition for the realization of plan targets. For the first time, that demand went beyond the coalition programme as proclaimed at the end of 1944 and, given the change in the balance of political forces, it was not met until 1947, despite a rapid increase in the influence of the Communist Party. At that time, however, nationalizations affected not only the eight big banks as originally envisaged, but all banking institutions.

Thus, from early 1948, the overwhelming majority of the Hungarian economy was formally held by the state as a result of the indirect nationalization of the bank-owned industrial and commercial companies, but these institutions as well as their organizational patterns and functions remained geared to a market economy or its transitory restriction as originally contemplated rather than adjusted to state economic management already operating in practice. In order to bring the operational mechanisms of the institutions and the economy into line it was necessary for the Communist Party, which was gaining exclusive power from the end of 1947, to abandon the principles of coalition and to discard the *raison d'être* of a considerable private economy governed by those principles. Before the main features of that turn in 1948 will be discussed, a brief reference should be made to the reorientation of foreign trade, the third major element, not yet mentioned, of the pre-1948 economic change.

As noted already, Germany played a dominant role in Hungary's external economic relations prior to World War Two. Those ties grew closer during the war, because the German war economy reserved an important role for Hungarian agriculture and the industry unaffected by air bombardments until 1944. That type of relations was not, of course, reestablished after the war, but trade with the Western European countries and the United States, which had not been insignificant, was picking up momentum, and there were promising prospects for building closer economic cooperation with the neighbouring smaller states of East-Central Europe, one that had been sluggish mainly for political reasons during the post-World War One period, and even ideas of a customs union and other forms of integration were embraced. However, there were other trends emerging against manifold relations from the very beginning.

Hungarian deliveries by way of enormous war damage compensation required a considerable part of industrial and agricultural production and exports to be adjusted *a priori* to the needs of the Soviet Union. These aspects were only strengthened by the Hungarian-Soviet economic agreement signed in August 1945, since under the agreement, which had been proposed by the Soviet Union, Hungary undertook to deliver finished products, in excess of war damage compensation quotas, for imports of considerable quantities of industrial raw materials and primary commodities. (Hungarian experts trained in traditional commercial schools were surprised at and pleased with the Soviet proposal, for such exchange was, to their knowledge, of advantage to supplier of finished goods.) In reality, however, the agreement of August 1945 marked the beginning of a new type of relations in the making: in the period of postwar reconstruction, Hungarian economy was developing along lines which secured for most of industrial production Soviet raw material supplies against deliveries of products that were up-to-date at the beginning, but became less and less marketable elsewhere. In other words, with the passage of time and through the large-scale investment projects of the following

decades, the structure of Hungarian economy was being increasingly determined by the reliable raw material resources and market of the Soviet Union, which, constituting the existing set of conditions, mapped out *a priori* the direction of the development effort in Hungary, thus laying the groundwork for separation from world economic processes.

The agreement of August 1945 included an accord on economic cooperation, under which Hungarian-Soviet mixed enterprises, with a share of 50 percent held by each country, dominated bauxite mining, oil extraction, alumina production, navigation and airlines in Hungary. The Soviet share of capital consisted mostly of German assets in Hungary, which has passed into Soviet ownership. Together with other (formerly German) enterprises passed into Soviet ownership, these enterprises came to be owned by Hungary between 1953 and 1955. Until that period the Soviet Union was the largest, and after 1949 practically the only, foreign owner involved in the Hungarian economy.

For all these developments, Hungarian foreign trade was still characterized by multilateral relations in 1946-47, the respective shares in exports being 26-27 percent for the Soviet Union (ranking first), 20 percent for Switzerland (ranking second) and 12 percent for Great Britain (ranking third). In imports, mainly in terms of loan, the United States ranked first (25 percent), followed by Czechoslovakia and the Soviet Union (14 percent each). It appeared at the time that Yugoslavia, with which a comprehensive fiveyear trade agreement was signed in 1947, would be Hungary's second major partner along with the Soviet Union.

As is known, participation in the Marshall Plan, launched in Summer 1947, was rejected by the countries of East-Central Europe to accommodate the wishes of the Soviet Union. (According to the official Hungarian arguments of the time, absence from the preparatory Paris Conference was explained by Hungary's not being in a position to take part in talks on which the great powers were not of one opinion and which were not to be attended by all of them.) With the rejection of the Marshall Plan, Europe was practically split into two parts in economic terms. Then an official Soviet statement in January 1948 (published in *Pravda* on January 21, 1948) made it clear also that a role was to be reserved for Soviet-dominated bilateral agreements rather than multilateral ones in building economic relations between the smaller states of East-Central Europe. All the CMEA, formed in January 1949, did was virtually to give a legal form to the principles thus established.

The reorientation of foreign trade relations was well illustrated by the fact that the Soviet Union's share in Hungarian imports soared from 11.4 percent in 1947 to 21.4 percent by 1949, its share in exports remaining at around 25 percent. The ratio of Hungarian exports to non-CMEA countries fell from 64 to 51 percent and that of imports from them was down to 50 from 70 percent.

A decisive part in these changes was played by the fact that foreign trade came to be directed and mostly handled by the state from as early as 1945 or that, more specifically, state direction was upheld with some shifts in the pattern of institutions evolved during the war.

The enterprises employing more than 100 workers as well as some smaller ones of importance, a total of nearly 600 companies were nationalized on 25 March 1948 and, by virtue of prevailing regulations, so were an additional 180 enterprises until the end of that year. Apart from other circumstances, this measure made it

clear that the Communist Party regarded the coalition programme outdated and considered immediate, rapid establishment of a Soviet-type political and economic order the goal to pursue. (Nationalizations were prepared by the Communist Party alone, which had not informed the nominally still existing coalition parties until the action began, and the question was taken up by the Parliament months later, so expropriation was ordered by decree and covered by an *ex post facto* law.)

Nationalization was supported by a dual ideological tenet. It was guided partly by the belief that a market economy based on private property and competing enterprises pursuing profit-oriented self-interests was irrational, because it operated under *ex post* regulations, and that conscious direction and *ex ante* regulations of planning were incomparably more rational. (It was believed that goods on the market were "measured" *a posteriori*, at the end of the production process, whereas in a planned economy producers were to know in advance which goods they were to produce in what quantities and under what conditions.) The other basic motive was the idea of equality cherished by the socialist movements and now coupled with concepts of a planned economy in supposing that conscious state direction was not to be motivated by selfish interests and was, therefore, able to realize optimal or just distribution and to determine the proportions of available resources to be allocated to economic development, satisfaction of population demands and other purposes.

The belief in the economy's susceptibility of centralized direction and in the realization of optimal distribution was necessarily combined with devising a technique of what analysts later called centralized redistribution on the analogy of methods used by some primitive societies. The function of the state was believed by those in charge of directing society to be one of concentrating the values produced and distributing them in pursuit of a better and more just society.

The nationalizations effected under the hallmark of this ideology could not, of course, stop at the expropriation of plants employing over 100 workers, as was indeed experienced by the larger part of entrepreneurs, if not *via* propaganda, in the way of further administrative measures restrictive of private property. Consequently, by 1949, there liquidated themselves not only plants employing less than 100 workers, but most of foreign-owned plants hitherto unaffected by nationalizations were also placed under state control, the reason being either indebtedness resulting from restrictive measures or direct political actions, including charges of sabotage. Then, in December 1949, nationalized by decree were the still existing private businesses employing more than 10 workers, making a total of over 4,100 small firms, most of which were clearly of a small scale, not of factory type. The nationalizations, which had been effected partly under economic and political pressure, partly by decree until the middle of 1953 (involving pharmacies in 1950, tenement houses in 1952, etc.), were extended to the majority of the remaining non-agricultural private property capable of producing income. (In early 1953, the number of artisans was little more than 50,000 against 170,000 five years before and 190,000 in 1938. In 1949 more than 30 percent of industrial workers were employed in small-scale industry against as little as 3.8 percent in 1953.)

Unlike the Soviet Union serving as a model, Hungary did not seek total nationalization of agriculture or, more specifically, its equivalent collectivization in devising its system of plan instructions. While at the end of 1948 the leadership proclaimed the beginning of collectivization called cooperativization, it did not en-

force, despite its possibility of using administrative means, its practical realization except occasionally and partially, albeit on a rather wide scale. (By the middle of 1953, little than 26 percent of arable land, representing 14 percent of the total arable area until the economic policy shift to be discussed in more detail later, was placed under management by kolkhoz-like cooperatives, along with state farms already existing, whereas over 55 percent remained in the hands of smallholders. Cooperative farm members numbered 376,000 against some 1,300,000 individual peasants.)

It is not known whether the Hungarian leadership shied away from the total collectivization of agriculture because it knew of the catastrophic famine that followed in the wake of Soviet collectivization or sized up the cost of reorganization, but it is certain that it found a way, even though formally keeping the larger part of private farms, to include agriculture in the system of redistribution. Prior to the grave financial burdens and the wide gap between prices of agricultural and industrial products, the largest role was reserved for the compulsory delivery system, ruthless and extremely harsh, of produce and livestock (all the scale down to eggs), with the quotas fixed to leave peasant farms with no margin except for subsistence or even less.

II. System of the "Classical" Planned Economy

Direct economic management — an idea and reality

Nationalizations in March 1948 brought a radical change, or turn, not by significantly increasing the role of the state, but by creating the conditions for a complete transformation of the system of economic institutions, for copying the Soviet model regarded as an example to follow.

The appointed enterprise managers were selected, then as well as later, clearly by political, not professional, criteria. Their task was not to direct enterprise activity, but to comply with instructions from above, from the state and party apparatuses. However, perhaps the most essential and most enduring element of change was that the enterprise ceased to exist as a unit separate from state administration and became an executive link in the apparatus, which was reorganized into a sectoral system on a strictly hierarchical basis.

Once the function of state administration had turned into one of direct economic management, the existing pattern of organization as established in modern states appeared no longer applicable.

Almost concurrently with nationalizations, there were set up industrial directorates functioning as sections of ministries to take charge of direct management of sectoral production. Parallel to industrial sectorization, there were formed functional sections of the economic ministries with general responsibilities for particular tasks (matters concerning finances, plans, investments, technical development, control, etc.), but, considering that the degree of sectorization had extremely diversified the functions of authorities, organs were set with more and more differentiated functions mainly for economic management and in other areas. (The

single Ministry of Industry was split into a Ministry of Light Industry and a Ministry of Heavy Industry first in 1949, the latter was split again into a Ministry of Metallurgy and Machine Industry and a Ministry of Energy at the end of 1950, and in 1952—53, when specialization was carried to extremes, the light and the heavy industry came to be managed by a total of 7 ministries, including one of local industry, while separate ministries were responsible for managing the construction industry, the building materials industry and the food industry.)

As the sectoral ministries took charge of particular areas, separate authorities were set up, ministries or similar organs of a lower level to exercise different economic functions. (The National Planning Office, established with a small staff in August 1947, soon grew into an economic superministry having a department for each ministry. The former banks became offices specialized for particular functions. The National Bank, which functioned as the bank of issue, was like a huge chief accountancy with territorial subunits keeping books of the incomes and outlays of enterprises; another bank managed centrally allocated investment funds, etc. Vocational training and labour supply were administered by the Office of Labour Reserve. Control was exercised by a Centre of State Control and later by a ministry. Collection of agricultural produce and livestock was supervised by a separate ministry, etc.)

The merger of central state administration and economic management was followed by that of territorial and central administration. Here, too, of course, what formal reorganization did was to close the process which had advanced markedly during the previous years, for in post-1945 Hungary (until 1950) not even formal municipal elections were held except in Budapest, local administration being essentially in the hands of officials designated by the central government at all levels. Local revenues and the availability of funds dwindled to a minimum, with provision of finance depending directly on the intentions of the central government.

The 25 large territorial units of administration (counties) were reduced to 19 in the middle of December 1949. Thereby the leadership formally expressed its acceptance of the Trianon borders restored by the Peace Treaty after World War Two (the former county boundaries were of the pre-1918 pattern, with the territorial units cut by the new borders seen as truncate counties), but, at the same time, it made another step toward realizing its designs of centralization. Moreover, as was the case with the changes in national borders, several districts of economic regions which had evolved through centuries were cut off from one another: a significant part of the pre-existing administrative centres was left with no meaningful function to perform and, consequently, towns were definitively condemned to decline, with administrative units including districts which it has been impossible to organically integrate over the past 40 years. The new organizational system of administration (council system), which followed the Soviet system even in name, was introduced in 1950. The local administration (county, district, town and village councils) nominally functioned as the executive apparatus of council bodies established by formal elections, but in practice it was a division of the central government, so much so that its internal structure was adjusted to the functions of central direction and destined to enforce its direct instructions.

The following one and a half decades naturally witnessed several changes of detail (in 1948—50, for instance, smaller enterprises with similar lines of produc-

tion came under the control of industrial centres; from 1952 trusts were set up with practically the same function; the industrial sections of ministries were called now departments now directorates; the division of labour between different organizations was changing its pattern, etc.), but the dual structure, strictly hierarchical, of the state apparatus in charge of economic management (exercising sectoral and functional responsibilities) remained unchanged.

State administration or, more specifically, the directing state apparatus became very similar to two mirrors facing each other: the pattern of functional organizations reflected the sectoral system and sectoral units in turn differentiated their organizational patterns by function, with lower-level direction mechanically copying both structures. (Any task which was attended to at the highest level by a ministry and a department within the ministry was assigned to a separate organization (department, section or at least clerk) in local administration and the enterprise apparatus as well.)

Production, too, was reorganized concurrently with management. The creation of specialized factories (a process coming to a head in the mid-1960s after an intensive period between 1948 and 1951) was aimed at establishing economic units with single lines of production. As a first step, activities extraneous to a particular sector (services, commerce, marketing) were separated from productive organizations, but separated soon after were also intra-enterprise activities that could be classified as belonging to different branches of industry. (Thus, for instance, a formerly vertically organized leather factory's import and export units were transferred to the leather industry's foreign trade company subordinated to the Ministry of Foreign Trade, its unit for domestic sales became part of the wholesaling leather or shoe enterprise subordinated to the Ministry of Home Trade, and the leather and shoe plants were placed under the supervision of the Ministry of Light Industry, whereas rubber works manufacturing sole were managed by the Ministry of Heavy Industry.)

The creation of sectorally specialized factories was still under way when specialization by product was started. Since parallel economic activities and competition were thought to be irrational, it seemed obvious that a certain kind of product should be turned out at one place. Of course, product specialization was never carried to perfection (a reason why the process was so lengthy), because certain practical considerations (e.g. the geographical distance of factories) left room *a priori* for parallelism, but the "rules" governing specialization were disregarded over time on other grounds as well. It was an element of this approach to the organization of production that the machinery and equipment of small plants nationalized or liquidated were pooled at larger plants in order to build manufacturing capacities of considerable scale. (While in 1948 there were registered over 4,600 data-supplying organizations of manufacturing nature, this figure fell to as low as 1,600 by 1950, and it did not indicate the merger of organizations in the small-scale industry.) That process led to the practical abolition of the so-called background industry, the network of plants supplying component parts for more sophisticated products. Consequently, enterprises either tried to procure the required component parts through the hierarchical organizations, the administrative system of distribution operated on the basis of complicated material and product balance-sheets, or sought for autarky—often with the support of their immediate superiors—in order to become independent of suppliers. While breaking in this way the

limits of specialization, they adjusted themselves to the existing set of conditions created by an artificial, bureaucratic system, and they did so in fact semi-legally, rather than being guided by traditional economic rationality, by profit orientation.

Strict specialization in production and management, which was practically intended to establish a uniform pattern of division of labour in the entire hierarchical setup, was carried out in the belief that it would serve to evolve a very simple and transparent structure with tasks, functions and tiers of officialdom clearly delimited. (At the end of 1948 it was with this end in view that the professionally organized trade unions were reorganized on a sectoral basis, with their tasks declared to be promotion of workers' long-term interests and with surpluses production subserving them rather than the traditional defence of interests.)

It was thought that such a clearly structured system would allow precise planning on the entire spectrum of products, including timing and potential, and that the management centre would be able to have a clear view of isolated partial tasks, to coordinate them and to hand them down as targets for lower levels.

The plan was regarded as the chief tool of economic management. However, the plan became contained only strict and detailed instructions rather than a possible outline of the future in accordance with the original meaning of the term. On the basis of concepts formulated by the centre of management there were drawn up extremely detailed preliminary plans which were broken down in still greater detail down the line of the hierarchy, specifying the performance expected of organizations and individuals at the lowest level. At the higher tiers of the hierarchy the draft plans prepared for the fulfilment of targets as envisaged in the preliminary plans were subsumed again at every level and revised now in light of a wider spectrum of conditions present for implementation. At the highest level of the hierarchy, where the "aggregative" process ended, the nationwide plan was finalized and adopted, then broken down for lower levels and handed down as instructions to subordinate organs. This procedure was believed capable of breaking down nationwide tasks down to workshops.

In reality, however, that system did never work, nor could it work, in accordance with the concepts of its architects. The most it was able to achieve was certain central targets and in a spendthrift way and in the combined presence of temporary conditions (free and cheap labour, apparently limitless funds diverted from other purposes, etc.). At the same time, it proved *a priori* unsuitable for regulating partial economic processes. The gap between presumptions and reality was due, among others, to the fact that in every economy of such type, including the Hungarian planned economy, macroprocesses were governed only by a rather rough control mechanism which left a very wide margin for error in mapping out tasks. Of course, the management organs, supposed to be conscious, sought precisely an extremely rapid rate of onesided development differing from earlier patterns and, in that effort, refused to consider the traditional economic obstacles thereto. Even so, the few signalling systems (foreign trade imbalance, dramatic strains of supply) which warned of problems in the economic processes were instrumental not only in that the attainment of targets required enormous efforts by the population or was regardless of traditional economic rationality, but also in that the deviations of microprocesses from the leadership's conceptions were impossible to perceive or to influence. Again, it was precisely the lack of control mechanisms that made it possible for the extremely centralized management to

put off addressing problems by finding relatively rapid makeshift solutions in response to actual signals or by generating other strains likely to emerge often in the longer run. Thus, some of the problems stemmed from the possibility for the mistaken definition of comprehensive goals or, more specifically, from the fact that such wrong decisions, which can be made in every economic system, had given a management seeking economic totalitarianism, an *a priori* wider scope for enforcement than in the market economies and that, for lack of control, such errors were "more viable" than in a system operated by a different mechanism.

As everywhere, there were two channels for making error, and they were actually used by decision-makers, who, in the absence of proper control, were liable to be mistaken in judging the possibilities for economic growth and setting quantitative targets in general (at the beginning overestimating possibilities considerably, but after 1956 underestimating them at times in view of "spectacular" records of underfulfilment and then overestimating them again as a backlash of caution). Nevertheless, decision-makers were also liable to be mistaken in marking out the directions of development and the areas to be developed (industries or groups of them, manufactures, etc.) — this being the greater source of danger as it was more difficult to detect and correct —, for there was no genuine, relatively prompt feedback control in this respect either.

The internal mechanism of this system operated in other than expected ways. Planning through strictly specialized apparatuses set for subsumption for above and breakdown for below never relied on "objective reality", i.e., on possibilities undistorted by hoped-for selfish interests, but on an intricate maze of the end-results of complicated interests, on the confrontation of conflicting interests which were never allowed to come into the open. The mechanism called plan bargain became institutionalized from the very outset: the lower levels of the hierarchy always felt compelled to underplan their probable tasks as far as possible, and to enlarge resources to be made available to them, knowing that their superiors would set stricter conditions, whereas the higher levels, being aware of this attitude, started *a priori* from such planning by the subordinate organs and persons and therefore proceeded *ab ovo* to increase the targets indicated as realistic and to earmark less resources. Under such conditions, plan indices naturally could not coincide except by chance with real economic possibilities, irrespective of whether these are taken to have meant an "existing reality" or a forced rate of growth, a course held realistic by the management centre.

However, it was not only the hierarchic plan bargain just mentioned which caused this system to deviate from the supposedly optimal mechanism of plan instructions. Specialization and the establishment of production lines were based on the belief that there would emerge a transparent structure of clearly hierarchical relations that was not to be cut across by horizontal patterns and was to be one-way, i.e., was not to be complicated by a variety of systems of subordination. In reality, however, the one-party system which came to power from 1948–49 evolved — despite its constituting a basic condition for building an economy of plan instructions — a dual structure apparently contradictory *ab initio* to its own logic. Although party and state tasks and even functions were virtually merged, the dual system of institutions became firmly or fully established precisely at the time of such merger.

Earlier, in the period of the multi-party system, the political organization of parties was naturally sharply separated from administrative or economic organiza-

tions, even if the members of the parties were motivated by their political ideas at their places of work. From 1948, however, the party was assigned an official role in decision-making at all levels of the hierarchy and, accordingly, the head of the party organization at a particular work organization—both as a member of the hierarchy separated from the state and as a local representative of the political institution playing a leading role *ex officio*—exercised functions which, never clearly defined, added up in practice to at least a power wielded by his counterpart on the state level. The dual structure was not cut across merely by mergers or overlaps of functions, however. As noted already, most directors of enterprises and holders of other senior positions were selected mainly by criteria of political reliability. Thus, it became a general rule to transfer from the party apparatus to state offices leaders who often had better party contacts than coordinate party functionaries did or held two posts (e.g., a minister could be a member of the party's central leadership or even its Political Committee; an enterprise director could sit on the district, town or county party committee). This not only entangled the dual structure (an enterprise director sitting on a territorial party committee was, e.g., even in the party hierarchy, superior to the parallel party secretary), but also differentiated the possibilities open to officials at one level of the state hierarchy to affirm the interests of their respective areas. (Figures for the 1970s clearly showed that enterprise directors holding several posts were more successful than their peers holding a single post in obtaining development funds, since there was intense lobbying for hierarchy-dependent development fund not only within the framework of plan bargaining, but also through more informal avenues opened by party, professional, political and sectoral connections, etc.)

Thus, after all, economic decisions were made, not under a simple and transparent system, but under an extremely complicated mechanism, mostly not legal and ignored, for affirmation of interests, one under which the plan, or the central goal reflected a compromise between the positions of different interest groups that not even the exponents of the predominant view could claim for their own.

It should be noted on this score that the dual, or parallel party and state hierarchy apparently contradicted the economic logic of the system, yet it was not inconsistent with the dominant political and power considerations.

As mentioned before, the established form of a planned economy was based on the assumption that the economy was to be perfectly coordinated by conscious human guidance. Apart from the characteristic features described above, which in their concrete forms could always be deemed to be manifestations of human weakness or error, the command economy had from the first moment immanent qualities which differed in nature and form of appearance, but determined the operation of the system at least just as much and, at the same time, caused it to contrast strongly with what the operators had supposed it to be.

The planned economies, including the one in Hungary, were marked by situations of permanent shortage and made the sellers' market rather than the buyers' or consumers' market the determinant factor. The explanations for this phenomenon were basically supported by the disclosure of a deeper interrelationship, namely, the elasticity of budgetary constraints. While in the market economies it is the economic actors that are forced by the risk of bankruptcy, namely rigid constraints, to adjust their standards to the needs of consumers or buyers, in a planned economy based on state ownership such risk was unknown, because

funds for development or operation were made available *a priori* "from the outside" wholly or in part and, though they appeared to be scarce at all times, were susceptible of increase without limits, i.e., budgetary constraints appeared to be elastic. This caused enterprises to be insensitive to costs and prices except through norms which the state was able to transmit to them, and, considering that some form of state support was always at hand, adaptability in such an economy implied something quite different from adjustment to consumer demands or market requirements. Adjustment under such circumstances was needed to the bureaucratic pattern of demands moulded by the hierarchy or, more specifically, not even to demands, but to relationships created through plans or other media intended to transmit demands. (Of course, also known in other economies are methods which the state apparatus, or local administration employs to correct regulation by the market and to help enterprises, industries or sectors with price subsidies or manipulated prices, protective tariffs, tax reductions or easy-term credit, etc., but the terms and conditions are harsher and budgetary constraints remain stable, even though enterprises can occasionally influence them in advance, but never subsequently, chiefly by other than legal means.)

Furthermore, the exponents of a command economy had supposed that, unlike market economies, such a system would guarantee steady development through conscious guidance, i.e., economic growth would not be interrupted by crises, cycles and slumps. Beside the fact, to be touched on later, that the Hungarian economy was profoundly influenced by swings in politics, analyses of a longer time-horizon have disclosed that a planned economy is also subject to cyclical movements, though different from those observed in a market economy, which cannot be traced back to political shifts. Some of these cycles—as essentially investment waves, leaps and periods of retrenchment regularly succeeding one another—are a virtually immanent feature of this system. However, in the wake of the world economic changes during the 1970s, it became equally clear that planned economies were not immune either to the effects to which every country is exposed and that, due in large part precisely to the immanent qualities of the system, their adaptability proved smaller than that of most countries of similar economic strength or at a similar level of development.

Among the various characteristic features of the operation of the Hungarian economy mention must be made of the *in natura* approach, which was slow in losing ground even under a reformed system from the late 1960s. That approach also was rooted in aversion to the market economy and hence to commodity and money relations, since the use of physical targets (piece, ton, meter, etc.) instead of uncertain value categories originally appeared more readily evident. Although in practice the system of plan instructions finally allowed a much wider scope than intended for financial and price regulations, it was capable of conveying instructions expressed mostly in kind or similar numerical indicators. Also, the successful performance of producing and marketing enterprises could not be measured by adjustment to the market and hence by profit gained or by value produced, but only by fulfilment of centrally set targets.

An important role in the emergence of the *in natura* approach and in its long survival after the abolition of direct plan instructions was played by the fact in Hungary economy became part of the political system and that the two spheres (politics and economy) were not separated. Since the leadership had formerly dealt with

economic questions from a political angle and by political means for the most part — to a lesser degree subsequently and to a large measure even in the most recent years —, economic tasks and problems also had to be formulated in political language, in which the economy meant chiefly targets *in natura* or theses of a similar nature expressed in terms of figures or slogans.

However, organizations necessarily adjusted and adjust themselves to centrally set targets defined *in natura*. If, for example, targets were fixed in prices or other quantitative terms, producers became interested in turning out products with the use of the least material and in unacceptable quality or, quite the contrary, squandering many times the energy and material needed. Therefore, the rough physical targets stimulating purely quantitative performance were soon abandoned, but, no matter how much plan instructions were refined and combined with qualitative criteria, there always remained elements which the directing organs were unable to grasp and which allowed producing and marketing enterprises to meet requirements formally rather than actually.

It was the economic dominance of the political approach and methods that in the system of plan instructions left wide scope for organizational expedients, different from traditional arrangements, such as campaign, perhaps the most typical of all. In cases of difficulty, campaign served to push the system in the apparently desirable direction by ignoring economic rationality, but in reality generated fresh strains in other areas of the economy, strains which led to successive campaigns. Consequently, this method, which was originally employed to meet extraordinary tasks, grew into a constant element of the mechanism and even became the organizing principle of the economic management apparatus, so much so that it retained its role, though restrained, even under a reformed planned economy.

Economic development plans in the first part of the 1950s

We have mentioned earlier that a chief function of the economic system established in 1948 — 49 was to achieve an extremely rapid rate of development. (As described above, the turn which started in late 1947 and early 1948 was first manifest in, among others, the shortening by 7 months of the fulfilment period of the three-year plan launched a few months before.) At the same time, the goal was not simply to speed up economic growth, but to give it a direction, mapped out rather clearly, to suit the concepts that had stiffened into a dogma by the time planned economy was introduced in Hungary. (The three-year plan for 1947 — 49 originally envisaged allocating 30 percent of all investment funds to agriculture, 26.5 percent to industry and 25.5 percent to transport. The new effort undertaken in the wake of the turn is best characterized by the fact that industry ended up receiving 35 percent of investment allocations as against 21 percent earmarked for transport and 15 percent for agriculture, with the bulk of the funds for the latter raised from the self-financing of small peasant farms. With industry in the focus of the development drive, priority had been given to the heavy industry, representing a trend similar to the wartime effort forcing its way again, before the economy was switched over to peacetime production.)

Like the views about the economy's susceptibility to guidance, the economic development concept consisted of various elements, but was, in the last analysis,

rather simple, yet fairly alien to real conditions, and its consequences and after-effects brought about a pattern of relations that was hard to rectify and had far-reaching implications. Those in charge of directing the economy started from the premise that a modern economy should, as in the Soviet practice regarded as the direct model, be dominated by industry, partly because such was the case in the most advanced countries, partly because it was decisive to military tasks and, finally, because it was the agent of progress, the working class was to prosper as the result of industrialization, agricultural labourers were to become workers and to be moving ahead, climbing the ladder of social hierarchy. However, industrialization itself was conceived of as following a rather stereotyped schedule on the British pattern, which had been studied, and seen as the model of capitalism, by the classics of Marxism. It was believed possible to match the centuries-old development of Britain by avoiding its adverse effects and making use of the fresh possibilities inherent in the new system of society during a couple of five-year plan periods.

The idea was to develop first and foremost the heavy industry as the basis of a modern large-scale industry, together with the raw material base represented by the raw material-producing and -processing sectors, namely mining and metallurgy constituting the only basis for the processing industry. The economy was planned and accordingly managed during the following decades in such a way as to ensure that mobilization of significant material resources for the other spheres would become possible after industrialization had been completed. The scarce resources were used in furtherance of this goal. Once permitted by the central management of the economy and by the redistribution of material resources (centralization and central redistribution), an extremely sharp differentiation was made between the economic sectors, with the major source of development finance constituted by income produced in agriculture and with personal consumption kept at a very low level, but, under the hallmark of industrial development, the so-called producers creating no new values (as the infrastructure was termed) were also sharply separated from directly producing branches and no more resources than required for their operation were made available to them so as to spare considerable resources even in this field for use in industry.

Of course, it was inevitable to depart from these ideas from the very outset, namely an "ideal" priority for economic development projects could not be set except with inconsistencies. On the one hand, industrial development called for imports, which presupposed counterpart export deliveries, with trade to be practised partly with countries, and on a larger scale than desired, which had greater demand for products of other than the priority sectors of the Hungarian economy (products of agriculture and the light industry found readier markets in West European countries than did products of the branches providing the basis for industrial development), so there was no choice but to develop those sectors as well, to an extent exceeding their capacity to secure basic supplies. Moreover, demands were made by the operation of the economy, society and management, so the infrastructure was also to be kept going, even if not to be developed, with a sizable drain on available funds.

The directions of economic development (initially understood to mean the industry and later to comprise a wider, though still narrow, spectrum of the economy, involving a partial "rehabilitation" of agriculture from the mid-1960s and of

some infrastructural facilities, to be treated below, from the early 1970s) were modified with great frequency whenever policy shifts occurred and at other times over the past four decades, because the priorities set apparently proved blind alleys relatively soon. Yet, until the end of the 1970s, there was little change in the essence of the decision-making mechanism as far as priorities were concerned. It remained characteristic also of sectors other than priority ones to assert their claims supported by strong arguments in the competition for development funds, such as those marshalled for import substitution, increase of export potential, exploitation of national traditions and endowments, investment project completions, reliance on cheap raw material supply from the CMEA, a guaranteed solvent demand of CMEA-countries and, after 1956, satisfaction of population demands. Though with wide variations, the consequences were by and large similar in every period and can therefore be characterized, regarding the past 40 years a whole, by the following: there emerged a huge economic potential at enormous costs, i.e., through investments with the minimum effect, the scattering of resource allocations gradually creating an industry rapidly lagging behind the international vanguard in all fields and an agriculture competitive in quality thanks to natural conditions but producing at high cost. (We shall come back to this global picture to shed more light on details.)

Unlike the so-called sectors of material production, i.e., industry (inclusive of the building materials industry) and agriculture, economic policy regarding the infrastructure except housing construction basically sought all along to ensure the operation of facilities rather than to establish orders of priority. In some areas this meant, in the strictest sense of the term, guaranteeing a minimum level of functioning as of the larger part of urban communal facilities, management of state-owned tenement houses, the telephone service, the network of hospitals (chiefly in the capital) or primary education, retail stores for most of the period, etc.

The infrastructure in other areas was allocated sizable resources and registered apparently significant development, but more thorough inquiries made and make it clear that what economic policy sought was virtually to ensure the conditions of operation in this respect as well. Related tasks included those largely of an economic nature but often dictated by ideological and political requirements, such as development of the network of crèches and kindergartens called for by the fact that in the 1970s the process of forcing women to take up employment was essentially completed (prewar wages generally followed the one earner per family pattern, but switched to two earners from 1946 and in particular from 1949), emergence of mass demand for housing in the wake of the radical disintegration of the peasantry and their influx into towns, or development of the polyclinic network trying to adjust itself to the extension of social insurance coverage *a posteriori*, increase in the capacity of secondary and higher education, expansion of the road and service networks trying to keep up with automobilism, etc., namely areas where even considerable outlays and development efforts could not but create or maintain a state of *quasi* development characteristic of the other areas.

The priority always accorded to the productive sectors in the selective satisfaction of needs has been but one of several problems attending the economic development concept as outlined above concerning infrastructural facilities. (In the market economies the inner mechanisms stimulating the efficiency of production and the interest in increasing effective household and personal consumption tend

to secure, more often than not, an essentially parallel development of the infrastructure and other sectors. In the centrally directed economies this area is usually developed *post festa*, when conditions reach the point of impeding the operation of the productive sphere.) Another reason for 40 years of infrastructural shortfalls, occasionally hindering the operation of the economy, lies in the immanent peculiarities of economic development and the economic mechanism, for this model has generated much greater and more enduring strains in the infrastructure than more balanced and organic development efforts, better coordinated by inner economic limitations, do. Relevant studies have found evidence to show that the specific performance of certain elements of Hungary's tertiary sector (e.g., rail transport, health service, education) is more favourable than the corresponding indicators even of the much more advanced countries, yet constant shortages are confronted with unsatiable and exorbitant demands germinated by the management and the structure of the economy.

Although, as noted earlier, even the three-year plan for 1947–49 was virtually fulfilled on the analogy of the Stalinist industrialization, the real intentions of the leadership were revealed by the first five-year plan for 1950–54. Drawn up in 1949, its original version demanded from the population enormous sacrifices on behalf of a quickening tempo of development, but the targets stepped up in 1954 indicated by themselves, regardless of the emergent problems and without any detailed analysis, that the leadership had not actually separated desires from possibilities: the original plan envisaged a nearly 90 percent increase in manufacturing output over the 1949 level, a target which was raised to 310 percent in 1951, and the target to increase the output of the heavy industry by 100 percent was stepped up to 380 percent. To achieve that goal, an unprecedented ratio of the national income was to be allocated to investment or accumulation, but is still proved impossible to bring development concepts into line with the availability of funds: investment allocations were raised by nearly 70 percent in 1951 and the funds earmarked for the heavy industry were increased by over 100 percent in comparison with the plan of 1949. Moreover, the development resources required for the priority targets of the heavy industry could only be planned to exceed twice the original allocations (with a nearly fourfold rise envisaged in production) by diverting funds from other sectors of the economy. Under the plan of 1949 heavy industry was to receive 36 percent of all investment allocations, but in 1951 this share was raised to 44 percent within the nearly 70 percent increase in funds allotted to investment purposes, whereas the planned shares fell from 6 to 4 percent for the light industry, from 17.5 to 13 percent for agriculture, and from nearly 28 to little more than 16 percent for social, cultural and housing investments.

The leadership required maximum effort of everyone for the implementation of the stepped-up plan and, to that end, found it permissible to employ the most varied forms of physical coercion and administrative fiat (to mention but the most striking examples, in the period 1950–53 court proceedings were instituted against 650,000 persons (almost 7 percent of the population of 9.5 million), police courts imposed 850,000 penalties for petty offences, internment and labour camps were set up, non-fulfilment of plan targets and non-compliance with delivery obligations could be deemed to be crimes under the law on the protection of the planned economy, etc.).

While enormous resources were used up, there was no chance of realizing the

plan, but precisely the extraordinary effort, the huge investment projects and the enforced transformation of society acted to switch the economy to a course that became determinant during the decades that followed. True, the 341 new industrial plants as planned in 1951 were never established, nor were the 263 as determined in 1949, but 72 were nevertheless completed together with 41 major expansion projects. Most of these were not simply heavy industrial establishments, whether completed or started, but served lay the groundwork primarily for the further development of the heavy industry. No doubt that the capacity of war industry, which was given priority within heavy industry, was increased 20 times the 1949 level by 1954, but heavy industry remained unable to supply, directly or indirectly, the other branches of the economy and industry itself with means of production by reliance on exports and the resultant import capacity (for export of heavy industrial products did not even cover imports required for this group of industries).

Although the productive capacity of industry increased twofold between 1950 and 1954, that apparent result was largely due to an over-expansion of coal mining and iron and steel production, along with the growth of the war industry, while traditional machine-building and telecommunication with a lower material and a higher labour content, together with the light industry, inclusive of foodprocessing, saw their role in the economy reduced.

In agriculture—under the impact of the centrally decided production pattern, exorbitant compulsory delivery quotas, enforced cooperativization and generalized vexatious interference with citizens—there was a reduction in total cultivated area (from 9.6 million cadastral yokes in 1938 to 9.4 million by 1953 and to 9.1 million by 1956) and in average yield of crops from the prewar level, while this, combined with the pressure for production of industrial plants, reduced availabilities of all staples for export and domestic supply.

During the period of 1950 to 1954 a total of 360,000 persons left agriculture to seek jobs elsewhere, but the increasingly intolerable housing conditions in towns caused a growing number of people to live in lodgings far from their families or the travel several hours daily under inhuman conditions. (Total additions to the housing stock were 96,000 dwellings during those few years, meaning that the rate of population growth was higher than that of housing facilities at a time when not even wartime damage had been reconstructed. Population growth during that period was 23 percent in provincial industrial towns in the process of expansion or emergence and over 10 percent in Budapest, places where the discrepancy between population growth and the number of new dwellings was far wider than average.)

A most palpable and immediate consequence of enforced economic development was the fact that as early as the middle of 1953 real wages lagged 20 percent behind the 1949 level, though the latter itself had dropped from the figure for 1948, and thus fell far short of the prewar figure.

An attempt at change and then at no change

The middle of 1953 witnessed an important shift in Hungary's economic policy. At the initiative of the leadership which had come to power in the Soviet Union after Stalin's death, Mátyás Rákosi was removed from his post as Prime Minister, al-

though he remained, the head of the party. Imre Nagy, the new Prime Minister, announced as a government programme an effort at change which had been approved of by the party leadership and which reflected the endeavours of the new Soviet leadership in several aspects.

The attempt at renewal, referred to as a new stage at the time, naturally did not promise any transformation of the political and economic system, but was calculated as a necessary step to replace the extremist methods and goals by creation of conditions more acceptable for the population and society and by realization of more realistic targets. The economic concepts envisaged slowing down the rate of industrialization, preferred production of consumer goods over that of heavy industrial products and the manufacture of means of production, and sought to expand agricultural output.

The change was clearly indicated by the fact that the ratio of national income destined for accumulation dropped from an extremely high 23.4 percent in 1953 to 17.6 percent by 1954, the share of industry in investment allocations fell from nearly 47 percent in 1952 and 1953 to 35 percent, that of heavy industry was reduced from 44 percent in 1952 and 41 percent in 1953 to 30 percent, while that of agriculture surged from little less than 17 to 24 percent.

While these and similar changes (e.g., reconversion of producer-goods plants to production of consumer articles) were effected by the previous methods (central plan instructions), the new economic policy in agriculture was combined with novel instruments. In the second part of 1953 and in 1954 decree upon decree was issued to liberalize the living and working conditions of peasants. Of course, these changes remained within the confines of the established political and economic system (e.g., the burdens of individual peasants continued to be heavier than those of cooperative farms and the latter's more serious than those of state farms), but withdrawal from a cooperative farm was permitted, even though subject to strict conditions, enforced collectivization was abandoned, compulsory delivery quotas were reduced and even part of the backlogs were cancelled. The obvious aim was to increase or, more specifically, to restore peasants' motivation for production by spectacular and tangible measures, a policy which, after all, was only possible to implement by a partial retreat of direct central management.

The stage for longer-term changes of even greater significance was set by efforts initiated against bureaucracy in the form of traditional campaign. The new leadership wanted to eliminate bureaucratic phenomena by launching its struggle for the rationalization of management early in 1954. That effort, however, went far beyond similar actions in the past in so far as it was extended to include identification of the causes behind the undue expansion and malfunction of the directing apparatus. Committees composed of higher-level officials and economists were set up to disclose, in the favourable atmosphere created by political and economic policy shifts, deeper interrelationships, and even aspects formerly treated as taboo were subjected to criticism. In point of fact it was these inquiries that first allowed experts a deeper insight into the real functioning of a system described in textbooks and at courses as ideal and purposeful. It was these inquiries which in the following years gave rise to concepts presenting an alternative to the existing mechanism of plan instructions but, at the same time, seeking to preserve the foundations of the political and economic order. The initial changes occurred as early as the end of 1954, but the new economic policy shift (and political change)

effected early in 1955 forced the attempted quest of a new course to continue half underground for a while only to regain momentum in 1956–57 with the emergence of a more favourable political atmosphere.

Within the top-level directing apparatus, where no meaningful change and personnel shift had taken place, the new stage marked by the name of Imre Nagy found few supporters. Thus, when late in 1954 and early in 1955 the “more traditional” forces opposed to a radical break with the Stalin era gained, for a transitory period the upper hand again in the Soviet Union, the Hungarian leadership, which kept its pre-1953 position almost intact, was extremely quick to gain ground after barely one and a half years of wait and see. Imre Nagy was removed in April 1955 and even expelled from the party a little later for the “errors” committed in 1953–54, with the blame thrust virtually on him alone.

In 1955 and the first part of 1956 there was a virtual return to the practice and economic policy followed before the middle of 1953. The only consequence of the facts disclosed and the official self-criticism made was that the methods employed and the tasks set were less extreme at the beginning. (For all that, enforced collectivization was resumed, compulsory delivery quotas were raised, the development of the heavy industry received renewed emphasis, etc.)

The Hungarian leadership was only partly responsive to the new course proclaimed in the Soviet Union at the 20th Party Congress in February 1956, nor did it find any way of meeting the economic problems in addition to the accumulating political strains which, not discussed here, were ultimately to ignite an explosion. Clear evidence of this was the new five-year plan for 1956–60, which was drawn up by May 1956 and approved in July. True, it reflected no concepts as unrealistic at first sight as those contained in the previous five-year plan, but the leadership stuck to the idea of giving priority to the development of the heavy industry, including sectors that were to lay the basis for future industrial expansions. Planners were supposed to solve an impossible task, not least in elaborating long-term concepts, namely that of making the underlying instructions, politically and ideologically motivated as they were, consistent with available economic information and with competence. The intention was to try to satisfy the demands of the light and food industries as well as of agriculture, along with the priority development of the sectors supporting industrial growth, partly to ease the pressure of supplies that were at an intolerably low level, partly to meet probable import needs, while securing considerable rates of growth in other sectors of the processing industry. Under the existing system there would have been but one way of easing the apparently unsurmountable strains of distribution, that of scaling down growth, which, however, would have run counter to dynamic development, the system's supposedly fundamental hallmark, and would even have been tantamount to rehabilitation of the Imre Nagy era, something politically unacceptable.

By the time the new five-year plan was adopted in July 1956 half of the first plan year had passed and the concepts had practically proved unviable, but the leadership refused to admit it. This notwithstanding, the economic problems were but an indirect cause on the uprising, which began on October 23, 1956; the direct motivation was of a political nature. Still, ten days later, what the new power headed by János Kádár and having removed Imre Nagy, reappointed Prime Minister of October 24, and his government had to do was to articulate its policy on fundamental economic questions.

Readjustments in politics and economic policy — continuity and innovations

While the comeback to power with the assistance of foreign armed forces and the subsequent reprisals made it unambiguously clear in political matters that no essential change was to be made in the political system as established in 1947–48 (meaning the leadership's hold on power over society and the virtually complete absence of democratic control mechanism), the path to follow in the economy was far from marked out so clearly, since signs were already evident of a practice, yet to be fully established, under which the power sought reconciliation and cooperation with society excepting the active adversaries and, within the bounds of political and ideological principles, even displayed willingness for cautious innovations under the hallmark of the policy course.

The Imre Nagy Government abolished the compulsory delivery system in agriculture with effect from October 30, 1956. Revocation of that decree would have threatened to set even the hitherto rather passive peasantry against the new leadership and to cut short farm activities simultaneously with the general strike which was paralysing the industry, thus giving rise to problems in basic supplies. Of course, the reconfirmation on November 12, 1956 of the abolition of the compulsory delivery system was more than a simple political gesture. The government gave up an element of the former economic system which had been believed indispensable, while undertaking pioneering efforts in other areas of the economy that were suggestive of allowing scope for methods largely different from those employed during the previous 6 to 8 years. The mistaken agricultural policy of the past period, forcible collectivization and the entire course of economic policy harming agriculture were condemned. The government declared its intention to regard agricultural development as a basic task and to rely in that effort on producers' material interest and the free choice of farming methods. It took note of the disintegration of cooperative farms, a process which had started in spring of 1956 and was gathering speed in October, and, with it, of the liquidation of agricultural farms practically of the kolkhoz type. During the two years between 1956 and the middle of 1958, 364,000 peasant farms resumed operation on a total area of 1.3 million cadastral yokes. A sizable part of cooperative farms formally continued in existence, but the number of their members was rapidly decreasing, from 343,000 in the middle of 1956 to 119,000 by the end of that year, with additions of as little as 50,000 new members during the following two years. At the end of 1958 the number of cooperative farms fell to 67, with their size shrinking to 59 percent and their membership to 45 percent in comparison with the figures for the middle of 1953. Consequently, agricultural production became dominated by private farms, the role of state farms reduced considerably, and the so-called cooperative sector was marginalized. (The share of state farms in gross agricultural output dropped from 14 percent in 1956 to 9.3 percent by 1957 and that of cooperative farms from 9.6 to 4.8 percent. In 1957, 87 percent of net output was accounted for by private farms.)

The new leadership's willingness for change was manifest not only in the agrarian sector, but also in the economy as a whole. At the end of 1956 the government initiated the setting up of a broadbased expert committee (with the participation of

numerous non-party scholars previously neglected) to elaborate an economic government programme. The task was not merely, and not primarily, to set out an economic policy concept, but, by completing the work well advanced before October 1956, to devise a new economic mechanism, an economic system suitable to replace the system of plan instructions, while not affecting the substance of the political system.

The termination of political confrontation and the rapid consolidation of central power during a short period (in late 1956 and early 1957) entailed an increasing prevalence of views bent on compromise and set for the operation of the existing economic management system. Under the original concept the system of plan instructions was to be completely abolished and the implementation of plans not descending to particulars was to be secured by economic instruments, but the proposal drawn up by the middle of 1957 and considered final found direct intervention by central management permissible in several areas, although it still upheld the concept of central economic management free from plan instructions and relying mostly on economic regulators.

While the possibility of what was called a new system of economic management, a new mechanism, emerged from the committee debates and suggestions, the fundamental questions remained unclarified, for the reform concept was, in point of fact, confined to a market-like arrangement for commodity production, with no consideration given to the capital and labour markets. Since the politically delicate aspects were deliberately shunned, no substantive consideration was given to consequences arising from the administrative ownership of state enterprises, the interpenetration of state administration and economic management, and the exercise of political power. Thus, on the whole, what was devised was a system under which central management was to employ the whole spectrum of instruments to control and direct the economy even in the absence of plan instructions.

However, as early as the middle of 1957, the leadership was no longer interested in a concept based on compromise and rejected the draft without a debate. Though the decision was said to be motivated by both internal and external political factors of the moment, the chief reason for rejection lay in a conservative approach marking the new leadership. Among the elements of domestic policy, mention may be made of the successful restart of production, the rapid defeat of political resistance, and the growing influence of the forces supporting the new leadership and attached essentially to the management system existing prior to October 1956. Among the external factors, reference can be made to the renewed deterioration in the relationship between the Yugoslav leadership favouring a break with the Stalinist arrangements and the Soviet leadership, the parallel increase in the influence of Chinese concepts upholding the Stalinist approaches, and the large-scale CMEA projects of development and cooperation emergent at the time.

By the middle of 1957 the above factors led the leadership to conclude that a balanced but rapid development of the economy and the desirable improvement of living standards could be ensured without comprehensive change, *via* the shifts already introduced (chiefly in agriculture), an economic policy free from extremes, rationalization of management, and mobilization of resources inherent in CMEA-relations. The demand of the reform concepts "to do something different" than before October 1956 was branded as ideological revisionism and preponderance was gained clearly by the approach of "doing the same better" instead of carrying

out substantive change. A basic role in this was played, along with the shifts in the internal and external situation as mentioned before, by the leadership's reluctance to substantive change, an approach which, after the impatient aggressivity experienced during the previous period, found support or, at least, acceptance on the part of the majority of the population in the space of a few years.

It was essentially the views of János Kádár that down to the middle of 1988 determined on the whole, though naturally not in every detail, the practice of the new leadership, which came to power in November 1956.

The position which the leadership formulated as a balanced middle-of-the-road policy mainly against a two-way extreme (voluntarism characterizing the first part of the 1950s and revisionism applied to Imre Nagy and the reform concepts until the mid-1960s) started from the experience chiefly of the post-1948 years and particularly of 1956. The leadership drew the conclusion that extremist solutions and sudden shifts involved political danger. Therefore it considered continuity to be its main virtue and proceeded from the premise that it was not advisable for existing stability to be upset by innovations with uncertain consequences. It maintained that eventual malfunctions in partial aspects should naturally be remedied, but in a way to ensure the dominance of tried and tested methods and not to call into question the continuity of politics. (While the period 1948 to 1956 was characterized by, among others, constant reshuffles of ministries, the directing apparatus, and even organizations in general, the division of responsibilities among ministries witnessed no change between 1957 and 1968 and, although the illusion of solving problems by way of organization continued to exist, less recourse was had to apparatus shake-ups in general.) It was also held that no goal, not even official ideological concepts, could be realized if the material needs of the population were ignored, namely the standard of living had to be raised constantly, as was emphasized and actually practised until the early 1980s. In contrast to the pre-1956 years, the prevalent view was that the population should not be required to keep demonstrating its acceptance of the regime, but that doing nothing against it was sufficient proof of loyalty. The resultant practice contributed greatly to a gradual depolitization of society, for as long as the relatively rapid rate of economic growth generated the sources of rising living standards, the leadership did indeed care about its citizens by using its own means, in accordance with its political principles, thus securing social peace, which, based as it was on paternalism, was subsequently referred to as consensus.

Part of that consensus was the practice, initially sporadic but later facilitated deliberately, under which the leadership promoted population welfare not only by centrally distributed income, but also by reliance in other means, namely by allowing some latitude for diverse forms of earning and using income through channels deviating from the course of central direction. The so-called second economy, which was expanding from the 1960s, became a major source of rising living standards, since official wages and salaries derived from full-time jobs had never been sufficient to buy car and week-end cottage, to finance travel abroad and, not counting a few well-paid and privileged groups, even to mechanize households in general. Moreover, official monetary incomes were adjusted to the state-owned tenement housing scheme, although allocations of state housing did not meet but a fraction of needs even in the boom years of state housing construction (1975 to 1980). Consequently, the construction of dwellings and in part cottages became

both an end and an operating area of the second economy. (Until the mid-1970s, two-thirds of dwellings on average were built under self-help schemes; this ratio fell to 50 percent with the growth of state housing construction between 1975 and 1980, but increased to the previous level by the mid-1980s. The annual number of dwellings built through self-help schemes varied between 32,000 and 33,000 in the mid-1960s, rose to 60,000 by 1972, but fell to 34,000 in the early 1980s, while increased again to above 40,000 by 1986.)

The extent of the second economy is hard to tell exactly in view of the fact that some of the related activities had always been on the border-line between official tolerance and clandestinity. At any rate, in contrast to the second part of the 1970s, when economic policy did not yet seek to specifically stimulate certain activities in the second economy as was the case in the post-1982 years, about two-thirds of families derived income from sources other than the state and cooperative sectors. The percentage ratios of people engaged in the second economy were 40 for workers in industry and the building industry, nearly 90 for agricultural workers, 20 to 25 for intellectuals, and 40 for pensioners. On the national average, some 20 percent of the hours worked were devoted to such activities.

After 1956, prior to the economic reform of 1968, there occurred numerous shifts, not too spectacular in themselves but significant in overall terms, both in politics and in direct economic management under the hallmark of the prevalent approach. Among other things, in the effort to continue the virtual rationalizations of 1954-56, the number of plan indicators were reduced further (a total of only 8 overall indicators were established for the ministries from 1959), the ministries were empowered to issue plan instructions varying by sector and making allowance for specific conditions in the different areas, in contrast to the previous practice of no differentiation, and even the tasks of enterprises were determined through a few most important indicators. A much wider scope was left for material incentives in orienting the activities of both individuals and organizations, and so on.

However, there was no sharp dividing line between the rude measures of repression prevalent before 1956 and the incentives applied from 1956 and often simulating commodity production, because both methods were present in both periods. Still, even the smaller shifts in the management system came to create a new situation. The looser and more purposeful arrangements, which were replacing the previous physical indicators (e.g. deductions from profits through prices and taxes), demonstrated, unlike compulsory deliveries, the ability of central management to control processes by indirect methods (for there was naturally no change in, e.g., the insistence of hierarchical management on retaining control over economic processes). Economic actors were under diminishing pressure to cover up their reserves and to fulfil plan indicators formally, against economic rationality and even common sense. (With the system of plan instructions growing in flexibility from the end of the 1950s, the instructions issued by directing organs, for instance, increasingly served to feel out the capacities of producing enterprises and were even based on bargaining with them under a practice which was forcing its way to institutionalization.)

On the whole, the situation was characterized by the fact that every centrally initiated change was of an *ad hoc* nature and was intended to remedy the most striking problems and "wrongs". Over the years the efficiency of the official systems of

direction and institutions was increasingly ensured by informal relationship, by arrangements never approved but accepted. On balance, rectifications and spontaneous shifts resulted in a significant relaxation and erosion of the original mechanism of plan instructions, but failed to revamp the system of economic management until 1968. Tantamount to instructions, plan remained the major instrument, and prices were fixed by the authorities rigidly separating producer and consumer prices and both from world market processes. The single hierarchical set-up of enterprises and authorities did not change, but became less rigid, with horizontal relationships remaining virtually absent.

Radical change

The post-1956 decade saw two series of radical change in the economy along with less significant shifts and with efforts at continuity. The goal in both cases was clearly to follow up to the measures already introduced in the Soviet Union and most CMEA-countries. Moreover, the process of collectivization, which was set in motion early in 1959, was definitely preceded by a decision coordinated with the leaders of the CMEA-countries.

At the end of 1958, after two years of propaganda professing the voluntary principle and of a corresponding practice, there was a sudden decision to speed up collectivization in Hungarian agriculture. As little as three winters were needed to reverse the private farm—cooperative farm ratio by the spring of 1961, i.e., to increase the number of collective farmers from 169,000 to 1.2 million and the share of cooperative farms lands from 14 to 70 percent. The means of pressure used for collectivization was psychological in general rather than physical, but the rapid transformation was ultimately accomplished owing to the peasantry's enforced realization that private farming would not have a secure future, just as it was not allowed except temporarily in the periods 1945—48, 1953—54 and 1956—58.

Like other countries of East-Central Europe, Hungary did not possess the material resources indispensable for the organization of large-scale agricultural production. Although the goal referred to as a dual task, namely to impart an impulse to production and concurrently to establish the organization of economic activity, could not be achieved in that way (livestock numbers fell sharply and only the volume of mass produce did not decline in crop farming), there arose no dramatic problems of supply similar to those ensuing from collectivization in the Soviet Union or experienced in other countries undertaking suchlike schemes. This was due, not to the newly established cooperative farms, but to household farms, auxiliary farms and private farms. (The household plots amounting to 8 to 10 percent of total land accounted for about one-fourth of agricultural production in those years, an additional share of 12 to 14 percent to be credited to auxiliary and private farms cultivating 6 to 8 percent of total area.)

That the household plots as areas formally held by collective farms, but practically cultivated by cooperative farm members on their own played such a significant role, which was to remain determinant also in the future, was the result—like several other typical arrangements in the Hungarian economy—of a transitory solution holding steady, of a temporary “concession” given to it *vis-à-vis* arrangements believed to be ideal, rather than formed part of a conscious long-term

policy. The peasants forced into cooperative farms had sources of additional income secured by two "concessions" essentially independent of each other: in the conviction that irrational adherence to traditional independent farming would soon fade away, the leadership tried in this way to tide peasants over the period of transition between private and common farming, on the one hand and, on the other, to compensate peasants for the temporary loss of income promised from common farming until cooperative farms would have given proof of their decisive superiority in terms of efficiency. Accordingly, the temporary character of household farms and their inferiority to collective farms were emphasized until the mid-1960s, a situation that changed gradually when the above concepts did not materialize and collectivization appeared not to increase performance by itself. The household plots, which were in the nature of private farm, came to be considered an integral part of cooperative farms, with their temporary character gradually forgotten.

Following collectivization, a few years had to pass before the serious problems of agriculture and the resultant difficulties in supply brought the leadership to change its agrarian policy concepts. (The difference from arrangements in other countries with a similar political order or from the antecedents in Hungary was manifest precisely in that the case in this respect was one of continuing the Imre Nagy traditions invariably rejected, namely, in that when ideas and reality were in conflict, the former were adjusted to the latter, not conversely, in agriculture.) The shifts introduced from 1964–65 and intended not to create a semblance of radical transformation in this field either took a few years to form a system and enabled Hungarian agriculture to produce outstanding results among the CMEA-countries. (The 1980s then revealed also the significant shortcomings of that system, composed as it was of hardly adjustable elements and preserving numerous traits of central management.)

The changes in the agrarian economy took place essentially along to mutually complementary lines: economic policy and central management adopted a new approach to agriculture, particularly to cooperative farms, considerably increasing allocations through redistribution, and the central management of cooperative farms was greatly elasticized in a few years, with the possibility opened for translating into practice, without a formal reform, most of the basic concepts relative to the agrarian sphere before the reform called new economic mechanism was carried out in the economy as a whole.

Partly indicative of change was the fact that at the end of the 1960s Hungarian agriculture and sylviculture received 19 percent of investment allocations against 14.2 percent of the average for 1961–65, exceeding by far the ratios in other CMEA-countries. (In the 1970s, owing to economic difficulties, the share of agriculture in investment resources dropped to the previous level, representing 14.3 percent of the average for 1975–80, and amounted to 14.9 percent in the following five years.) However, development resources would by themselves have been insufficient to secure success, for the agrarian sphere in the Soviet Union, for instance, had a relatively favourable share in investment allocations. A role similar to that played by investment resources and other financial conditions in a rapid improvement of performance was reserved for the fact that from the mid-1960s the machine stations as owners of state machines separated from cooperative farms were abolished and from 1966 the cooperative farms were permitted to have larger

machines of their own, while the plan breakdowns by administrative district and cooperative farm, except for areas sown to bread grains, were abandoned. Similarly, previous regulations subjecting contracts with state or state-like enterprises, which were vested with prerogatives in purchasing and marketing produce, to review of cooperative farm plans by those enterprises were repealed. These measures, and others not discussed here, combined to increase the independence of cooperative farms both of central administrative organs and of local administration responsible for direct management. The gradual replacement of political "cadres", directed to agriculture at the time of collectivization, by reputed local farmers with agricultural expertise or by better qualified specialists helped cooperative farms make fuller use of the possibilities thus opened. In that way the conditions emerged, even though in part and with rather wide variations in different regions of the country, for an enterprise-like operation of cooperative farms.

Despite subsequent gradual adjustments, the collectivization carried out at the turn of the 1950s and the 1960s practically liquidated the traditional peasant farms and made cooperative farm membership as a relationship of employees or wage-workers the dominant element. This set in train a huge social mobility and, for long years to come, enabled industry to increase output chiefly by swelling the workforce rather than by way of modernization. During the period 1960 to 1970, the number of persons employed in the agrarian economy fell by 560,000, while the numbers employed in industry and constructions industry practically increased to the same extent. In that decade, when even the size of industrial workforce decreased in the industrialized countries, with new job opportunities created almost exclusively in the tertiary sector, Hungary was still characterized by a pattern of employment typical of the first part of the century: in 1960 nearly 39 percent and, ten years later, as little as 26 percent of earners lived out of agriculture, but, considering the establishment of large-scale farms, even that ratio indicated an extremely high live labour input. At the same time, the ratio of persons employed in industry and construction industry rose from 28 to nearly 37 and from 6 to 7.4 percent, respectively.

During the post-1956 decade, collectivization was accompanied by another radical change, by the transformation of enterprise organization in 1962–64. Thanks to consolidation after 1956, Hungary did not launch a campaign of reorganization as carried out by the other CMEA-countries in an effort to simplify industrial management. When it was decided to abolish the industrial directorates as sectoral units in ministries and the trusts vested with similar functions, reference was made, in addition to that "backlog", to the real problems of multi-tier hierarchy in management, blurred responsibility, and particular interests acting against the central will. It was believed that those intermediary directing organs now doomed to liquidation had previously been necessitated by the direction of a large number of professionally specialized enterprises, and it was hoped that merger of enterprises, or elimination of one tier in the hierarchy, would increase the rationality of management, improve inter-enterprise links, and motivate the future large enterprises for representing national economic interests and abandoning the previous narrow enterprise approach. Finally, large organizations were believed to be of greater advantage even to the directly productive sphere because of being capable of mass production. Thus the concept of reorganization, while following foreign

models, sought a remedy for the malfunctions of the economic system and to address problems encountered in plan fulfilment.

The campaign-like process of reorganization, which was started at the end of 1962 and declared to have virtually run its course a year later (but continued for years after its formal completion) was aimed at merging enterprises possibly in each industrial sector or, where it seemed impossible for one reason or another, at organizing enterprises by product-mix. While this principle was not strictly adhered to in the course of implementation, the Hungarian pattern of enterprises, which was rather undifferentiated, became even more distorted: following the shrinkage of small state enterprises already insignificant, there was a radical decline in the number of medium-sized enterprises and an increase in that of large and especially mammoth ones employing more than 10,000 workers. (Over 1,000 workers were employed at 190 and over 10,000 at 7 industrial enterprises in 1960 against 244 and 10, respectively, in 1965, whereas the number of plants with less than 50 workers fell from 108 to 46, of those with 50 to 100 from 139 to 86, and of those with 100 to 500 from 644 to 343.) Parallel to the organizational concentration of state industrial enterprises, a similar reorganization took place in cooperative industry (the average staff of industrial cooperatives soared from 129 to 218 during the period 1960–65).

Reorganization did not produce the expected results, but created instead a structure that became determinant for decades, perpetuating the pattern of production, impeding adjustments to external markets and involving enormous costs of operation, as the new large enterprises had grown into a political factor in the meantime: their managers were vested with considerable discretionary powers, without the coordinative functions exercised by former directors, and disposed of immense values. The stability and needs of the new organizations appeared as nationwide interests in the world of political organizations, and satisfaction of their demands necessarily gained priority over other considerations.

In the main, reorganization sought solutions for the malfunctions of the traditional system of plan instructions while maintaining the system itself. Formerly, it was the task of enterprises to fulfil centrally fixed output targets, but the new structure made it their responsibility to determine and satisfy their own needs. Of course, that system called liability for supply (which was fully developed in the German Democratic Republic and is still in operation) continued to increase the political weight of large enterprises. At the same time, though showing an apparent departure from the "classical" system of plan instructions as a result of simplified hierarchy, the institutional system became in reality less capable of adaptation to the market, since it combined the command economy with one based on large monopolies.

Economic goals after 1956

Economic policy set aside rather soon the second three-year reconstruction plan, cautious and balanced, for 1958–60 and identified itself with the idea of "catching up with and surpassing" (the most advanced countries by 1975–80) as proclaimed in the Soviet Union in 1959 but having made some headway earlier. Reliant on CMEA raw material and energy sources and on specialization in production in

some member countries, there were gaining ground bolder and bolder concepts which, though more modest than ten years before, were practically based on the same strategy. The second five-year plan (re)formulated for 1961–65, ignoring the emergent economic strains already known, envisaged a continued acceleration of development. For various considerations, priorities were accorded to one industrial branch after another, enjoying special allocative treatment extended by political decisions, such as the chemical industry (including branches servicing agriculture, the plastic industry, the pharmaceutical industry, rubber manufacturing), the construction industry (including the building materials industry and housing construction), location of industry in provinces, machine-building, bauxite mining and alumina production, etc. The widening spectrum of tasks overstepped the limits of plans and, by 1963–64, gave rise to economic difficulties extraordinary by contemporary standards. (During the period 1961–65, national income rose by 24 percent against 35 as planned and industrial output by 47 percent against 48 to 50, but even that level required the mobilization of much more resources than envisaged and resulted from an increase of nearly 20 percent in workforce, while agricultural production increased by 10 percent in terms of value according to statistics, but actual increase was less in reality, against 22–23 percent as planned.)

The failure of the Hungarian variant of what was called the big leap in Eastern Europe made it clear as early as 1964 that the growth concepts were unviable. Therefore, by 1965, there was adopted another plan in the nature of stabilization, and it was due to the last year of the five-year plan or, more specifically, to the relatively quick response of the leadership, that shortfalls in plan fulfilment remained within the above margin.

With the point of departure kept in view, the third five-year plan for 1966–70 envisaged rather cautious targets without, however, any essential change in the economic development strategy: the planned rates of increase were 19–21 percent for national income, 30 percent for accumulation and 14–16 percent for real incomes (living standards), which meant a continuing forced rate of growth.

Owing to prudence exercised in setting the targets, plan fulfilment was apparently successful this time in so far as agricultural production increased according to plan, while national income and the real income of the population rose even faster, but the results were accompanied by the inability of management to keep investment expenditure within limits, and the actual growth of expenditure was 8.6 percent on the annual average, representing an extremely high rate of over-spending as compared with the planned average of 3.5 to 4.4 percent. The reasons were the same as in the previous years and decades: differentiation between branches, sectors, products and tasks remained based on central priorities, but, considering that the goals continued to be formulated in hidden processes of bargaining, or according to central concepts rather independent of market forces, the setting of priorities was predominantly accidental as the diverse demands which originally received little attention were forcing their way rapidly, so what prevailed again was the trend to overall industrial development. As against certain products which had been accorded priority in the preceding period, principal emphasis was now laid, again by central decision, on another group of products within one and the same sector, a practice which, in the longer run, acted to reinforce the trend to

a scattering of development funds, stressing the need "to develop all lines of production rapidly, but some of them at a faster rate". At the same time, the so-called tertiary sector continued to receive no priority. During the 1960s the share of total development resources in the advanced industrial countries or those roughly at the same level of development as Hungary was 30 to 40 percent for productive investments (industry, construction industry and agriculture) against about 55 percent in Hungary (which, it is to be admitted, was the lowest among the CMEA-countries, while the respective shares were over 70 percent for Romania and Bulgaria, 65 percent for the German Democratic Republic, etc.).

In sum, from the post-1956 period to the reform of 1968, extreme differentiation was followed by a more balanced pattern of development through central guidance both in industry and agriculture and in the different industrial sectors, more development resources were allocated to agricultural sectors as well as to the food and light industries, and somewhat less emphasis was given to the heavy industry, including extraction of raw materials and production of primary commodities. The major concern of central management shifted away from mining, metallurgy and energy to the chemical industry.

Economic policy was guided by seemingly optimal, but in reality unreachable goals, yet central management was capable of creating a set of conditions for concentrating resources to such a degree as to suppress economic rationality for a while. Given the inner limitations of the economy, the implementation of each decision "correct" in principle quickly came to meet with mounting difficulties and economic processes deviated farther and farther from the plans. One of the motives for the development of the chemical industry, for instance, was import substitution, but with the rapid growth of output there was no increase in the importation of chemicals and the gap between the imports and exports of the sector kept widening. The characteristics of foreign trade in chemicals were those of the entire Hungarian economy and carried in themselves, as early as the 1960s, the problems that were to become determinant in the following two decades. Rapid economic growth and industrial development entailed rising demands for import from the highly industrialized countries, but a smaller volume of exports to those same countries. Already at that time, this situation perpetuated a deficit in the balance of foreign trade with capitalist countries under a rigidly separated system of accounting and foreign trade (on the convertible currency account called capitalist and the rouble account called socialist) or called for repeated stringent measures to maintain the equilibrium with great difficulty and at a great loss. Trade with CMEA-countries was governed by five-year and annual intergovernmental agreements securing raw and primary materials for the Hungarian economy as well as productive instruments and consumer goods unequal to modern, but of acceptable, standards. However, both the import of manufactures and Hungarian exports on this account were characterized by the fact that deliveries under the interstate agreements ruled out direct enterprise motivation and that the guaranteed market, precisely in the 1960s, evolved a rigid pattern of production and conserved technological levels.

Among the foreign trade partners the Soviet Union continued to rank first, playing a dominant part, so to say, with roughly one-third of Hungary's total imports and over 30 percent of its exports. Ranking next were the GDR and Czechoslovakia, both of them with a share of 10 to 20 percent each in imports and exports. In

terms of trade turnover, even Poland was ahead of the Federal Republic of Germany, the largest capitalist partner, in those years.

On the whole, foreign trade served not to enhance participation in the international division of labour, not even to establish intra-CMEA division of labour as determined at the end of the 1950s (although the manufacture of some temporarily prospering products like electronics for the consumer market and agricultural machinery was stopped in Hungary as part of that effort), in other words, to make conscious use of mutual (comparative) advantages, but mainly to secure products in short supply and to offset imports.

After decades of industrialization, exports to capitalist countries were mainly characterized by unprocessed goods or ones requiring less labour input, consisting in large part of light and food industry as well as agricultural products. Thus the pattern of Hungarian exports differed ever more sharply from the structure of the economy and even from the structural change in world trade. At the same time, until the end for of the first third of the 1970s, Hungary continued to enjoy the advantages of boom in the world market, of exports to capitalist countries based on relatively cheap imports (of products and raw materials) from CMEA-countries, but that trade position served short-term, momentary goals (e.g., rebalancing of foreign trade) rather than a well-considered economic development programme.

III. The Economic System Reformed

The reform of 1968

Following collectivization and the reorganization of enterprises in 1962–63, the effort to secure the equilibrium and continuity as determinant aspects of government practice from the end of 1956 to 1988 was twice suppressed by the need or pressure for change: for the first time, in the course of the economic reform decided upon in the mid-1960s and, for the second time, from 1967, when new goals were announced to replace the previous line of economic policy.

When in 1963–64 the leadership opted for change in the economy it was far from thinking of a reform or, as was referred to with increasing frequency from 1965, of a new economic mechanism. Interest in some sort of change was stimulated by the unfeasibility of the second five-year plan under way and by the continuing lack of improvements in economic performance, even after the reorganization drive in industry, under the Khrushchevian programme of “catching up and surpassing”, which appeared increasingly unrealistic. From 1962–63 there were even more striking signs of a relaxation in the ideological and political rigidity experienced since 1957: amnesty was granted for persons imprisoned for their activity in 1956 or actions against the system immediately after the events; some of those who had played a major role in the arbitrary rule during the 1950s were expelled from the party and even removed from the administration of justice and the police; the so-called class-alien category of people, which had been a great handicap in the continuation of studies, was abolished, etc. All this was closely related to efforts, regaining momentum in the Soviet Union, to break with Stalinist traditions (the 22nd Soviet Party Congress was held in 1962). The new economic con-

cepts emerging in the Soviet Union and other CMEA-countries parallel to the ideological détente also had a stimulating effect, definitely prompting the Hungarian leadership to take more than the usual corrective measures. During the preparatory work for change, which started in 1963–64, practically all expert opinions pointed in the same direction: economic performance could not be improved except by breaking down the system's rigidity and replacing instructions with more flexible methods better able to ensure adjustments. Nor could it be otherwise since the experts were essentially the same as those who had participated in the elaboration of the reform concepts swept aside in 1957.

External effects (namely the fact that when the decisions in favour of change were adopted in November 1965 and in May 1966 it appeared likely that a Kosygin reform of a similar nature would be carried out in the Soviet Union, entailing significant shifts in the entire CMEA-system, and that changes were in the making in the other CMEA-countries as well) proved to be decisive once again. At the same time, the adoption and introduction of a new mechanism was also strongly influenced by internal factors. It was only the interplay of such twofold influences that permitted the new economic mechanism to remain the single reform carried into effect in the region save Yugoslavia.

The major role played by what was called external effect was manifest in the absence of any particular dispute within the leadership concerning the need for and the direction of change. In the mid-1960s, when the decision was made, it appeared that Hungary would fail to adapt itself to CMEA and the other member states precisely by refraining from carrying out any substantive change. On the other hand, the depth and lasting nature of change were essentially determined by internal factors.

The first such factor to mention was that the leadership was trying to cure concrete ills and, having experimented with every other remedy between 1957 and 1963 and with no one being able to offer a better formula, it had to accept what had once been recommended in 1957 (true, it accepted the concept in such a way that its origin was not mentioned by tacit agreement and referred to it as the new mechanism).

Another important and decisive element consisted in that the overwhelming majority of the political leadership was of the view that what was involved was in fact a measure of a technocratic nature intended to improve the operation of the economy and likely to result in no substantive change in the system as a whole. Furthermore, the direction, depth and lasting nature of the reform were greatly influenced by the emergence in the political leadership of an influential group whose members turned advocates of substantive change, for different reasons and to different degrees, without coming into conflict with the rest of the leadership and—*via* considerable concessions—could gain acceptance for their conception. (Among them were in the first place Rezső Nyers, who was party secretary for economic questions from 1962; Lajos Fehér, a member of the Political Committee and Deputy Prime Minister in charge of agricultural questions; and even Jenő Fock, who, dissociating himself from the traditional approach to a less extent, rose to be Prime Minister from his post of Deputy Prime Minister at the time the reform was being prepared, and served on the Political Committee as well.)

In the elaboration of details, the technocratic approach to change ruled out, *a priori*, consideration of questions other than economic in the narrow sense (as was

also indicated by formal protests). Moreover, there were raised two additional ideological—political obstacles which reduced sharply the possibility of economic change itself. On the one hand, the condition of enterprises viewed as constituting the property of the whole people could not be called into question, so directors remained local representatives of central management rather than of a separate property regime (based on self-management or, e.g., shares) and, consequently, despite acceptance of enterprise autonomy as an important prerogative, enterprises retained their role as virtual executive agents of the state apparatus.

The other restrictive principle was that economic policy should not change because the stated goal was to better realize the previous correct concepts. What this served to ensure was not, of course, the continuing pursuance of a concrete, timely goal, but the inviolability of an economic strategy that had been formulated, in point of fact, at the end of the 1940s and also determined the arsenal of tools to be used. Economic policy, seen as a taboo, was similarly inconsistent with the generally accepted reform principles, as it could not be implemented except through the virtual dominance of central management rather than market or partially market regulation.

Associated with these elements were also numerous requirements of political precaution affecting even questions of detail, namely that the reform was not to stir social unrest, to create not even temporary strains. A concomitant of this requirement was that, among others, there was no change, despite every argument for economic rationality, either in management or the organizational pattern of enterprises, any alteration of the price system was limited to a maximum annual increase of 2 percent in prices, etc.

The underlying principle of the reform was a combination of planned economy with the advantages of the market, but the set frameworks created an economic system that was centrally directed through reliance on the market as well. The entire investment mechanism, the price and wage systems and the financial system served for a conscious restriction of market regulation and enterprise autonomy. Enterprises were granted a minimum of autonomy in these spheres, but their practical action was meticulously determined by the central government authorities, albeit not in form of plan instructions, but through regulators and such other supplementary informal arrangements as plan directives called plan consultations, guidelines, indicators and similar written instructions of authorities. These devices remained in use to collect most of enterprise income, to determine the modalities of utilizing what remained, conditions of credit (provided only by the central bank), exchange rates, conversion factors and foreign trade targets, to separate the wage bill and other costs of production, establishing uniform nationwide wage categories for employees and workers, etc.

On the whole, restricted market regulation applied to products, manufactures and materials, essentially separated from the external economy, but not to capital, money and labour. Still, all this appeared to be an enormous change, for, under preexisting norms, the operation of the economic system had been inconceivable without detailed central plan instructions, plan breakdowns and a related system of distribution of resources and materials, tools which were now abolished. The rehabilitation of economic institutions hardly acceptable before, like competition, interest, market, or consumer demand, was a hold innovation.

While specialists who had elaborated the details of the reform were wholly

aware of numerous inconsistencies, the mechanism contained many elements the action of which had been neglected. Their position was guided by a dual conviction: on the one hand, belief in the self-generating effect of the reform processes and in the possibility of eliminating after a while such brakes as compromises and concessions and, on the other, awareness of the political limitations to the realization of the concept, which was held ideal, and hence of a greater advantage in failing to clarify important conceptual and practical aspects.

Nevertheless, most of the leadership looked on the reform as a one-time innovation and considered that the task was not to establish a well-functioning and consistent system, but to devise a means to secure the constancy of the prevailing system, under which power was exercised. In other words, it treated the change of 1968 as a final result rather than as a point of departure.

The reform halted; partial reversal

As against the hopes entertained by the advocates of the reform, it soon became evident that the unaltered organizational system and central management were gaining the upper hand over a self-generating mechanism.

The reason that the political leadership sought no essential transformation of the obtaining situation was not its lack of will to achieve more, but the fact that international conditions, particularly after the reform endeavours in Czechoslovakia had been suppressed in August 1968, underwent a thorough change. Hungary not only remained alone in abolishing the system of plan instructions, but its economic mechanism was also out of line with the unaltered CMEA-system, while the overwhelming majority of CMEA-countries explicitly held the Hungarian practice to be unacceptable, to be politically and ideologically dangerous.

The forces opposed to the changes effected were quick to emerge in the first years of the new mechanism. The endeavours of sectoral management organs, now in a less favourable position, and of most enterprise managers blended with those of senior functionaries incapable of abandoning the old routine and wielding strong influence mainly in the trade union apparatus as well as in the party apparatuses concerned with ideology, agitation and propaganda and in lower-level party organs, namely with the concepts of conservative forces rejecting the new on ideological grounds. Those endeavours were reinforced by the anti-reform attitude of CMEA-countries. At the same time, the intensifying action of those consciously opposed to change was also combined with anti-reform mechanisms emanating from the functioning of organizations and the institutional system, so it was hard to tell in practice which measures were alien to the new mechanism, whether actual measures were specifically intended to suppress the reform or they emanated from the automatism of existing institutions.

From the outset, the leadership resorted mainly to the "traditional" method of instructions in responding to new problems emerging in the course of the reform but not manifesting themselves in the open (e.g., acceleration of labour mobility after the lifting of administrative restrictions, inadequate efficiency, slowdown in industrial growth), yet the reform principles and the major practical shifts were not formally cancelled. The leadership avoided spectacular retreats or refrained from eliminating the characteristic innovations introduced in 1968 chiefly for the

reason that the stance of its command centre had been determined by the lesson of the period 1953–56 that indecision, uncertainty, hasty modifications of previous decisions were likely to entail incalculable consequences. In other words, an attitude seeking continuity and averse to change became the overriding factor once again.

To avoid a spectacular retreat was made possible primarily by the fact that it had become evident relatively soon that within the given frameworks the new mechanism presented no immediate danger to the interests of any influential group. The essential constancy of the system based on a dual hierarchy (party and state) and surviving after 1968 as well as the modified competence and means of central economic management virtually completed the arsenal of existing methods used for accommodation of interests increasingly on the basis of bargaining, and while available resources gave sense to and left scope for bargaining for centrally held development funds, with management exercising important functions of distribution (i.e., “distributing” development funds rather than collecting profit and imposing restrictions as it did in the subsequent period of constraint) economic actors failed to forge a force interested in effecting any substantive change in the prevailing situation (fittingly characterized by an analysis as being neither a plan nor a market as against a conceptualized harmony of plan and market) and in the course of economic policy still pursued.

The attitude of the central leadership, which was in favour of careful progress, is well-characterized by the November 1972 party decisions known as having stopped the reform. The system of economic management put into effect on January 1, 1968 (when official parlance ceased to use the term “reform” or “new mechanism”) was deemed to be an appropriate means of a socialist planned economy. However, given the changing set of conditions, it was said necessary to strengthen management, which was still understood to mean central direction at the time and even afterwards. Economic management was required to devote special attention to the 40 to 50 largest state enterprises accounting for a considerable part of total industrial production and to secure satisfaction of their needs by separate measures. (Those enterprises, mainly in the heavy industry, found it harder than average to adjust themselves to the changes introduced in 1968 and the larger part of their managers resolutely defied the reform.) Other partial measures of intervention in economic processes were likewise intended to ensure the stability of the existing economic structure and to lessen the anxiety of the apparatus about change.

Just as concrete decisions, propaganda tried to prove that the planned economy would not be impaired and that planning would retain its role. In the effort to secure continuity, the leading figures known to be consistent advocates of the reform were not removed from power until two years later, so the process of partial reversal, increasingly manifest after 1972, was virtually directed by the same persons, by the same apparatus responsible for steering the course of the previous reform.

Thus the reform was seemingly under way, since the really essential elements of Hungary's economic system differed from those of the systems operating in the other CMEA-countries, not only because of the changes of 1968, but also because of their effects which were spilling over nonetheless. In reality, however, what emerged was not a mechanism as conceived under the hallmark of the reform, but

a system imitating partial market methods and relying basically on redistribution and centralized management. What is emphasized most in related studies is this ambiguous situation more like the traditional planned economy than closely similar to a market economy. Some people speak of an administrative market, making clear that Hungarian enterprises are not linked directly to a real market, but are geared to its variant as transmitted by the authorities, while others call the Hungarian economy one of indirect management as distinct from the decentralized management of market economies and from the centralized or direct management of the "traditional" planned economy. Still others draw a distinction between a market-like and a bureaucratic coordination of the economy, saying that the Hungarian economy did not, despite the reform, go beyond the dividing line of the two systems.

A main feature of the post-1968 economic system is that central management did not in effect give up the basic premise of a planned economy, namely that such an economy is always capable of grasping timely tasks and transmitting them with the help of some language (formerly the plan and then regulators) for enterprises as executors. That "regulatory" illusion rested largely on fiction at three points of decisive importance: first, the "centre" did not always feel the timely tasks, still less the need for action to carry them out, although it was most effective in this respect; second, it was unable to render the tasks into the language of regulators, i.e., central instructions never produced the presumed effect on implementation; and, lastly, what had an influence to bear on the previous two elements, there existed no uniform central will except an idea, a compromise of partial wills, which no one fully identified himself with.

Thus, instead of transmitting real market conditions, the regulators designed to determine the operating conditions of enterprises created a simulated market incapable of imposing strict budgetary constraints, since regulation itself as a means of simulation was susceptible to influence. The role of plan bargaining was assigned to "regulatory" bargaining, but at the beginning of the 1980s, when the price system underwent a significant change, there also emerged a kind of price bargaining that imitated market prices. As can be seen, instead of a stringent set of conditions there emerged in reality a series of regulators, mainly "tailor-made", which, to boot, embodied other than immanent economic aspirations, for the economic system naturally remained under the control of the political system, with economic decisions directly conditional on political concepts, a state of affairs which, irrespective of the contradictions of the economic mechanism, necessarily caused fundamental problems to accumulate.

A decade of missed opportunity. Economic policy in the 1970s

In connection with the elaboration of the economic reform, although no change in economic policy was envisaged, there were several realizations which made it implicitly clear that experts found it topical and even inevitable to change not only the arsenal of means employed, but also the objectives defined. On the one hand, frequent references were made, in support of the need for reform, to the fact that available manpower as the chief reserve of the Hungarian economy (women and people leaving agriculture because of the existing organization of production) had

been depleted. (True, intensification replacing the previous course of extensive development was thought to be capable of implementation, gradual but automatic, through reliance on the new tools of the new mechanism, yet it presupposed pursuance of new economic goals.) The situation was similar with regard to the requirements of structural change as formulated in connection with the new, fourth, five-year plan from the turn of the 1960s and 1970s onwards, but it was of no avail that experts were clearly aware of Hungary's economic structure being adapted to an obsolete concept, because the leadership, though largely accepting the need for change, rejected any process likely to erode the established stability and nipped it in the bud.

In point of fact, opportunities for change presented themselves, in theory, on two occasions: at the time the reform was introduced and immediately afterwards when, in contrast to the situation of 1963–64 which had originally provided inducement for the new mechanism, Hungarian economy was not burdened with basic problems, growth was dynamic, and foreign market conditions were clearly favourable. Of course, under such circumstances, there was no direct motive, either political or economic, for the leadership to undertake change likely to entail relatively minor strains only. (Why change, when things “go well”?)

When, however, after the oil crisis of 1973 the restructuring of the world economy got under way, the leadership, in defiance of growing pressures, refused to start or allow substantive change, because at first it maintained that the CMEA-countries were not affected, or affected only slightly, by transitory shifts of the moment, but when partly Hungary's intensive and indispensable extra-CMEA economic ties, partly the so-called Bucharest principle of prices adopted within CMEA (a system of raw material prices following world market prices with some delay) made the erroneous assessment of the situation obvious, it took the view that the economy could be adjusted to changing conditions without undergoing substantive transformations. The leadership continued to refuse any means likely to generate social strains and acted in the belief that central economic management could be in control of adjustment with no serious repercussions on either the population or on the enterprise sphere. One of the conditions for action along this line was an enormous scheme of import and consumer price subsidies as part of the mechanism for redistribution, with such subsidies consuming a rather high ratio of budgetary revenues, which soared from nearly 40 percent at the beginning of the 1970s to 50 percent by the middle of the decade. Consequently, enterprises became less sensitive to momentary boom and to effective costs, their goals necessarily deviating from central endeavours, which in turn called for renewed interventions, i.e., management imposed more stringent conditions, but sought to guarantee the persistence of the existing structure as a whole.

After awareness had been created of the “spil-lover” of world economic changes (the contemporary “official” term indicated by itself the conception that external changes affected the Hungarian economy indirectly rather than directly), two factors made it possible to put off for years looking facts in the face and to entertain the illusion of keeping the crisis under control. One of the factors was the reference to terms of trade altered by the price explosion. Starting from the fact that Hungary as an importer of raw and primary materials had suffered statistically verifiable losses owing to the price explosion of 1973 (between 1970 and 1973 Hungary's terms of trade worsened by 17 percent, meaning equivalent extra ex-

ports for the same volume of imports, with shifts in prices causing a loss of 6.4 percent of GDP in 1974 alone), the leadership regarded the emergent situation an inevitable natural disaster and conceived of its readjustment policy accordingly. (It should be noted in passing that the loss from intra-CMEA terms of trade in 1974 exceeded by a considerable margin the losses suffered elsewhere, true, owing in no small part to the increasing "dollar content" of exports on the rouble account and to the reliance of exports on imports from the West, a fact which the leadership was reluctant to face up to and which was not made public until the early 1980s.) The leadership and central management, in addition to being mistaken in expecting the unrealistically high raw material prices to be offset by the market of manufactures within a short period of time, took little or no notice of the fact that in the altered situation, with the boom ended and market competition sharper, there had surfaced fundamental structural strains which had been accumulating for a quarter of a century. In respect to the worsening terms of trade from one year to another, though it had been a recurrent development with a steady tendency for years, the substance was covered up by direct causes: behind the phenomenon lay the basic problem of the Hungarian economy consisting in a rather sharp difference, lasting and marked, between its import needs and export capacity, a phenomenon which called for radical change, namely adjustment to the new situation, to be eliminated or reduced. Though the record of performance forced out of the economy with its existing structure made it momentarily possible to offset, without radical change, (part of) the losses from the worsening terms of trade (the foreign trade deficit could be reduced by extra exports), it required enormous outlays (for, precisely at the moment that material resources should have been earmarked for restructuring by scaling down production of an inadequate pattern and hence by stopping economic growth, what happened was just the contrary, dynamization) and conserved the economic structure, which, in turn, led to an accumulation of substantive problems.

The other factor accounting for the failure to respond to the need for real adjustment was a new source, hitherto unknown, opened for making up for the loss suffered. When in 1966 the experts preparing the reform issued their "constant" of the Hungarian economy ("...the national economy has evolved a pattern resulting in large surpluses of obsolete products unsaleable on capitalist markets. At the same time, expansion of output is coupled with growing import needs that can only be satisfied from capitalist markets to a widening extent"), they did not foresee that by reliance on favourable credit facilities suddenly available in capitalist countries made it possible to overcome strains temporarily.

Following the price explosion of 1973, the sudden halt in the economic growth of Western Europe and the United States and the appearance of petro-dollars in the revenues of oil-producing countries created a notable supply on the international money market. This was allied with the fact that in the first part of the 1970s, improvements in East-West political relations, the so-called détente and the years of preparations for, and follow-up to, the Helsinki accord held out obvious arrangements that had been inconceivable on both sides for political reasons. (After the reestablishment of diplomatic relations with West Germany, economic and commercial ties between the two countries widened at a fast speed: in 1972 the FRG ranked third in Hungarian imports (with a share of 7.5 percent) after the Soviet Union (nearly 35 percent) and the GDR (10 percent) and only sixth in

Hungarian exports (with a share of 5.5 percent) after the Soviet Union (36 percent), the GDR, Czechoslovakia and Poland (nearly 10 percent each) as well as Italy (6.2 percent), whereas from the mid-1970s it became the second major partner in both imports and exports, accounting for 12.4 percent) of Hungarian imports and 8.4 percent of Hungarian exports in 1986, for instance, far outstripping the GDR (with a share of 6.7 and 8.4 percent, respectively). Another characteristic figure: whereas Hungarian imports rose by 42 percent in 1975 compared with 1970, Hungarian imports from the industrialized countries increased as little as 20 percent, but went up 88 percent in 1978 over the 1970 level, and imports from CMEA-countries advanced as little as 77 percent, total imports also registering an increase of as low as 80 percent.

Given their state guarantees and their essentially reliable stability, the CMEA-countries promised to be good debtors, so the need was obvious for Hungary, just as the other countries of East-Central Europe, to make use of the long-desired possibility to expand imports from the industrialized countries, thus modernizing the economy, and, in the hope of a future economy with an export potential, to take loans to finance the foreign trade deficit.

In the period 1971–75, domestically produced income increased by some 50 percent in comparison with the previous five years, but that increase absorbed twice the amount of foreign funds as in 1966–70, equalling 6 percent of gross production. The consequence was that the volume of debt, which accounted for 21 percent of GDP in 1972, rose to 28 percent on the average of the following four years and to 55 percent on the average of 1976–79. The weight of credits and related burdens was indicated still more strongly by the ratio of current debt servicing to exports on the non-rouble account: 20 percent in 1972 against 45 six years later.

However, despite the emphasis on efforts at restructuring, the government drew on credits to conserve the economic structure and to finance current deficits. Even after 1972 the leadership continued to deem it inconceivable to abandon the goals of dynamic growth and increase in real wages, i.e., improvements in living standards more or less identified with the former, as two basic criteria and characteristics of the socio-economic system, and insisted on accustomed stability, considering it inadmissible to revamp the enterprise setup even at the time of a general deterioration in foreign market conditions and in the performance record of the Hungarian economy. Accordingly the loans were used, to a lesser extent, to raise the living standards of the population and, to a greater extent, to support enterprises operating at a loss or to finance unremunerative investment projects instead of structural change by reliance on additional funds available for the first time in 40 years. Here is one example in illustration of related concepts: for the period 1976–80 (fifth five-year plan) national income was planned to increase at the same rate as during the previous quinquennium (30 to 32 percent); the response at the macroeconomic level to changes on the world market consisted in plans for domestic consumption to grow at a rate (6 to 8 percent) lower than that of economic expansion; despite changes in world market prices, the rate of export expansion per unit of increase in national income was expected to rise considerably parallel to a decline in imports (under the previous two five-year plans, an increase of 1.6 units in national income required an expansion of 1.5 points per unit of exports, but this time 1.2 units were calculated, and hopes were for 1.8 units of increase,

against 1.3 units in the growth of national income and 1.6 units in export expansion registered during the preceding period), whereas the market of manufactures was expected to offset increases in raw material prices and development policy aimed at securing energy and raw material supplies. Accordingly, plans were for increases of nearly 100 percent in investments in electric power generation, 37 percent in mining, 32 percent in metallurgy, against as little as 10 percent in branches of the processing industry, over the figures for the previous five years. One more characteristic figure: nearly 80 percent of the large investment projects were designed to promote import substitution rather than to support exports.

Turn in economic policy — hesitant reforms

By 1977–78, especially in 1978, the consequences of economic policy and illusions revealed themselves with dramatic force to the leadership: while economic growth in 1978 did not remain far below the planned level (4.2 against 5 percent), the upshots of forcing a fetishized rate of growth within the frameworks of the existing structure became clearer than ever. Domestic utilization not only was not smaller than the increment in national income (the difference envisaged was 3 percent), but even exceeded it by about 6 percent; the external balance of payments did not improve against hopes, but showed more than twice the deficit registered in the previous year (rising from 28.3 billion to 59.8 billion forints), amounting to 10 percent of national income (in terms of dollar, the foreign trade deficit increased from 674 millions to 817 millions); all this was coupled with an accelerating increase of debts and their highly unfavourable composition (gross debts jumped from 5.4 billion dollars in the preceding year to 7.3 billion, while the ratio of repayments due within one year was 65.6 percent and that of those due within three months was 36.6 percent, respectively).

Under such circumstances the leadership had to face up to the mistakes of the existing concept, and the meeting of the Party Central Committee at the end of 1978 announced a radical turn in economic policy. (As part of that change, personnel shifts were effected in three successive stages, the smaller part of the advocates of “traditional” concepts were removed from the leadership, the Central Committee appointed a new secretary in charge of economic policy, the leading officials of the National Planning Office were replaced, etc.)

The turn implied a new order of priorities to replace necessary improvements in living standards, preference to economic growth, protection of enterprises from foreign market effects, in one word, stability, and gave primacy to restoring the (external and internal) economic equilibrium over the rate of economic growth and domestic utilization, including the living standards of the population. Initially, in 1979–80, the leadership was hopeful that this course of policy would be viable without deterioration in the standard of living, but later (especially from 1982, when Poland and Romania became insolvent, new credits were practically unavailable for a while, sizable foreign deposits were withdrawn from Hungarian banks and Hungary, too, was on the verge of becoming insolvent) it was clearly seen that a worsening of the situation would be inevitable in this field as well.

When the turn in policy was announced, central economic management was fully aware that a defensive economic policy trying to avoid a payments crisis was

not enough by itself. Mention was also made of the need for structural change. Though no reforms were proclaimed, the failure of the concepts that had been prevalent since 1972 and the desire to let foreign market effects come directly into play paved the way for a renewal of the traditions and concepts of 1968 already in the months of preparations for the shift in policy course.

Between 1979 and 1984, processes were basically characterized by two factors. The practice of economic management was guided by short-term considerations and was largely aimed at preserving solvency and, as part of it, securing a surplus in the balance of foreign trade. All this was achieved by more direct economic management, strict import restrictions (centrally imposed at times on an item-by-item basis), enforced exports and drastic reductions in development projects. These methods of management are fittingly referred to in literature as "manual guidance". Under the pressure employed, exports rose by nearly 45 percent between 1978 and 1984, while imports remained practically stationary.

The following data indicating the consequences of the new economic policy naturally stand real comparison, not with the market economies, but with similar data for the previous 30 years of the Hungarian economy alone. In an economy where an annual increase of 4 to 5 percent in GDP was regarded low, the dramatic character of the change in policy is shown by the fact that the total increase in GDP was as low as 11.1 percent between 1978 and 1984 (at the end of 1978, when the change in policy was announced, the hopes were for an annual increase of 3 percent); even more characteristic of the change was a reduction of 5 percent in domestic utilization, with a decline of over 30 percent in (gross) accumulation and of 17 percent in investment allocations, during the same years. Such a lasting trend of development was not only unrecorded, but was even inconceivable during the previous 30 years. The basic principle of the post-1956 policy was abandoned when those years saw a fall of nearly 10 percent in real wages against the accustomed annual increases of 3.5 to 4.5 percent (true, real incomes rose by 6.4 percent as a result of other changes to be discussed later). The rapid rate of open inflation directly responsible for the decline in real wages was by itself contradictory to the official image of the system and was an added indication of the sharp turn in policy. The period 1970–77 witnessed an annual average price increase of little less than 4 percent against a total of 20 percent during the next two years (1978–80) and an additional 30 percent in 1984 over 1980.

Another characteristic factor was the headway, though swinging but generally rapid, made by the reform concepts. Whereas in the mid-1960s the decision on the new mechanism was adopted virtually with the exclusion of publicity, preceded only by inner work in committees, the concepts about an alternative economic system could be formulated in openness—perhaps unprecedented since 1947, except 1956—from the turn of the 1970s and the 1980s onwards. The reform mood, the feeling that a third wave of reform was rising (after 1954–57 and the second part of the 1960s), was kindled not only by a much larger freedom of publication by experts, but also by other factors. After a relative lull during 1972–77, inner work was being intensified from 1978, with the participation of a wide range of experts, to elaborate concepts about the economic system that pointed far beyond the domain of economic policy and in 1979–80 there were adopted internal decisions, partly published, partly relating to the future, which were clearly indicative of an official will for change of a reform-like nature. A parlance called

reform rhetoric, the use of terms relative to a market system in references to economic action, became dominant in central economic management as well as in political pronouncements. Although the political leadership did not, in effect, adopt a stance on reform until 1984, no thorough assessments were made of the post-1968 period and, moreover, official statements suggested that small errors had been made in the appraisal of the post-1973 period and mainly in actions to follow up on correct realizations, i.e., continuity was the paramount consideration, but officials in the posts of economic guidance referred in unambiguous terms to the timeliness of going ahead with the reform of 1968 even if, in keeping with political directives, they used the phrase "further development of economic management" rather than the term "reform".

An overall view of the dual trends in the years 1979–84—the practice of economic management and the advance or rehabilitation of reform concepts—makes it evident that there was a case of prolongation of the period called the decade of missed opportunities. True, the policy of restrictions can be said to have been a success, for the country preserved its solvency, with the volume of debts even reduced somewhat in 1981–82, despite the continuing worsening of the terms of trade, the limited availability of international credit and its more stringent terms and conditions. However, most of the results came, not from improved economic performance, but (as often in the previous decades, albeit in less sharp situations and in cases of strains easier to slacken) from the possibilities inherent in the wareconomy mechanisms used by central management for dealing with crises. Along with the pressure for exports and with import restrictions referred to above, these possibilities included clever use of a few temporary economic opportunities such as currency speculations of the central bank (making use of the dollar's rising rate of exchange), skilful manoeuvres as part of state economic policy (processing of imported Soviet oil, with advantages derived from deferred rises in CMEA-prices, and exporting it to industrialized countries) and intra-CMEA trade on the dollar account, which was on the increase (export of grains and meat to the Soviet Union).

For all its restrictive measures, the paternalistic system continued to regard stability as the chief value and basically sought to rely on methods believed to have proved their worth. This prevented it from accepting any change evoking the danger of a substantive conflict. Of course, structural change, which was declared to be necessary, could not get under way when bankruptcy of enterprises remained politically unacceptable and the requirement of full employment was upheld. While perceiving a worsening of the country's economic situation, enterprises did so through the equalizing mechanisms of redistribution rather than their eventual adjustment to market conditions. Though the population, too, felt the unusual fall in real wages, the leadership did not give up virtually maintaining the level of consumption. Inevitable reductions in domestic utilization could not thus be effected except at the cost of accumulation and momentarily less palpable savings.

The emergent practice was naturally justified by rational considerations as well. The stability of the enterprise system, for instance, was motivated by, among others, the fact that domestic supplies and the need for exports could always provide an excuse for production at a loss. On the other hand, maintaining the level of consumption by the population and the inconceivability of unemployment ensuing from structural change were needed for the political leadership, based as it was on

a "provident" state, because a social policy separated from the economy and an effective legal protection and affirmation of interests were inconsistent with the system's self-image. (At the same time, restrictive measures slowly reached a point where "providence by the state" withdrew from more and more areas without being able to change other conditions. Thus state dwelling construction and housing allocation were practically halted, development of communal facilities in other than urban areas relied mostly on self-help projects of local communities, etc.) In other words, the considerable efforts exerted were successful in averting momentary dangers without, however, being accompanied by economic readjustments of any scale, while the reserves of both economic and political confidence were being exhausted.

As for the reforms and substantive change, the situation was naturally the same as in economic policy, for the absence of adjustment was precisely a concomitant of unchanged mechanisms. True, there were adopted measures and decisions that were clearly indicative of continuing with the reform of 1968. In 1981, the three industrial ministries representing sectoral interests were merged into one in the hope that the functions of direct management would thus be replaced by administrative functions. In 1982, a part of the second economy, which had been forced into undercover or semi-legality, was allowed to come into the open and, moreover, the emergence of new forms of small businesses considerably increased the significance of the economy extraneous to state and state-like cooperative activities (called the socialist sector). (In 1979, 72.2 percent of incomes from work, against over 61 percent in 1986, was earned in the socialist sector. The incomes of the self-employed and business partnerships soared to 10 percent from less than 5 percent of their previous incomes from work. Nearly 10 percent of full-timers joined in the activities of organizations that were neither state nor private and were known as intra-enterprise business partnerships and specialized groups for industrial services. The new type of small organizations set up from 1982 came to play a decisive, if not exclusive, role in the growth of GDP; according to statistics, capable of presenting the minimum rather than the maximum of non-socialist forms of economic activity, this sphere accounted for nearly 11 percent of the gross value, and over 16 percent of the net value, of domestic production in 1986.)

Among the steps pointing in the direction of reform, mention should also be made of the option for a more substantive and more comprehensive change made by the HSWP Central Committee after lengthy internal debates in 1984, accepting the need to separate proprietary and administrative supervisory functions at the enterprise level and to set state administration organizationally apart from economic activity in the so-called competitive sector, to separate the functions of issue, credit and other in the undifferentiated banking system with a view, *inter alia*, to improving conditions for the flow of capital, and to allow legal scope for enterprise windups.

Contrasted with all these apparently significant decisions and shifts were the factors at work to ensure prolongation and the dominant continuity of the pre-1979 period. The organization of the Ministry of Industry as a practically isolated measure brought no substantive change in the absence of enterprise autonomy because the functions of sectoral ministries were taken over by other institutions, territorial party organs, financial and price authorities, etc. The liberalization of opportunities for small businesses resulted in significant shifts (also illustrated by the aforemen-

tioned data), but only to a lesser extent in the management mechanism, because the measures introduced in 1982 effected practical change mainly in two respects: on the one hand, they allowed the more mobile segments of the population to supplement their falling real wages from additional sources and, on the other, secured extra labour for enterprises engaged in out-of-date economic activities. (For practical purposes, most of the intra-enterprise business partnerships implied voluntary association for the doing of extra work.) At the same time, these work organizations and their organization of production subjected to fewer limitations hardly had a fertilizing effect on the public sector and, owing to strict restrictions and the lack of political and legal guarantees, no room was allowed for a real mobility of private capital either. (Small businesses were set up mainly in the less capital-intensive servicing sector and were increasingly characterized by efforts at rapid enrichment and by a hedonist utilization of profit.)

The Central Committee decision in 1984, considered by some as the reform decision, proved to be more formal than of practical value. The intention was to have the changes decided upon introduced step-by-step, as indeed they were, rather than as a reform package, as a set of decisive measures, and the concepts, turned "harmless" in comparison with the original proposal, were *a priori* in the nature of compromise and subject only to refinement in the course of implementation; just as in 1968, the leadership considered the reforms as strictly economic measures, although during the preparatory work experts had clearly pointed out that unless the system of political institutions were changed the innovations would be subdued by the previous mechanism. And, finally, even the ambiguous economic shifts were accepted by the political leadership on condition that the concessions (because the measures adopted could be seen as such after all) were to be subject to economic growth and rising living standards as characteristic traits of the social order.

Abortive attempt at growth — new programmes

The political requirement (formulated as a norm by the Party Congress in 1985) to outline an encouraging perspective for the period following the "seven lean years" (1979–85) imprinted its mark on the five-year plan starting with 1986. It was clearly seen already in 1984–85, but to no avail, that even the modest targets of the previous five-year plan, set under the hallmark of the turn in economic policy, had been unrealizable, a large part of experts voiced in vain their disagreement in an unusually straight-forward way, the planning of a rate of growth ultimately modest by comparison to "traditions" was useless because the mechanisms were set in motion by the political posture and the need for acceleration: before substantive change was to be grounded on the momentary gains in 1979–84, the developments of the period 1974–78 repeated themselves in the economy, aggravated by the shortfalls of the previous ten years.

From 1984, the measures of economic restraint were soft-pedalled, while the restrictions impeding structural change remained in force. The consequences were quick and dramatic. The decline in investment activity observed since 1980 was halted from 1986. (As is known, the investment rate in planned economies has

always represented a much higher ratio of GDP than in the market economies, so in Hungary it has always amounted to more than 20 percent [23 to 24 percent] of GDP.) Consumption by the population increased, too (1.3 percent in 1985 and 2.7 percent in 1986). Hence domestic utilization exceeded the 1984 level already in 1985 and continued to increase the following year, whereas the GDP continued to decline somewhat in 1985 and started to increase at a modest rate in 1986–87. Concurrently there was a deterioration in the balance of foreign trade, the balance of payments and the budgetary balance alike until effects contrary to those in the preceding three years began to be felt as a result of sobering up since the second part of 1987. (A surplus of 720 million dollars on the foreign trade balance in 1984 fell by 50 percent the following year and turned into a deficit of 400 million dollars by 1986, still amounting to 361 million dollars in 1987. The balance of current payments, which showed a surplus of 330 million dollars in 1984, was closed with a deficit in the following three years (460, 1.400 and 850 million dollars, respectively). The budgetary deficit amounted to 3.7 billion forints in 1984, 15.8 billion in 1985, 47 billion in 1986 and 35 billion in 1987. The gross volume of debts increased steeply in 1984 and after, running to 8.8 billion dollars in 1984, 12.8 billion in 1985, 15 billion in 1986 and 18.7 billion in 1987.)

Of course, external indebtedness was again the gravest factor of constraint, indicating the dramatic pressure on the Hungarian economy: the average volume of debt amounted to 56 percent of GDP in 1980–83, 79 percent in 1984–87 and 90 percent in 1987. In percentage of exports on the non-rouble account, debt servicing represented a ratio of 50 percent in 1984, 90 percent in 1986 and 80 percent in 1987.

In the wake of the processes taking place during the period 1984–87 economic strains were so apparent as to generate political distrust of an unknown scale over the previous 30 years and leading to two waves of unusually spectacular change in summer of 1987 and in spring of 1988. In the summer of 1987 the HSWP Central Committee and in September (following the replacement in June by Károly Grósz of György Lázár, who had been Prime Minister for 12 years) the new government cancelled, unsaid but at an unprecedented speed, the five-year plan under way and heralded a programme for stabilization. With its narrow scope for action, the programme undertook to solve two tasks hard to reconcile: to restrain external indebtedness in a few years' time and to eliminate the budgetary deficit and, during the same period, to speed up (or, more accurately, to start) structural change, taking into account an inevitable increase in social strains, but promising, *inter alia*, to halt the rapid decline in the real value of pensions, to offer state guarantees for a minimum of social benefits, to rely on compulsory social insurance for other welfare services, to check inflation, keeping it at 14 to 15 percent in 1988 and reducing it from 1989, all this to be achieved by leaving more room for the operation of market mechanisms, liberalizing the economy (deregulating producers' prices, lifting restrictions on export and import lines, allowing more leeway for undertakings), but strengthening the role of the state in restructuring.

The second wave of change is associated with the party conference of May 1988. The general demand for transforming the system of political institutions had not been met by the plan for a cautious continuation of shifts well-tried over the previous 30 years, and demands were publicly voiced to replace officials who had played a leading role in the mistaken economic policy and the underlying political course.

Károly Grósz (replacing János Kádár, who had held his office since November 1956) was named to head the reorganized party (and the government).

To the extent that in the light of developments during these few months it can be clearly judged, personnel shifts have strengthened the leadership's pragmatism palpably present from the mid-1960s (despite all the retreats), largely eliminating propensity for routine based on "tested methods". In addition, the endeavours and methods of the new Hungarian leadership show close similarities to Gorbachev's endeavours, so intra-CMEA conditions for realizing the concepts of change have undoubtedly never been as favourable as they are now.

Looking to the future and outlining prospects would be alien to a writing of this nature dealing with developments down to the present under an historical approach. Nevertheless, it can be stated as a fact that the programme for stabilization (inclusive of the government programme) has practically lost timeliness in the space of a year. What is involved is not only that certain promises have become impossible to fulfill (with the rate of inflation close to 20 percent already in summer of 1988 and forecast to be similar by 1989, with the promised pensions law yet to be drafted and with the outlines of a wage reform as envisaged in 1988 still vague), but that the concepts themselves have been reshaped in certain aspects. The economic concept, published in broad outlines already in summer of 1988, has switched emphasis from a dual task of one year before to structural change and appears to rely on additional credit for debt servicing. The official endeavour to restructure the economy with orientation to a market economy has apparently strengthened, with greater possibilities opening for the presence of foreign working capital in Hungary and even for an upswing in domestic undertakings. (The Central Committee meeting in summer of 1988 adopted a decision to this effect.) At the same time, financial regulations brought into line with these changes are in practice strongly blended with fiscal policy giving priority to considerations of daily finance, with frequent changes in regulators and economic conditions and with continued, though professedly temporary, restrictions of the enterprise scope for manoeuvre. The strains accumulated over the previous decades and the tasks ahead are extremely diverse. Along with the requirement of restructuring, let us mention, without pretending to be exhaustive, that all areas of the infrastructure are deplorably neglected, lagging far behind the general level of the country's development; the equipment of the health service network and educational establishments from primary school to university, the road network, the technical facilities of railways, the automobile park, the communications network and other fundamental institutions are at the limits of their capacities. Accordingly, the related problem areas include the health care scheme (gratuitous in principle, but in practice relying on gratuities from patients); the pensions system (not even trying to keep in step with the quickening tempo of inflation during the past decade); the wage system and wage rates (in need of thorough revamping); institutions of a directly political nature like the trade union setup and the related mechanism of interest representation or integration, etc.; the actual worktime of population groups of working age (given the indispensability of earning extra income), which is among the longest in Europe; the rather unfavourable birth-rate and mortality rate (particularly of males of working age); alcoholism and suicides (on an endemic scale); widespread corruption and bribery (almost indispensable for the operation of the economy in some areas) owing to the convergent elements of a short-

supply and a market economy; the prevalent pursuit in several areas of quick enrichment rather than of a stability-oriented business policy (for fear of restrictions on the relative freedom of business, which is regarded by many as a temporary concession), etc. By contrast, the leadership's scope for manoeuvre is very limited in coping with these phenomena. There is no chance of achieving a quick success and a spectacular breakthrough, since the predicted period of implementation of the programme for consolidation ranges between 6 and 10 or 15 years.

Confronting all these problems are a variety of social needs calling for relatively rapid shifts to be satisfied. Related demands can be supposed to have come to a merely temporary rest in the wake of the changes introduced in 1987–88 and, parallel to a steady and lasting deterioration in living conditions, may be caused by attempted solutions, less ambiguous than before but still marked by half-measures, as well as by schemes and arrangements designed to remedy the malfunctions of the political system to provoke hardly calculable reactions among the population.

Obviously enough, the CMEA-system will remain of decisive importance to Hungary. It is rather difficult to foresee the extent to which and the pace at which the Hungarian, Soviet and Polish leaderships interested in related reforms will be able to push through their ideas as well as the consequences to be entailed by the operation of more market-like mechanisms within CMEA or by radical cutbacks in subsidies to Hungarian enterprises delivering products under interstate agreements.

Along with numerous problems to be tackled and developments hard to predict, one factor appears to be certain: the Hungarian leadership is persistent in seeking to create a more market-oriented economic system and is distancing itself at a quickening pace from the traditions rooted in practices prevalent in the Soviet Union of the Stalin era.

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Chapter Two

The Hungarian Law of Association

The Act on Economic Associations came into force on January 1, 1989 in Hungary. In what follows we shall review the main features of this legislation.

I. Development of the Law of Association in Hungary

1. Before 1945, Hungary had an associations law basically revealing traits of the German group of laws, but the forms of occasional association known as civil-law societies in the draft Privative Law of 1928 resembled not so much the German *Gesellschaft* as rather the French *société*. The commercial companies governed by the Commercial Act of 1875 were much more like the German than the Austrian forms of limited liability company, while the cooperative forms as introduced in 1930 stood closer to the Swiss arrangement. As can be seen, the Hungarian law of association remained basically within the German group of laws, presenting a mixture of various subgroups, that is, German, Austrian and Swiss arrangements. However, as early as the 1930s and the 1940s, that law of association did not meet world standards any longer and is, consequently, impossible to update without a thorough revision. The forms introduced prior to 1945 are unfit to cater for the needs of larger and more advanced undertakings, because the relevant regulations did not yet cover aspects like reshaping enterprise management, new approaches to the protection of public and creditors' interests or requirements of workers' participation.

2. In the classical period of a directly planned economy there was no need for associations between economic organizations as they were ruled out by the rigid system of plan breakdown.

Nevertheless, in relations between private persons, the Civil Code of 1959 incorporated, after a great deal of debate and within a rather narrow scope (i.e., restriction of tendencies to exploitation), the institution of civil-law society, which was used at the time mainly to manage the property relations *inter se* of engaged couples and consorts. In addition, in the fields of small-scale industry and private trade, there existed a form of unlimited general partnership as regulated by the Act of 1875, while, with attention to some foreign companies unaffected by nationalizations, the Law-Decree putting into force the Civil Code retained several rules

on unlimited mercantile partnerships, limited liability companies and joint stock companies and repealed the provisions on deposit companies and cooperatives.

The 1960s were the initial stage of revival of cooperative associations, an interesting feature of which was the endeavour to break fully with the old private and commercial law traditions. "Simpler schemes of economic cooperation" and "cooperative joint undertaking" were adapted to agricultural realities, on the one hand and association took on forms closely linked to the activity of members on the other.

While innovative formulas were applied in the cooperative sector, the Government Decree of 1967 on State Enterprises left room for associations between state enterprises by stating that a joint enterprise must take the form either of joint stock company or of limited liability company as they existed before 1945, an streamlined the outdated rules by issuing a communiqué and providing model documents. Such enterprises were formed with little capital stock, mainly for carrying out activity of agency, and their account of liabilities and assets could show neither profit nor loss. However, that old regulation proved a complete failure in two or three years.

On the old model of occasional partnership under private law, association as another form of company introduced in the public sector was not granted juristic personality and was therefore governed by the rules applicable to simple civil-law societies. A contributing factor in that regulation was probably the formation of associations mainly by former trusts and that economic policy denied them juristic personality in an effort, which later proved a total failure, to prevent association from becoming organs of middle management. That arrangement was misconceived from the very outset as the particular conditions of associations (usually many employees, considerable assets of their own, etc.) called for juristic personality and required associations to develop into an integrational form of association combining coordinative and representative functions in contrast to the traditional civil-law society.

The period 1968–80 was characterized by a search for avenues of progress during the two large waves of regulation, namely Law-Decree No. 19 of 1970, the first comprehensive enactment on economic associations, and the wholesale amendment of the Civil Code in 1977 as well as, in conjunction with it, Law-Decree No. 4 of 1978, which can be considered to have been the basic legislation on associations up to 1989. Both enactments were passed during a peculiar period of the economic reform in Hungary. The first fell on the beginning of reversion to arrangements previous to the economic reform just started, although it had been destined to satisfy the needs of full-scale development, while the second fell on the end of the period of reversal, namely when the reform endeavours were beginning to gain strength, but the work of preparation was marked largely by an economic policy environment which was not yet geared to an actually existing "mechanism". In disregard of this political background one can hardly make an objective assessment of the pertinent legal regulation.

3. As compared with the regulation of 1967 on associations, the legislation of 1970 was based on a more realistic economic policy groundwork. Hence it follows that

(a) although associations were not granted juristic personality, a "simple association" was introduced as an independent form of enterprise;

(b) although the possibility remained of establishing joint stock companies and limited liability companies, there was introduced a form of joint enterprise in the narrow sense which held much of the characteristics of former cooperative arrangements;

(c) in response to practical needs, separate regulations introduced cooperative forms of association (e.g., the so-called foreign trade companies of the domestic industry and foreign trade enterprises or the so-called research and development associations as governed by Decree No. 32/1967. (X. 15.) of the Council of Ministers and Order No. 1/1968. (XII. 1.) of the National Committee of Technical Development) in which pooling of assets as a traditional feature of associations was relegated to the background;

(d) it was realized that association was not simply a civil-law phenomenon and therefore its administrative, financial and labour aspects were also regulated;

(e) pursuant to the aforementioned Law-Decree of 1970, Decree No. 28/1972. (III. 16.) of the Minister of Finance incorporated in the law of association joint ventures or, more specifically, association with foreign partners on Hungarian territory, enabling the partners to choose any of the older forms of commercial association of the new form of joint enterprise. I should like to stress that during the 1970s foreign partners always chose in practice the form of limited liability company, and until now they have never opted for the forms of internal association open to Hungarian enterprises.

4. The legislation of 1977–78 made significant progress by incorporating the economic association of enterprises into the Civil Code, and Law-Decree No. 4. of 1978 referred to above gave a detailed and complex regulation of this area, the main new elements of which are as follows.

(a) The incorporation of pre-existing forms, independent under cooperative law, into the general forms of association served to reduce the trend to sectoral separation. It should be noted, however, the scope was left for taking into account certain cooperative traits. This notwithstanding, the regulatory system inclusive of income regulation continued to distinguish forms of association between state enterprises, cooperative enterprises and, with some overlaps with the latter, industrial and agricultural enterprises, which were accorded significant benefits.

(b) The basic form of associations other than legal entities became the economic association of enterprises, which, along with the primary purpose of pooling assets, contained cooperative elements and risk-sharing, but enterprises continued to be restricted in setting up associations with citizens in the form of civil-law society with a rather limited scope of action, while citizens' associations received a minimum legislative coverage, mainly in the Civil Code, that is, outside the frame of Law-Decree No. 4 of 1978 (which governed, among others, the property relations of building partnerships and consorts).

(c) Partnership was regulated as a cooperative association possessing juristic personality, and the previous institution of compulsory partnership or, more generally, compulsory association (with the exception of water management societies as a very special form of association) ceased to be a concern of Hungarian law.

(d) In light of the experience that enterprises tended to form jointly enterprises mainly for supplementing their activities, the above Law-Decree considerably reinforced that institution and completely displaced the previous forms of commercial association. It was no longer possible for artisans and retail dealers to form

an unlimited mercantile partnership, and the establishment exclusively by domestic enterprises of joint stock companies and limited liability companies was made subject to permission by the Council of Ministers (the regulation on the participation of foreign partners was not affected by the provisions of the Law-Decree of 1978). Moreover, the new regulation introduced a type of joint enterprise whose members were liable for the debts of the joint enterprise to the amount of their deposits, instead of going surety under the general rule. Given the rather strange denomination of "deposit company", it was intended to constitute a form closely similar to the limited liability company, but an internal order of the Council of Ministers vitiated limited liability by allowing a deposit company to be set up exclusively by domestic enterprises and subject to additional contributions to be pledged by members.

As can be seen, the regulation of associations in 1977–78 went to the opposite extreme of the legislation of 1967, completely excluding forms of association based on securities and limited assumption of risk, and by overemphasizing members' joint liability, direct and unlimited, it worked strongly against the flow of capital in the name of an economic policy that was directed predominantly towards centralization in the mid-1970s. This law of association between enterprises was in force until 1989, with the difference that the restrictions on deposit companies and on the establishment of joint stock companies and limited liability companies were lifted at the end of 1986.

5. Finally, the regulation of small undertakings in the early 1980s embraced the cause of citizens' associations, which received little legislative coverage in 1977–78 and suffered long years of neglect. Although a large part of small business were not associations (traditional small-scale industry, retail trade, cooperative undertakings, contractual operation), business partnership, or its variants (mainly intra-enterprise business partnerships) and their backlash effects on civil-law societies involved a thorough change of mentality. It was no longer possible to think in terms of association between enterprises alone. As a matter of course, citizens' associations raised quite different problems (the need or possibility to take action against, e.g., tendencies to exploitation or income acquired without labour). Thus the emergence of small businesses heightened the ideological problems, real or apparent, concerning associations. However, following from that was the need for law to bring civil-law societies much closer to forms of association that had an organization and juristic personality, but this in turn operated to deform considerably the originally amorphous civil-law societies.

From the foregoing it is perhaps clear that the development of the Hungarian law of association, irrespective of the fact that it tended to relax rigidity in the separate treatment of the forms of property, virtually continued to bear the mark of sectoral regulations. The economic policy approach to the law of association varies widely in respect to "international" associations, associations within the public and cooperative sectors, and citizens' associations and hence these four "sectors" are governed by rather different regulations.

It is equally disturbing that as a result of past legal development the concepts of association and company are hopelessly intermingled. In languages that are capable of distinguishing the two, association is not a legal term, but a comprehensive economic and legal policy notion. Yet, in the Hungarian regulation of 1977–78, "company", or "society" (*társaság*) refers exclusively to forms of legal entity. But

if this term is understood to include commercial companies both with and without juristic personality, this way of distinguishing them is not viable. In future, therefore, we shall use the single term "company law" (*társasági jog*) and, for general reference, "association" (*társulás*) as a generic term of economic policy.

II. Assessment of the Hungarian Law of Association as in Force until 1989

1. It appears to me that the state of the Hungarian law of association which was effective until 1989 was no different from the general state of the economic reform in Hungary, its merits and flaws being closely interrelated with the latter.

A survey of the laws of association in other socialist countries leads us to state that the Hungarian law is more fully developed. This is true not only of the countries still clinging to the rigid system of plan instructions, but also of those like Poland or China. The Soviet, Czechoslovak and Bulgarian regulations are concerned, not with domestic associations, but largely with joint ventures formed with foreign investors, yet the degree of progress made by Hungarian law is not matched even by the Chinese and Polish rules on domestic associations. This holds also for the Yugoslav regulation, which covers at best intra-enterprise associations in a greater degree of detail than the Hungarian law. The Yugoslav arrangement is specific in so far as—unlike the rest of socialist countries which, while favouring a reform of the economy, were forcing the old forms of commercial association, particularly in respect of western capital investments—it applied the domestic form of associated work organization, a special form of association (partnership of internal work organizations), to joint ventures as well.

In a system of plan breakdown there may emerge a law of association only in exceptional or sporadic cases or in response to new needs created by, e.g., foreign participation (see the Czechoslovak stock law of 1949 or the Romanian legislation since 1972), establishment of joint enterprises by large economic organizations (see the Soviet and GDR regulations on amalgamations in 1974 and 1979, respectively) or occasional associations of citizens (see the civil-law society which the Polish Civil Code of 1964 did not cover). In some socialist countries like Bulgaria, arrangements between cooperatives are more closely aligned with associations. The new Soviet law of 1987 on state enterprises suggests the possibility of evolving a law of association, but I believe that such a possibility cannot be translated into practice except in the process of transition to a socialist market economy and at the pace it will be advancing. This assumption is supported by the Czechoslovak Economic Code of 1964, in which associations between socialist organizations made their appearance, but failed to come into being because of the discontinuance of the reform.

In the domain of CMEA integration it has been possible, since the adoption of the Complex Programme in the early 1970s, to establish international economic organizations in the form of association, but—owing to wide discrepancies in internal economic mechanisms and the continuing intertwining of their majority with plan breakdown, the insufficient level of development of commodity and money relations within the CMEA and the impossibility ensuing from the national dispari-

ties in those relations to determine the value of services as well as the inadequacy of arrangements under internal laws of association — there operate neither joint enterprises established by direct contract nor partnerships despite the existence of such a possibility in principle. The only realities within CMEA are represented today by large associations based on multilateral treaties among States (and strongly criticized precisely for their administrative features) and by joint enterprises set up under bilateral agreements. Although the Model Regulations of 1978 were slightly modified as of January 1, 1988, there is little likelihood that socialist integration will, within a foreseeable time-horizon, become a motive force for our law of internal association as the Common Market is for the states members of the Economic Community of Europe. One may nevertheless expect some gradual and partial progress, for the amendment of 1987 increased the importance of joint enterprises over associations that had been formed in pursuance of administrative regulations. However, considering the continuing optional character of the Model Regulations — due to the fact that the majority of member states were still reluctant to adopt a binding convention and that national regulations on joint ventures are still inapplicable to intra-CMEA arrangements —, there is invariably little chance of putting together joint undertakings in a direct way within CMEA. In the future, too, it is setting up interstate, that is, “joint enterprises governed by public law”, mainly on a bilateral basis, that can be expected in the first place. (The Soviet Union, for instance, has concluded such arrangements with nearly all CMEA-countries, but those agreements make no specific reference to regulations of CMEA-countries relating to international economic organizations.)

2. Reverting to the achievements of Hungarian legislation on associations, I should like to refer in particular to the progress made in respect to integrational-cooperative forms of association. It is common knowledge that the traditional laws of association of West-European countries did not cover such forms of association, which were therefore, completely unknown to the commercial laws of Germany, France or England at the end of the last century. Those forms represent a new trend in western laws as well: the laws of nearly all West-European countries came to cover forms of association pursuing objectives like coordination and integration of members' economic activities rather than pooling of capital or economic undertaking. Among those forms, the way was led by the French *groupement d'intérêt économique*. It cannot be considered to have been accidental that the efforts of the EEC at the unification of law succeeded first in regulating the so-called European cooperative association.

The achievements recorded by the Hungarian law of association in this field are shown mainly by the regulations on partnership, but economic associations have also developed various cooperative sub-types. Therefore it would probably be ill-advised to lay undue emphasis on the otherwise right endeavour to enhance the flow of capital and to thus doom to decay older coordinative-representative forms of association and others not specifically aimed at capital investment. Development of these forms should also be a goal to pursue in the codification of the law of association. It is therefore a basic objective to clearly demarcate association from trusts characterized by concentration of executive power and to adjust it to criteria of the law of competition.

Furthermore, it is advisable to do away completely with the vestiges of sectoral separation, which is typical mainly of cooperative associations in our legislation

(see associations for research, development and production, agro-industrial associations, foreign trade companies, R&D partnerships) and to consign sectorally separated associations to oblivion in such a way as to ensure that room for preserving their merits is left by a uniform set of permissive rules.

3. The flaws of the current law of association (to be eliminated by the new legislation) are, in my view, closely interrelated and may be stated to be the following.

(a) The outdated separate treatment of forms involving juristic personality (enterprise-like associations) and possessing no legal entity (economic associations vs. companies) in connection with a rigid separation of associations between enterprises from those between individuals. Such differentiation was rather common in the past century and was a general feature of the traditional law of association, so its application was suggested not only by political considerations, but also by the traditions of conservative legal policy.

As against traditions, however, one should accept the fact that differences between forms of association, both legal entities and not, have attained a high degree of relativity in modern industrial societies. Associations which are inscribed in the register of firms and acquire rights and obligations in their own name have come near to reaching the status of legal personality, as is, for that matter, also demonstrated by the few years' development of business partnerships in Hungary. Consequently, Hungarian economic and legal policies should stop making a fetish of juristic personality. It is not accidental that in French law all forms of commercial association having a trade name are treated as legal entities, while the development of German, Austrian and Swiss laws equally shows that associations other than legal entities having a trade name are already closer to juristic personality than to their traditional dogmatic basis, that is, civil-law society and that even some civil-law societies switch to enterprise form, just as foundations do. The intermingling types of associations are widespread in the West, with rigid compulsory forms on the wane, factors without which an advanced law of association is hard to conceive of. Of course, one must not run into the opposite extreme, for juristic personality has a definite function to perform, more than is involved in the condition of groups other than organizations as subjects at law. It should nevertheless be clearly realized that legal capacity, or the status of subject at law is an attribute not only of individuals and organizations recognized as legal entities, but eventually also of communities, or groups of people and that the future law of association should likewise be conceived in terms of a status involving not only subjects at property law, but rights and obligations in different branches of law.

(b) The rigid separation of associations between enterprises from those between individuals. Under Hungarian law, associations with juristic personality between enterprises and individuals (except water management societies subject to very special regulations) could not be formed until 1988. (Limited liability company became a mixed institution as of January 1, 1988.) Associations other than legal entities could be established between individuals and enterprises exclusively in the form of civil-law society, which was, however, required to pay a high rate of tax until 1987, that is to say, cooperation of individuals with enterprises in the form of an association was subject to outright restrictions. So far as economic policy was concerned, it was finally possible to clarify (but this approach was not and is not always consistently followed by ideology) that there was no reason to restrain the development of institutionalised association between private persons

and the socialist sector, because a restrictive approach tended to impede investments by the population in the socialist sector. (The property aspects of this question will be discussed at a later stage.)

(c) Excessive differentiation between domestic and international associations. As mentioned earlier, this is still a general feature of socialist laws. It can be stated as a fact that, despite the existence of a possibility in principle, the forms of association open to Hungarian economic organizations *inter se* (joint enterprise, deposit company) were not used at all by foreign investors. Joint enterprises were set up in the old, antiquated form of limited liability company and lately of joint stock company (the latter being typical of banking institutions). Until 1987 a joint stock company and a limited liability company could not be formed between domestic partners alone; now they can, but the application of old rules gives rise to considerable problems.

It is amply demonstrated by international experience that associations between domestic or foreign partners alone are impossible to treat separately under an advanced set of commodity and money relations. This has nothing to do with the fact that nearly all countries make a few special rules for foundation and supervision in respect to associations formed with foreign partners; only the most industrialized countries are in a position to dispense with such rules.

Under a socialist system of plan instructions it is inevitable that joint venture is relied upon in exceptional cases and is subject to special permission or that wider recourse to it is governed by rules sharply different from those relating to cooperative arrangements between domestic enterprises. As is well-illustrated by the Yugoslav experience mentioned above, notable results can also be achieved by forms of association between domestic enterprises alone or by foreign participation in joint ventures, provided that the conditions determined by economic regulation (transfer of foreign exchange, etc.) are appropriate and foreigners are given sufficient guarantees against nationalization.

It is equally obvious that economic regulations on joint ventures cannot be completely the same as those applicable to domestic ones, since individual countries either prefer the former or accord them the same treatment enjoyed by domestic economic organizations. Hungary should place the emphasis on preference, for it must be kept in mind that if in the second part of 1980s we want to use more working capital than we did in the 1970s we must extend to investors from the advanced countries of the West benefits similar to those accorded by the rival countries (custom-free zones, etc.). Here I do not refer to countries of South-East Asia (for Hungary is hardly capable of granting preferences on a scale accorded by, e.g., South Korea, Taiwan or, to give a socialist example, China), but at least the measure of preferences afforded by Yugoslavia or Romania should be matched. Such treatment should not be seen as discrimination against domestic economic organizations. Chinese experience clearly shows that this is understood by domestic enterprises. It is no accident that in Hungary, too, the making of concessions to joint ventures is supported most strongly by the Chamber of Commerce, although it would formally disfavour Hungarian enterprises.

Again, it should be noted on this score that rigid differentiation between participants from Western and CMEA-countries and thinking only in terms of Western investors in joint ventures are also hardly defensible in light of the latest Soviet developments. For instance, during the negotiation of the recent interstate agree-

ment between Hungary and the Soviet Union, the Soviet partner proposed the possibility for joint enterprises that would be set up in Hungarian territory to take the form of joint stock company, too. Participation in such a joint stock company is open to a Western partner as well; the relevant intra-CMEA regulation on association has provided for participation in principle.

Forming an association with an enterprise of a CMEA-country was not prohibited by Hungarian regulations on joint enterprises, but the pertinent 1972 Decree of the Minister of Finance was worded in such a way that its provisions could be construed to be applicable matter-of-factly to western investors only. The goal is therefore to elaborate a law of association which, in devising the forms of associations, will not distinguish domestic and foreign partners and, in regard to the latter, partners from a socialist or a capitalist country.

Finally, it should be noted that regulations on joint enterprises cannot be maintained at a level as low as that represented by the 1972 Decree of the Minister of Finance, for a similar legal arrangement can hardly increase the confidence of foreign investors.

(d) Overemphasis on unlimited or joint and several liability acted as a considerable restraint on investments by the population and as a brake even on associations between enterprises. It must be realized that unlimited or joint and several liability is the most primitive institution for creditors' protection and can no longer be the primary device to rely upon. Consequently it is necessary to introduce, in addition to arrangements involving unlimited or joint and several liability, forms of association that are based completely or partially on limited liability, that is, allow limitation of risk to be assumed by entrepreneurs. Emphasis should also be laid on partial liability, that is to say, that our law of association should extend coverage to deposit company without legal personality in which full members are liable for the total debts of the partnership, whereas silent partners are liable for only a part of such debts, and the traditional form of deposit company, having legal personality itself should be replaced by limited liability company, for the former formula as introduced early in 1987 parallel to limited liability company cannot be upheld in the long run anyway. However, I would stress again that full-scale institutionalization of forms of association based on limited risk-taking calls for creation of a wide range of institutions to protect creditors, ones that would provide guarantees against "undercapitalization" or other forms of abuse. A related task is for our criminal law to devise procedures for establishing the personal responsibility of business managers, auditors, etc. for fraud and other acts causing damage within the framework of the operation of an association, with the extent of such liability obviously to surpass the upper limits determined by labour law currently in force, although in view of Hungarian realities the degree of liability can hardly be equal to that of full liability for damage under civil law.

(e) An enterprise could not be established so far as an association exclusively as secondary enterprises, that is, through association of primary enterprises (state enterprises, cooperatives, etc.). In other words, a state enterprise could not be set up originally in some form of association, while the dominant view even denied the very nature of cooperatives as associations. That view is untenable now. On the one hand, individuals, too, should be allowed to form associations recognized as enterprises, that is, legal entities, and, on the other, primary enterprises should be enabled by law to assume a form of association directly, although in the next

decade enterprises that constitute an economic association will, as a general rule, obviously be established through association of other enterprises, that is, in the form of secondary enterprise.

While I believe it to be an illusion that state enterprises will change on a mass scale into joint stock companies at the end of the 1980s, the legal possibility should be open to some enterprises for such transformation. It would be extremely harmful, both politically and economically, to set out on efforts to change enterprises "from above" into joint stock companies immediately upon completion of their transformation to new forms of enterprises management. More associations are needed in the public sector, too, but the primary channel should be for operating state enterprises to form joint enterprises, including joint stock companies, with other economic organizations or banks, etc. As is also demonstrated by capital tickets or the differentiation of bonds, it is possible even in the case of state enterprises operating in a form other than commercial company to create long-term proprietary motivation for workers' collectives or individual workers. At the same time, anti-trust law techniques and contractual formulas can be used to give an enterprise supplying capital to another a say in the latter's business policy, so this calls for no joint stock company or other form of association.

Direct transformation into a joint stock company mainly of some trusts and large enterprises managed by state administration appears economically justified in cases where conditions are present. So it is the possibility that law should create for state enterprises to operate as potential joint stock companies in the first place, a possibility which self-governing enterprises—over those subject to management by state administration—also need for eventual voluntary transformation. The techniques of transformation will be discussed later in this Chapter.

(f) All this is linked with the unconcern, of our law on domestic associations with forms of association based on securities, that is, with joint stock companies, in point of fact down to 1987, although the previous years had seen the related restrictions cut across to some extent (establishment of Novotrade Corp. on special authorization, etc.).

I think it was not realistically possible for associations based on securities to become widespread before the hierarchical administrative dependence of state enterprises had been abolished, but now the law has practically created the degree of enterprise autonomy needed for the foundation of joint stock companies. The goal pursued in the establishment of self-governing enterprises during the period 1984–87 was to abolish the sectoral-territorial pattern of hierarchical administrative dependence rather than to secure capital flow; in the case of enterprises dependent on state administration not even a holding could have been more than an organ of middle management, but that measure was, for all its inconsistencies and inner contradictions, an indispensable prerequisite to evolving the necessary institutions for a capital market.

It should be emphasized, however, that the introduction of forms of association based on securities should be governed by the principle of progressivity, which is to say that what needs to be adapted is not the most complicated arrangements as used in the West. To give an example, the so-called deposit joint stock company is a specific product of recent development in the West, but in Hungary, where not even the ordinary joint stock company has evolved, it is hardly necessary to start regulations with such a complicated mixture of types, let alone the fact that the

very possibility for the emergence of such forms is yet to be created. The same holds for the differentiation of shares. Obviously enough, there is no use introducing the institution of joint stock company unless the overwhelming majority of shares are bearer's shares and transferable. It could be complemented by, e.g., registered shares, shares with extra voting right or without voting right, redemption stocks or special employee shares. Nevertheless, more complicated arrangements should possibly not be the first to be introduced.

(g) The long absence of infrastructure required for the operation of associations. Some facilities have been created by now. Thus, for instance, in 1984 there was adopted a relatively modern regulation on competition, although in need of refinement, and in 1986 a liquidation procedure (although the relevant Law-Decree needs essential amendment in view precisely of the law of association, because it paid little attention to the specific features of economic associations). In connection with the law of association, however, it will be inevitable to provide guarantees for the protection of creditors and the minority, which in turn will require the creation of special organizational institutions and a considerable development of the judicial organization. Arrangements to ensure authenticity of balance sheet, appropriate book-keeping and assessment of assets as well as the establishment of institutions providing for due publicity — without which forms of association based on securities cannot be viable — are questions central to a modern law of association.

Transformation of association among one another should be a very essential part of the new law of association. This question is so important as to be governed by separate legislation in some western countries (e.g., Germany). Related as it is to the lack of solution for the assessment of assets, it is almost completely unregulated in Hungary and therefore requires great attention. Finally, a modern legislative coverage of the security market, or stock exchange similarly forms part of a law of association relying on securities, too. Modernity should also be stressed in the case of the infrastructure, because there is no sense, either political or economical, in introducing forms devised by capitalism in the era of free competition and long outdated even in the West. The way should be blocked, during the preparation of the law, to choosing the easier path of simply reviving formulas of 50 to 100 years ago.

Economic regulation, too, forms part of the infrastructure, the primary purpose being an appropriate adaptation to associations of the new system of enterprise and business income regulations in order to avoid fragmentation of the uniform law of association by the tax system. To secure the operation of the law of association, it would be absolutely necessary to frame a single tax system applicable to those engaged in economic activity and to devise arrangements under which partners to any form of association receive their profit shares or dividends from post-tax profit as well as their remuneration for eventual personal cooperation in settlement of the association's debt owed to them. There is a need to change the system of contribution by the State of capital stock and, in respect to credit policy, to accord equal treatment to all forms of associations, whether or not they possess juristic personality.

Finally, it should be inadmissible in future for labour regulations and the rules on labour administration that are applicable to state enterprises to be mechanically adapted to associations (e.g., categorization of enterprises) as such a procedure

deforms the inner logic of associations. In the process of the wage reform it will be necessary to abandon income regulations outside the context of the tax system, thus eliminating discrimination against different forms of association in this respect.

III. The Law of Association and Forms of Property

1. Streamlining the regulations on associations will necessarily react on state enterprises, cooperatives and citizens' small businesses as it may provide an opportunity for lifting the previous restrictions on them. This is to say that in the course of development of associations attention should be paid to all forms of property so as to progressively eliminate the inherited differences in the treatment of the various forms of property.

Following the adoption of the programme for economic and societal development, the course of economic policy has become relatively clear for a new Act on associations to take it into account. Accordingly the Act should serve to ease the rigidity of our enterprise structure and facilitate the emergence of flexible forms of economic organization capable of self-development and transformation and meeting the needs of modern enterprises, small, medium-sized and large. Since our system of economic organizations was so far characterized essentially by the isolation of forms, the Act on Associations should lay the foundations for an integration of enterprises conforming to market requirements. In addition to promoting inter-enterprise cooperation, another important principle of regulation should be to satisfy the demands of capital flow, facilitating efforts to ensure the utilization of social capital where it promises more gain at long term. The Act should determine the terms and conditions for capital investment by enterprises and individuals, inlanders and foreigners alike, under a clearly defined set of stable guarantees.

The number of actors in the market should increase *via* associations flexibly adjusting themselves to market demands, thereby contributing to building the market in a planned way. Impetus should be imparted to investment in money or securities instead of to a short-term development of one's own enterprise on an autarchic basis and to wasteful consumption and unproductive investment by the population. Further steps should be taken towards evolving a modern organizational structure for the management of state property and, by removing the barriers to cooperation between enterprises and citizens, enabling individual initiative to develop within the pale of socialist undertakings.

2. The development of the law of association is inseparable from the traditions and the growth possibilities of the public and cooperative sectors dominating the Hungarian economy. The questions of, e.g., founding associations and exercising supervision over the legality of their operation are intimately related to general solutions for the registration of enterprises and legality control over them. Regardless of the inner logic of the public sector and with a modern system of registration of associations in operation, it is hardly conceivable to maintain an outdated procedure for the inscription of cooperatives that fails to conform to the principles of authenticity of balance-sheets and of publicity. Furthermore, there is hardly any possibility for a solution to legality control over state enterprises and cooperatives

by sectoral ministries or by special administrative agencies of the councils and, on the other hand, for its lasting coexistence with a modern system of supervision by a registry court over associations.

In some cases, of course, there is a likelihood that the needs of state enterprises and cooperatives dictated by their past course of development and the traditions of the law of association will come into conflict, as is excellently illustrated by the system of enterprise management. In the case of joint stock companies, the traditions of the Hungarian law of association clearly warrant preservation of the German tripartite structure of management, namely the meeting of shareholders, the management and the supervisory board. True, but at the majority of state enterprises there has emerged a two-tier system of management, meaning that the composition of the enterprise council (50 percent of managers and 50 percent of employees) may in theory raise the question of joint stock companies having the Anglo-Saxon system of boards in Hungary as well, that is, introducing a two-tier system of management and meeting of shareholders and directly incorporating the exercise of control over the association into the management. So what we have here is the prevailing arrangement for state enterprises confronted with one indicated by traditions of association.

The various aspects of this question considered, it is necessary, in my view, to retain the tripartite structure of joint stock company management as it prevails in the German-French group of laws, but it appears impossible to exclude (as our current law of association does) all say of workers in the affairs of associations constituting enterprises. Hence it follows that in respect to joint stock companies and joint enterprises with a specified workforce as well as to limited liability companies it will necessary to devise a participatory arrangement of some sort in the supervisory board (for more detail see below), that is, to change the status of the supervisory board considerably in comparison with the pre-1945 structure.

3. As mentioned earlier, cooperatives in the socialist countries are customarily kept outside the framework of the law of association. There is little question that this arrangement will be impossible to maintain in Hungary in the future.

Obviously, on the strength of traditions, it is impossible to have cooperatives covered by a new uniform law of association, but an appropriate balance of emphasis should be maintained, namely the forms of cooperatives should be more open, a requirement which was met only in part by the amendments to the Act on Cooperatives in spring of 1988. If state enterprises come to have capital interest (shares, bonds, etc.) and some of them transform into joint stock companies, while the law of cooperatives fails to relax its rigidity, cooperatives may become considerably underprivileged in comparison with the public sector. Already today a small cooperative is closer to a limited liability company than to a traditional cooperative, whereas the specialized groups should be fully recognized as a special form of economic association (a specific sub-type of unlimited mercantile partnership), because I think that the current uncertainty about notions and the lack of a clear definition of status do no good either to parent cooperatives or to entrepreneurial groups or state interest. To be sure, the specialized groups are not covered by the Cooperatives Act, they are market undertakings with a high degree of autonomy in general, but only a small fragment of them have a work organization similar to intra-enterprise business partnerships (*vállalati gazdasági munkaközösség*, *VGMKs*, short for their Hungarian term).

It appears to me that an approach which, on plea of the closed nature of the prevailing legislation on cooperatives and of some sort of indivisible "all-cooperative" property or property of the "cooperative sector", seeks to rule out even the possibility in principle for cooperatives to enter into economic associations is basically mistaken. That in view of the special Hungarian pattern of divided land ownership, established mainly in the case of cooperative farms, the practical possibility of doing so is limited is a different matter. It is unrealistic to start from the proposition that while a state enterprise is free to transform into an economic association or even a cooperative, a cooperative is not ever allowed such a latitude, because that approach is tantamount to discrimination in the opposite direction, being as it is a survival of a mentality formed amid the drive for nationalization and biased against cooperatives in the course of historical development. Indivisible cooperative property is owned by particular cooperatives or, through them, by their members, not by the movement, and cannot be recognized as "indivisible cooperative property of the movement". The rule under which the assets of a cooperative must be used for cooperative purposes in case of liquidation cannot be construed to mean that a qualified majority of members is not entitled to decide in favour of transformation.

The property of a joint stock company or a limited liability company is just as indivisible as that of a cooperative during the period of its operation. In addition, when through the will of founders a cooperative is transformed or (as is more often the case) an economic association is formed mostly by cooperatives (which is a rather widespread arrangement in agriculture) the specific features of cooperatives can be taken more fully into account. In countries with advanced cooperative traditions (like Denmark or France) a cooperative means no specific type of enterprise, but may, in principle, take any form of commercial association. Should cooperatives so desire, let them be "cooperative limited liability companies" or "cooperative joint stock companies", with members applying the basic principles of cooperativism. That line of development would not but strengthen the real cooperative movement.

Finally, regulations on corporate association (e.g., business company) and association for social (non-economical) purposes cannot also be rigidly separated, since an association for social purposes is an association, too, in the wider sense, so the relevant legislation should synchronize regulation of the two aspects. The question of whether to allow or to disallow "economic associations", for instance, has a considerable influence to bear on the law of corporate association. The idea has been suggested that if citizens become free to form limited liability companies along with small cooperatives and if forms of corporate association other than legal persons have a sufficient measure of flexibility, with the possibility for them to switch to other forms left open, it remains possible also for the Hungarian law to introduce only "association for an ideal purpose" on the pattern of several western countries. However, an association for social purposes in the process of establishment is a "pre-association", and the rules on corporate associations should also apply, *mutatis mutandis*, to non-economic groupings of citizens (clubs, circles, etc.) that have no need for the formalities of an association.

4. With this end in view, the excessive complexity and multiple transmissions of legal regulation on small undertakings should be eliminated. It is equally necessary for legislation to consider the purpose or function of the various forms of asso-

ciation rather than the attributes of their members as subjects, clearly affirming the principle of competitive and sectoral neutrality and the nature of activity. Consequently, the separate treatment of economic associations between enterprises and of associations between citizens for business operations should be abandoned and the two categories should be combined in unlimited mercantile partnership. This does not preclude the possibility of continuing to use the designation "business, or economic partnership" (*gazdasági munkaközösség*) with a view to avoiding undue uncertainties concerning unlimited general partnerships formed only by citizens, and business partnership as a sub-type of unlimited mercantile partnership could even be governed by a few special rules (e.g., maximum number of members and employees).

A further task is to separate market undertakings constituting real associations from the so-called autonomous groups of workers within the enterprise. As explained above, the overwhelming majority of *VGMKs* today are no real associations, so application to them of the regulations on associations does not but result in unnecessary administrative-bureaucratic rules. Most *VGMKs* are special internal units of enterprises and are in contractual relationship with the management. Contracts of association should no longer be forced upon purely "internal" *VGMKs*, which should be governed by the future rules applicable to intra-enterprise undertakings.

Thus, as concerns the future, there are three possible arrangements to consider in relation to workers' associations attached in one way or another to an enterprise.

(a) A particular community of enterprise workers as a *quasi* pre-association may make an offer to the enterprise management to the effect that it will work mainly for the enterprise, which in turn would make assets available to the former and undertake financial liability in its external relations. The Act should allow the property of such an associations to originate in sources other than members. In return for the assets made available and the liability assumed, the enterprise manager may set the contractual terms and conditions for the business partnership, and the registry court will inscribe the association subject to that contract. But any stipulation to the effect that a business partnership may not do work except for a particular enterprise should be prohibited by law.

(b) An enterprise may form an unlimited mercantile partnership with several of its workers, so it will enter into the partnership contributing capital. In this sense, subject to the rules on unlimited mercantile partnership, the enterprise is liable jointly and severally with workers, so financial liability is actually assumed, and, in respect to distribution of gain and loss, it may agree by contract, relying on the permissiveness of rules, on an arrangement other than the general.

(c) Workers of an enterprise may, eventually with outsiders, set up a business partnership as a sub-type of unlimited mercantile partnership, which, having assets of its own, will make an agreement on cooperation with the enterprise (perhaps with several enterprises). The enterprise may provide various kinds of assistance for the business partnership, which in turn will tie up a part of its capacity for the enterprise. This arrangement is a resurrected form of business partnership enjoying enterprise support.

5. The question is being increasingly raised, and with reason, that the old concept of property is a disturbing factor in elaborating a new and modern legislation on associations. In this respect there is a rather great difference between actual

practice and the majority view held in legal science. The latter has long been guided by a conceptual approach which, if put into effect, would remove the barriers to capital flow through the channels of associations. It is extremely difficult to imagine forms of association based on securities if the old traditional concept of property, rigid and absolute, is upheld in respect to specific things and means of production. It should be realized at last that while the property concept of law traditionally related to things (physical objects), the real object of property in a modern economy is constituted by assets consisting of rights and obligations, with even an enterprise being capable of transfer as a whole. Moreover, modern business transactions accord primacy to exercise of power through disposition, mainly indirectly, over partial rights of ownership in which tradition gave too much emphasis to possession and use. Under such circumstances it is unwarranted to maintain, as a general rule, ownership of concrete assets on separate patterns by members of associations possessing juristic personality.

So far as state property is concerned, it should be considered in its internal aspects, in relation to enterprises on the one hand and in its external aspects, in relation to other economic organizations on the other. Theory has long pointed to the necessity of recognizing different sub-types within the category of state property: Management of assets of a budgetary organ of the state, state ownership in public roads or public squares, the property of competing state enterprises or even of council self-governments are quite different matters. This makes it obvious that there are rather great differences within state property considered as one under constitutional law. I hardly believe anyone could speak of genuine council self-government without council property. In like manner, a state enterprise cannot turn into a real market undertaking unless its ownership in its own assets is recognized. That property is not group property, and its subject is not the enterprise collective, but the enterprise as an organization and a legal entity.

Such a concept of property is supported by the emergence of new self-governing state enterprises, as the drastic limitation of owner's rights—the reduction of former managerial powers to legality control following the elimination of compromise and residual rights—makes it clear that such enterprises are directed by the state exclusively through the exercise of political power. In respect to these assets, which are separated from the state budget, the owner's rights of the state are exercised by the enterprise itself, fundamentally through its management organs of a collective nature (enterprise council, general assembly, delegates' assembly of workers). The state is the owner of the enterprise as a whole, but the latter's property is owned by the enterprise, which may bring it or a part of it into any form of association. The independent property of state enterprise is of a market or commodity nature, which is to say in legislative language that its functioning according to the rules of civil law does not exclude the existence of state property under constitutional law, for the state is a system of organizations, and what is involved here is no more than replacement of the former state administrative ownership by enterprise ownership within the system of state organization.

The situation is obviously different with regard to enterprises still managed by state administration or to budgetary organs, for in their case there may be a justification for an arrangement under which the constant of the state organ exercising political power, namely the permission of the Minister of Finance representing the

budget, is required for the transfer of assets to an association formed by, e.g., budgetary organs.

I think that giving effect to this principle requires no amendment either to the Constitution (the need for a general revision, in the process of a wholesale constitutional amendment, of social property as defined in 1949 is a different matter) or to the Civil Code, because this problem can be resolved by an appropriate interpretation of their relevant provisions. For that matter, the Civil Code has since 1977 applied a device similar to the English trust or the German *Treuhand*, providing that a state enterprise must, under authority of the State, be regarded as owner by third persons in the domain of market transactions. Rather the problem lies in partial rules which prohibit transfer of certain assets to non-state economic organizations. These rules should be revised, most of them to be repealed as outdated.

Joint stock company and the other forms of associations (regardless of the person of founding members, which cannot even be ascertained at, e.g., a joint stock company possessing bearer's shares ensuring anonymity) should, in business operations, be treated as organizations of legal entities equal in every respect to traditional state enterprises. A comprehensive revision is needed to repeal those rules which determined the exclusive objects of state property and those of not negotiable property on much too wide scales or set administrative limits to their transfer.

All this brings us to the proposition that if we are to have a modern and advanced law of association it will be inevitable to live with mixed forms of property or to accept the emergence of secondary forms of property. Today it is entirely clear that enterprises of social organizations (among them those of representative ones) constitute social property, although they are neither cooperatives nor state enterprises. Even under the current CMEA regulations and Hungarian domestic law, it would be possible to set up on Hungarian territory international enterprises whose members could be a Hungarian cooperative, a Soviet amalgamation and an Austrian joint stock company or one domiciled in another western country. I hardly believe that such property could be called private, nor can it be declared to be state-owned even at present. On the whole, it would be necessary to stop overestimating the forms of property in a context of ideology and to actually awaken to the need for activity rather than the categorization of economic actors by traditional forms of property to serve as a criterion in economic life.

So when any state enterprise or any cooperative or even an economic association chooses to enter into another association with each other we have a clear case of social property from an ideological point of view. (Restrictions on changing into other forms of association should be lifted in general except when disregard of this principle is justified by creditors' protection. Accordingly, associations other than legal entities should be allowed to join another associations as members thereof. In case of share-purchase, for that matter, switch to another form of association cannot even be ruled out for all practical purposes.) The situation is the same when state or cooperative property blends with citizens' property, which is indispensable, and in point of fact most of the present-day forms of small undertaking—*VGMKs*, businesses operated under contract, or the majority of specialized cooperative groups—have so far operated on the basis of the primacy of state property. It is thus obvious that in case of such combinations provision should be made for the primacy of the socialist forms of property as a general rule, for socialist

property to influence individual property rather than conversely, and there should be some arrangement to guarantee that investment by the population will not endanger socialist objectives, will not lead to overall reprivatization. Precisely for this reason it will be necessary—in the case of, e.g., joint stock companies established by traditional state enterprises and retaining their character of state enterprise—to eventually restrict the number of shares obtainable by citizens in comparison to the capital stock or to limit the voting right in the form of shares entitling holders to dividend only (another solution might be for organs representing the state to have shares entitling holders to extra voting rights). Nevertheless, there should be no rigid application of the principle of supremacy of the socialist forms of property either, because one can imagine, say, a state enterprise contributing minority shares to an association basically of citizens such as a limited liability company or a deposit company. In the case of capital pooling (i.e., joint stock company in the first place) rather than of personal association the law of association should also provide guarantees for the implementation of state economic policy and the preservation of real socialist values.

6. This point finally brings us to associations formed by private persons. According to statistical data, their assets are extremely little for the time being. In their case it evidently remains necessary to set legal limits to growth, but account should be taken of the fact that among the existing small businesses even the small cooperatives with the largest membership have had little need to exceed the limit of 100 members. Moreover, once joint stock companies and limited liability companies have been covered by modern rules scope for growth will be allowed to small cooperatives in exceptional cases. The same holds for business partnerships, which have had a real need for exceeding the 30+10 limit in exceptional cases only, and that limit was raised to 30 members plus 30 employees in 1988. Therefore I believe that for associations of a personal character, set up only by citizens, a maximum of 60 members and employees combined, with no internal proportions set, will satisfy the needs of small enterprises over the longer run as well.

According to one view, the basic restriction would consist in prohibiting joint stock companies from being established only by private persons and preventing such companies, during their existence, from having but citizens as members or citizens from gaining majority in them. (This can be done by technical procedures such as ensuring mandatory participation of a state bank and its possession of 51 percent of shares, citizen's shares without voting right or issuance of registered shares obtainable only by legal entities.) However, this would be too rigid a solution, and it did not quite work out in the case of limited liability companies either that the law had required establishment of mixed associations, namely that at least one of the founders should be a legal entity. Such a rule can be easily evaded, considering that a small cooperative too is a legal entity. Similar cases could perhaps be met by determining the minimum contribution to be made by juristic persons.

Establishment of an association only by private persons should also be allowed, and in such cases it would not be fortunate to set a maximum limit to the capital stock, for economic organizations may later subscribe for shares anyway or even some banks may be commissioned to do so. "Private joint stock companies" could, as a matter of course, be excluded by law from certain fields of activity like the banking and insurance sectors.

A similar course should be taken in respect to limited liability companies, that

is to say, the law should, unlike the current regulation, allow limited liability companies to be formed exclusively by citizens as well. Nor should the law prohibit foreign capital from being invested in forms of citizens' association (or associations other than juristic persons), that is, foreign juristic persons, associated firms and individuals from joining such associations either as founders or participants. There is no rationale of either economic or legal policy for blocking this way to small businesses operating in pursuit of socialist goals.

It should be added, however, that undivided common property, which is necessarily associated with juristic personality and limited liability, brings these associations rather close to the status of cooperatives and is thus suitable to reinforce their socialist character. So what we have here is neither social property nor merely private property, but one which can be stated to be partially socialist in character. A citizens' limited liability company as a quasi business partnership possessing juristic personality is not necessarily "more private" than a small cooperative, which may, in case of abuse, likewise serve tendencies to capitalist development.

7. Undoubtedly there is a rather strong ideological antipathy to capital investment in citizens' associations without personal participation. This aspect is somewhat different from the question of size of private undertakings.

In the view of many people, participation in associations with purely capital contribution means income gained without labour and should consequently be disallowed. Regardless of the need to revise the principle of personal participation — for enterprise itself, capital investment, risk-taking, and intensive involvement in the organization and management of the activity of an association also mean personal cooperation (of course, counting input of labour as contribution of capital would be too far to go) —, this obviously presents opportunities for considerable enrichment, which may be restricted by taxation and income regulation, but naturally cannot be fully prevented.

However, if we think realistically, we must face the fact that certain segments of the population have, justly or unjustly, accumulated rather sizable material resources, which the state has but three ways to handle.

(a) A large part of the resources of the "unjustly" rich in the private sector could be seized by police action (e.g., confiscation without court order) or other administrative or financial measures (e.g., a drastic devaluation of the national currency and introduction of a new one), but choice of this course would entail extremely great dangers, both political and economic.

(b) Another line of action could be to disallow financial investment by the population, but its consequences are in part illegal investments (see illicit usurious loans rapidly spreading and uncontrollable, growth of illicit "silent" partnerships, fictitious employment) and in part a senseless luxurious consumption. Such is the current state of affairs, which can hardly be maintained for a long time, as I think it tends to worsen the public mood more than the next arrangement would.

(c) The last choice of action is for the law to allow capital investment by the population, subject to regulation and control and kept within appropriate limits through income regulation. This I hold to be the path to follow, with the least disadvantage and one on which we have already set out anyway with the institution of bond. For that matter, along with bonds there are in Hungarian society several other schemes (like lease of immovables, various lotteries, etc.) that yield

"income without labour". If in the interest of mobilizing the national economy we are to enjoy sustained investments based on the confidence of the population we should opt for this third variant coupled with sanctions against abuse and with appropriate income regulation.

Accordingly the principle of citizens' personal cooperation could be upheld as a general rule in the different forms of "simple" associations (other than legal entities), but there seems to be an equally good case for Hungarian law reintroducing the institution of limited partnership (deposit company), not only for enterprises, but also for citizens, or under arrangements allowing citizens to join such economic organizations either as full or silent partners, the latter also not to be obliged to participate beyond their deposits (which or the payable gain may eventually be subjected to an upper limit). Moreover, the general rule should be to allow purchase of shares from joint stock companies by citizens having no contract of employment with them (perhaps, as already noted, without voting right), but the by-laws may naturally provide that shares from a particular joint stock company cannot be purchased except by legal entities. It is this trend that would meet the need to have a law of association uniform in respect to the status of subjects, namely the requirement to abandon the distinction between forms of associations established by citizens and enterprises separately and to make no more than a few partial rules of substance differentiating, e.g., enterprises and citizens as members of a business partnership within an unlimited general partnership.

I would emphasize once again that the law and the by-laws can provide every guarantee for the protection of real state interests. Income derived from an association is, in principle, just like any other source of income, and social justice should be secured primarily by the personal income tax system and the inheritance tax, which can nevertheless be supplemented by devices of the law of association, which could enable the by-laws to provide, e.g., for issue of "sinking shares" for citizens, namely shares whose face-value will be amortized at a specified percentage rate in benefit to some public body or community organization (fund, foundation, town or village), the difference between the face-value and the quotations after full amortization to be payable to private persons holding such shares.

8. In closing the discussion of property aspects I should like to note that it appears generally advisable not to overstate the significance of ideological problems in connection with the Act on Associations, even though the Act itself naturally has to contribute towards a shift in ideology. Of course, concessions could be made first of all in terminology. The Anglo-Saxon partnership and company law, for example, were never in terminological accord with the French or German commercial companies, nor did the Swiss hesitate to replace the *offene Handelsgesellschaft* with *Kollektivgesellschaft* in reference to unlimited mercantile partnership. So no harm will be done if, e.g., citizens' limited liability company is given the green light by modifying the regulations on business partnerships, although it would be a more optimal solution to introduce unlimited mercantile partnership without business partnership as its sub-type.

It should be driven home that the status of an institution has to be judged by its substance rather than its designation. Hence the voices of indignation at the use of terms smacking of capitalism are largely unwarranted. (For that matter, there exist organizations that are called concern in Czechoslovakia or *firma* in the Soviet

Union.) Public opinion will have to learn to live with the fact that entrepreneurial risk is recognized in income, that extension of citizens' right to enter into associations, if coupled with appropriate income regulation, will not result in a more inequitable pattern of income distribution than exists at present, and that capitalism is unlikely to "set in" in the foreseeable future.

Finally, resolute efforts are needed to avoid, in a small and open economy like Hungary's, using an association terminology that is impossible to render into foreign languages. To cite an example, foreigners would take limited partnership usually for deposit company (a contributing factor to this confusion was the use of the latter term in, e.g., the publicity materials of the Hungarian Chamber of Commerce). Related to this is the need, mentioned earlier, to eliminate the distinction between society and association (*társulás* vs. *társaság*), a specificity of Hungarian law. Thus we should use the single term association on the understanding that there exist certain forms of association purely contractual in nature (such is civil-law society), economic associations other than juristic persons (like unlimited mercantile partnership and limited partnership), which have a firm name and are enabled to acquire rights and to assume obligations on their own behalf, and, finally, economic associations possessing juristic personality (joint enterprises and partnerships), which the new legislation should clearly include in the same category with joint stock companies and limited liability companies. In other words, the future Hungarian law of association should, in line with international trends, be structured on a balanced differentiation between forms of associations contractual and corporate in nature on the one hand and bearing characteristics of personal partnership and capital pooling on the other.

IV. On the Structure of the Law of Association

1. Elaboration of a uniform Act on Associations is a rather great enterprise. The world hardly knows any such legislation of a "full scope". Joint stock company and limited liability company, for instance, are governed by separate laws in most European countries and even commercial companies that are covered by a single legislation are generally delimited from civil-law societies. Such is a case in France and also in Switzerland, which has no separate commercial law, or in Italy. So too, Hungary could have solved this question by minor amendments to the Civil Code and to Law-Decree No. 4 of 1978 in respect of joint ventures, partnerships or civil-law societies and by enactment of a separate legislation on limited liability companies and joint stock companies. Since, however, a decision has been adopted to pass a uniform Act on Associations, this is the task to be accomplished.

At the same time, it should be kept in mind that the general part of a comprehensive Associations Act cannot be elaborated except in partial aspects, with a margin left for the formulation of a relatively small number of general rules only, particularly as concerns the Act's permissive and peremptory nature (which I shall discuss later), since these aspects can only be treated independently, in separation from each other, with respect to particular forms of association. Also, protection of creditors and the minority as well as transformation from one form of association into another cannot, in my view, be regulated in general terms, because these

three institutions require entirely different arrangements for, e.g., joint stock companies or unlimited mercantile partnerships.

However, a uniform Associations Act cannot entail eliminating the institution of civil-law society from the Civil Code. On the whole, it should be noted that associations possessing juristic personality have received too much attention in the course of drafting the new law. At the same time, in every highly industrialized country, "simple" associations, namely those with no juristic personality, constitute the majority of associations and, given their flexibility or variation of form, are necessarily in numerical superiority (not in terms of pooled capital strength) over associations invested with juristic personality.

Primarily from a dogmatic point of view, the law of association should continue to be grounded on civil-law society, which is fundamentally contractual in nature, its rules to be applicable, *mutatis mutandis*, to numerous mixed or atypical contracts. Civil-law society is invariably a necessary institution of civil law. It is quite another matter that the general civil-law rules on contracts should be formulated in awareness of the fact that the contract of association is radically different in structure from the contract of sale, as it is a contract of an organizing rather than a synallagmatic type, which is basically oriented toward the cooperation of partners. It seems to me that this characteristic should be expressed basically by ensuring that certain rules on contracts in the general part would be inapplicable to contracts of association. Thus, for instance, the general rules of the Civil Code on nullity could hardly apply to associations, for the result would be a mass emergence of factitious, legally non-existent associations.

If the forms of association relating to business operations are governed by a uniform Act on Associations, the substance of civil-law society should be regulated along lines similar to the French *societas*, as the French law solves this problem by governing unlimited general partnerships and limited partnerships in a fashion closely similar to juristic persons while allowing the contractual nature of personal partnerships to assert itself in the case of contracts of association. If, therefore, we move in this direction with respect to business associations (and, as has been pointed out several times, the Hungarian civil law set out on this course in 1985), we would do well to adopt the French model in respect to the "basic association", that is to say, that the civil-law society should be tied to the person of members and cease upon their withdrawal, while common property should not be an absolute requirement, but once such property exists it should not constitute an *in rem* unity in the nature of *Gesamthand*. Civil-law society should have a cooperative sub-type established for pooling of assets and possessing no common property but based solely on risk-sharing involving both occasional and lasting cooperation. Such an arrangement would eliminate the need for silent partnership, because the needs of simple money investment can be sufficiently satisfied by limited partnership subject to control by the registry court.

The substance of civil-law society should be subject almost entirely to permissive rules, with very special cases to be controlled exceptionally by peremptory rules. This solution would automatically end the current sectoral fragmentation of regulations on the contract of association, with juristic and natural persons equally enabled to be subjects of such contracts and with no need arising for a separate institutionalization of either research and development or foreign trade companies. The specific features, for instance, of foreign trade companies (which still are of an

administrative rather than a civil-law nature) could be expressed by the interested representative organizations stipulating contractual terms and conditions similar to usance, which is associated with civil-law society. In other words, simple coordinative associations would have a place in the Civil Code, not in the act on economic associations, since they need no firm name and cannot therefore represent a sub-type of unlimited mercantile partnership.

The civil-law contracts as regulated by the Civil Code should be the underlying legal domain of associations other than legal entities governed by the Associations Act, particularly of unlimited mercantile partnership and deposit company to be more fully discussed below. (These two associations could thus appear in the Civil Code, too, without detailed regulation.) Hence it follows that civil-law society could have a common name, but no firm name, and its liability should be regulated in keeping with the original provisions of the Civil Code and be governed by the divisibility or indivisibility of performance, that is to say, that it should not, as a rule, be joint and several.

Again, the role of the Civil Code as the underlying domain of law could be asserted in one more aspect, namely the general provisions on juristic persons should serve as the underlying legal domain of associations invested with juristic personality. Accordingly, also in future, the part of the Civil Code dealing with persons should define rather briefly (as do the separate Acts on state enterprises and cooperatives), but using the wording of the Associations Act in essential aspects, the forms of joint enterprise, partnership, limited liability company and joint stock company without regulating them in detail, thus avoiding excessive regulatory complexities in respect to both legal entities and otherwise while offering a solution to fill eventual gaps in law (yet transmission is single and extremely simple).

2. Embarking now on the content of the Act on Economic Associations, I consider it necessary for associations possessing juristic personality to include the following forms of organization: joint enterprise, partnership, limited liability company and joint stock company. In addition, the Act should cover in detail unlimited mercantile partnerships and its sub-types, namely business partnership and specialized cooperative group, as well as deposit company, all of them being associations other than legal entities. These legally recognized forms should embrace all associations formed in Hungarian territory by citizens, economic organizations and other juristic persons as well as inlanders and foreigners. (As can be seen, the possibility to join an association cannot be limited to associations invested with juristic personality, as was the case so far!) Obviously, the specificity of subjects may call for special rules which, however, should find a place among the rules governing particular forms of association, whereas foreigners should normally be understood to mean foreign firms regardless of whether they are legal entities or not under the internal law of their respective state. On the other hand, registration of such firms should be a general requirement, also under the internal law of the respective state, because access to substantive information about them is warranted by the protection of creditors. (Purchase of shares and participation of silent partners in a business partnership or a deposit company could be exceptions to this rule.)

Also, it seems necessary to abandon separate regulations by sectors, which, apart from "simple" coordinative associations as discussed above, were until now manifest mainly in the case of partnerships. If partnership is to be controlled essen-

tially by permissive rules, the agro-industrial partnerships—which are covered also at present by separate rather than uniform provisions—can be made subject to the rules on partnerships. However, this option makes it necessary not to sharpen the differences between partnerships and joint enterprises, as was the case so far, since certain variants of agro-industrial partnerships have come rather close to joint enterprises. It is not possible for the new regulation to confine the functions of partnerships to mere coordination, because such restriction would make no sense if a partnership is allowed to establish a subsidiary company. Similarly, there is no need for separate regulations to govern partnerships for research, development and production, since what we have here is no more than a particular association invested with juristic personality and operating as a partnership in the first stage of its activity and as a joint enterprise at a later stage, and its legislative coverage is possible without separate regulations once the appropriate rules for transformation have been laid down. (That agro-industrial partnerships and partnerships for research, development and production had special interests and were subject to additional financial regulations is a matter unrelated to their legal form.)

Again, contrary to the contention in literature on agricultural law, agricultural production systems do not constitute an independent form of associations, but represent a variant of economic organization which may assume the most diverse legal forms. Some of these systems are not even associations, but make up a clump of contracts of delivery, contracts for services and contracts of like nature with special extra stipulations relative to cooperation, while some of them appear within certain forms of associations like joint enterprise and partnership.

In the light of the foregoing, the Associations Act should cover the following six basic forms of associations, which are generally compulsory in the laws of association: unlimited mercantile partnership, deposit company, joint enterprise, partnership, unlimited liability company and joint stock company. These types (if governed by sufficiently loose rules) are of so wide a scope as to encompass the special forms demanded by literature on economics.

Thus, for instance, there can be no impediment to introduction of the so-called investment association in the form of joint stock company or limited liability company, as it would definitely be desirable for purposes of the State influencing the emergent availability of capital held by the population. The “only” function of such an association would be to channel deposits (first of all investments by the population) for financing special investment projects. Moreover, the so-called holding, which exercises proprietary rights over other enterprises, assumes no independent legal form in most western countries except Switzerland. Holding is thus a joint stock company operating in a special line of activity. An appropriate regulation of joint stock company leaves scope for setting up holdings as well, which are indeed indispensable in the process of transforming state enterprises into public limited companies. The relationship between holding and the associations within its ambit is to be treated mostly in the law of concern, since holding is engaged in a special line of activity, just as an investment association is, save that it is not an independent form of association under the law.

3. The question may similarly arise of transforming a subsidiary into a commercial company. In Hungary the former has so far had the distinction of being a type of institution, not a form of association, as is the case under western laws, but, unlike the western arrangement, it differs from a factory unit or a sucursal in that

it has juristic personality, so it cannot be regulated as a sucursal within the framework of legislation on public limited companies as it is now under the Commercial Code of 1975. I think that a subsidiary company should be allowed to be established by another enterprise in the form of one-man limited liability company, while it would remain untouched as an institution created in 1981, with its deformities corrected, and perhaps would even be caused to become extinct in the more distant future.

This problem is related with the general permissibility of one-man association, which is, of course, not one, but is relied upon as such for the basic purpose of limiting liability, one that is being made more general use of in the advanced market economies of the West. It appears to me that the Hungarian law should also allow setting up one-man associations in respect of both limited liability companies and joint stock companies (but, in the latter case, subject to the consent of the Minister of Finance as the legal representative of the state and for the benefit of the state only), while it should be disallowed in respect to the rest of personal partnerships. Both citizens (artisans, retail dealers) and enterprises (in respect of subsidiary companies) would be allowed to set up a limited liability company on their own as well, but subject to special guarantees for creditors' protection, which means that provision should also be made for transfer of liability in case of abuse.

4. Retreating to the peremptory and permissive nature of the Associations Act, I deem it necessary to start with the fact that associations have always been governed by peremptory rules to a greater extent than simple contracts of sale. Within the category of associations it is civil-law society and partnership as a specific cooperative association that should be controlled mostly by permissive rules, with limitations to be imposed only for reasons of protecting the minority and accommodating considerations of the law of competition, since these forms of association are apt to cover up illicit cartel or syndicate contracts. This rising trend of *jus cogens* regulation is followed in respect of personal partnerships, i.e., unlimited mercantile partnerships and deposit companies, as forms not possessing juristic personality and of limited liability companies. The law could state that in the absence of contrary provisions these forms must normally be subject to permissive rules. However, an essentially opposite regulation is needed for joint stock companies, which should normally be governed by peremptory rules, while permissive rules should enable the partners to lay down other arrangements in the by-law. It should be stressed, of course, that the peremptory and permissive nature of regulation may arise only in respect of contractual stipulations, while the "permissiveness" of legal norms is different in respect of organizational and other aspects.

The existence of legal requirements should be verified basically by the registry court, and entry in the registry of firms should have an *ex tunc* effect constitutive of a deed of association made in writing and countersigned by a company solicitor or a lawyer. This would provide sufficient guarantee for state interests, whereas questions concerning the liability of associations that might not have been inscribed but are already in operation could be governed by the rules applicable to the so-called civil-law pre-associations. Such is the case with cooperatives as well. Contrary to the existing system, which is basically in the nature of concession but contains certain elements of normativity, the system of registration should have a normative character, that is to say that the registry court should have power to examine the existence of legal conditions rather than to consider aspects of profita-

bility and economic expediency (but it would be "unfair" to write into legal conditions general clauses like "damage to national economic interests" as doing so would be inconsistent with the requirements of a socialist law-based State). Such an arrangement would be a great stride forward. Of course, exceptions could be allowed to the general principle of normativity in respect of, e.g., economic associations with foreign majority or owned 100 percent by foreigners.

As a matter of fact, it would not be wise to legislatively prohibit establishment of the latter in view of the openness of Hungary's national economy and the prospects of the world economy, but, as in many developing nations, protection of state interests requires giving the Minister of Finance discretionary powers to permit it by invoking considerations of foreign exchange policy in the first place. In that case it would not be necessary to limit the magnitude of foreign investments. (Additional guarantees can also naturally be provided by regulating the issue of registered shares, granting subscription privilege for the State, controlling the right of an undesirable foreign partner to join an association, etc.) On the other hand, in order to eliminate the current complicated and time-consuming procedure of coordination in the Inter-Departmental Committee, it could be spelled out that if the Minister of Finance fails to respond within 90 days of receipt of the application the permit must be considered during the procedure before the registry court to have been granted and that such permit must embody any further permits, thus eliminating the need for application for additional foreign exchange authority permits for transactions in the course of operation, etc. With the exception of enterprises operating in a customs-free zone, joint ventures already established should be regarded as Hungarian legal entities in every respect, and foreign firms should be allowed to participate not only in associations invested with juristic personality, but in any form of association.

It is to be noted that in the process of writing the legislation it was suggested that a separate Investments Act should be drafted in view of the fact that it would eliminate the need for the extra provisions relating to joint ventures to be included in the Associations Act. It appears to me that, following the practice of highly industrialized countries, the Associations Act could lay down the basic guarantees for foreign investors, such as protection against nationalization, possibility of foreign exchange transfer and repatriation of deposits and profits, whereas regulation of financial benefits would be the prerogative of the Council of Ministers. (It would be justified for the Act to state the minimum of investment required for entitlement to such benefits, which in turn should be notified to the Minister of Finance.) This would raise the current low level of legislation on joint ventures much higher without preventing the flexibility of economic policy.

Under a normative system of foundation, there would be no need for authorization by state administrative organs (apart from the quite different matter that specific activities should be subject to permission by special administrative agencies, trade licences, etc.) and for administrative supervision over the operation of any economic association, for state control would be exercised either internally (through members, a designated business manager as mentioned earlier, or perhaps a supervisory committee) or by the registry court, which may act *ex officio* (in respect to balance sheet audit) or on request.

Switch to a normative registry court system in respect of all economic associations would represent decisive progress by comparison with the current system of

concessions by state administration and with the fragmentized sectoral and territorial system of management, which is partly exclusive, partly parallel to the registry court procedure, and would considerably increase legal certainty and the transparency of the operation of associations, while securing social control over them.

Finally, drafting a single Associations Act would make sense only by incorporating the fundamental rules of the law of state administration, labour law and financial law along with those of civil law. For all its basis in civil law, such an Act is *a fortiori* interlaced with elements of economic law. Of course, complexity could also be achieved by way of eventual remissions (e.g., to the comprehensive tax system or to the registry court procedure). At the same time, however, it should be for the Act itself to lay down restrictive provisions on e.g., the number of partners to or employees of associations formed by citizens. In general, the implementing provisions of the Act concerning enforcement by the Council of Ministers should be minimal and, in the spirit of the new Act on Legislation, powers of multi-tier enforcement, that is the right of, e.g., the Minister of Finance or the State Wages and Labour Office to issue enforcement decrees or ordinances should be ruled out completely.

V. On the Distinctive Features of the Various Forms of Associations

1. It is perhaps the most important task of codifying a new law of association to simplify or to clearly define the forms of associations other than legal entities, by reliance on civil-law society, which, to be governed by the Civil Code also in future, should include, in view of the foregoing, not only the associations of citizens *inter se* and with legal entities, but also those of the economic associations of the currently existing enterprises which are already established for business operations without a common firm name. In this domain there is absolutely no need for any kind of administrative approval, registration and supervision, while income regulations go basically to members rather than to the associations themselves in line with the general provisions of law. It is from this society as governed by the Civil Code that two new forms of associations, namely unlimited mercantile partnership and deposit company, would be delimited by the Associations Act.

The economic associations now operating under common firm names and citizens' associations having (or seeking to have) a common firm name could form unlimited mercantile partnerships, which, naturally bearing unlimited and joint liability, could be open to participation by citizens, economic organizations or other juristic persons and foreign firms alike. This would not rule out recognition of business partnerships as a special formation and as a sub-type of unlimited mercantile partnerships. (*Arbeitsgemeinschaft* as a special form is also known in several western countries such as Austria and the Federal Republic of Germany.) The civil-law societies of a business character operating in the sphere of domestic trade could continue operating under an essentially unchanged set of conditions, but under the designation of business partnership. With regard to business partnerships as a firm exceptionally consisting only of citizens, it would be necessary to define only the exceptions from the general rules on unlimited mercantile part-

nerships, chiefly the restrictions on tendencies to return to capitalist development in this domain. In like manner, the market sub-types of specialized cooperative groups could be regulated as a variant of unlimited mercantile partnerships.

In the interest of ensuring continuity the *VGMKs* and the specialized groups which intend to continue operating as real associations would be allowed a period of one year to notify such intention to the registry court and to adjust their respective deed of association (specialized group) to the new set of requirements. This would raise no great difficulty for them. On the other hand, the *VGMKs* wanting to continue as a purely internal work organization would lose their character of association by the lapse of the one-year period, but would be allowed to operate, with their present designation retained, within the particular enterprises. The specialized groups not intending to transform into associations could similarly continue operating under the previous regulations.

The last form of associations other than juristic persons would be represented by deposit company, in which full partners would be liable up to the extent of their assets and silent partners up to the amounts of contributed deposits. Deposit companies would be controlled by the rules applicable to unlimited mercantile partnerships except when otherwise provided for by law. Citizens, enterprises and foreigners alike could choose to be either full or silent partners, that is, the restrictive rules on business partnerships should apply to the full members of deposit companies set up exclusively by citizens.

The prevailing rules on joint ventures call for no substantive modification. The situation is somewhat different with regard to partnerships, with the excessive uniformity of relevant regulations to be abandoned in order to ensure their operating capacity. Moreover, as has been pointed out earlier, it seems necessary to repeal the rules which have so far restricted the economic activity of partnerships, and there is no need to artificially prevent partnerships from acting as representative organizations. So the boundary between partnerships and associations formed by juristic persons should be drawn in relative terms only.

The new regulation on limited liability companies would extend to those set up only by citizens, that is, to the variants of business partnership that possess juristic personality, to the current deposit companies, and to limited liability companies established between enterprises and citizens. Accordingly, limited liability companies would embrace a wide range of entities from one-man small businesses and limited liability companies of subsidiaries to very large domestic and international enterprises, banks and several other organizations.

2. The focus of the new law of association should be on the institution of joint stock company. The relevant rules should be drafted in very clear terms, relying on the current Hungarian regulation, fulfilling practical needs, and drawing upon modern exchange laws in other countries.

The essence of joint stock company is in acquiring capital from a relatively wide range of investors, a reason why the overwhelming majority of joint stock companies (subject to eventual restrictions to be laid down in charters of association) should be ordered to issue public shares.

The basic variant would naturally be that of bearer's shares, but the Act should authorize joint stock companies to provide, in their charters of association for issue of registered shares (or ones to be purchased only by juristic persons) and, within certain limits, shares obtainable by, e.g., citizens without voting right (with

entitlement only to dividend), as well as sinking shares. Furthermore, joint stock companies as juristic persons should be allowed, subject to special guarantees, to reserve a definite part of their shares for themselves. Today this possibility is ensured as an exception by the exchange laws of several western countries. Such a regulation would enable an enterprise collective as a whole to have a share in the assets of their own enterprise, while employees' own shares would allow for proprietary participation of individuals. For that matter, these two schemes are closely interlinked.

If a considerable part of western countries (particularly the legislation of Sweden or of France in the early 1980s) have recognized the paramount importance of making employees aware of being share owners for the operation of enterprises and for social policy (buttressing the position of the so-called middle classes), a special importance attaches to incorporating such an element into a socialist regulation on joint stock companies. For a very long time we have been grappling, to rather little avail, with the problem of creating the minimum level of workers' awareness of their condition as owners, so we simply cannot afford to miss the chances offered by reliance on the leverage of shares. There would be a need essentially for two kinds of shares, the first to be purchased by workers from the enterprise at a preferential prices, and the whole scheme to be supported by the state even with tax benefits, and the other to be *quasi* property tickets the enterprise would proportionately allot to workers in the separate internal organizational units, with the principle of allotment to be determined democratically by the workers' meeting of each unit, perhaps within the limits established by the Act or the charters of association.

Employee shares would be transferable within set limits, within the enterprise ambit, and the enterprise would be under obligation to buy them back in case of quitting, inheritance, etc. (Of course, shares purchased on the market by workers of an enterprise would not be subject to these rules.) Otherwise, workers' share would be governed by the general rules on shares in respect of both voting and dividend, and, with a view to increasing their influence on business policy, workers or groups of them could even entrust the enterprise trade union organ with representing them at the meeting of shareholders.

3. In addition to regulations on employee shares, it is indispensable to provide for workers' participation in the management of economic associations deemed to be enterprises. At present, as we have seen, workers' participation is excessive at large state enterprises, but is zero at, e.g., joint ventures.

In the process of drafting the Associations Act the idea has been raised that since trade unions in Hungary exercise wide powers at the enterprise level and that the forms of economic associations cannot be normally removed from the sphere of mandatory trade union action, the trade unions being the legitimate representative organs of workers anyway, there is no need for workers' participation in the organs of associations.

I think it is a mistake to confuse representation of workers' interests with their say in management. There seems a good case for the law to govern workers' participation at joint ventures, limited liability companies and joint stock companies, but such coverage is not necessary in respect to other forms of associations. Nevertheless, it is advisable to consider regulating it in case of the workforce exceeding a certain limit, e.g., enterprises employing more than 300 workers (what

matters from the point of view of participation is not the size of capital stock). The problem lies mainly in that the enterprise council of an economic association must necessarily be composed of representatives of capital investors and that, therefore, the collective of workers has but a limited say in enterprise management (except when the collective of workers itself holds shares in the enterprise, as noted earlier). Hence there is no need for workers' participation in business management.

Precisely for this reason I think that the law should make it mandatory to set up a supervisory board at joint ventures and limited liability companies employing more than 300 full-time workers (this size of workforce is more or less the upper range for a medium-sized plant in industry), the ratio of workers to be one-third in that committee. The same should apply to joint stock companies, where setting up a supervisory board is always mandatory as a matter of course. The Act should specify the questions (e.g., appointment of the managing director, strategic plans, social issues) on which the decisions of the Board of Directors, to be valid, should be subject to approval by the supervisory committee or workers' representatives on the supervisory board should be vested with some power of veto (e.g., *via* a qualified majority of votes). Such an arrangement would be duly balanced, would create the necessary harmony with self-governing state enterprises and would even give the latter some encouragement to transform into a joint stock company.

4. As stated previously, the overwhelming majority of state enterprises could be transformed into joint stock companies and the flow of capital in their domain should be ensured mostly by issue of bonds and, in respect of workers, of property tickets. At the same time, however, it would be necessary to lay down special rules for the transformation of state enterprises into joint stock companies, thus giving way to the direct appearance of foreign capital in state enterprises and to direct investments by the population.

Transformation of a state enterprise into a trade association does not seem to be possible except in the case of joint stock companies because, although a state enterprise is a legal entity of institutional form has the same standing as a limited liability company concerning limited liability, so transformation of a state enterprise into a limited liability company, in the form of primary enterprise, is hardly a practical necessity. Nor is it deemed to be transformation in the legal sense (although is close to it economically) if a state enterprise takes most of its assets into one or several joint undertakings, for that variant does not put the enterprise as such out of existence, but constitutes a secondary enterprise. We have seen that this may call into being a whole network of joint stock companies and limited liability companies around a small centre.

Operating state enterprises in the form of joint stock company is a problem area in general, because an outside organization of owners is hard to devise. As discussed above, the Act should allow state enterprises to acquire the majority of their own shares, precisely in order to ensure the survival of enterprises managed by the enterprise council, but transformed into associations (the composition of the board would be analogous to the current composition of the enterprise council). However, the conjuncture of shareholders' majority and enterprise management—given the possibility for it to become a breeding ground for abuse despite all the safeguards to be provided—cannot be the general solution, even though it is a vehicle for maintaining the current degree of enterprise autonomy. On the other hand, in considering other solutions, it should be kept in mind that the state

has so far received even its "owner's share" through the general tax system, so if a state enterprise seeks to realize extra dividend it would, once converted into a joint stock company, be at a considerable disadvantage in relation to the rest of enterprises. Of course, in order to maintain the present degree of enterprise autonomy and to secure equal opportunities, the Act could provide that the organ holding the majority of state shares (the Minister of Finance as the lawful representative of state property or another organ designated by him) must not exercise either its voting right or its right to appropriate dividends, but must delegate the former to the enterprise management and leave the dividend with the enterprise. However, such an arrangement can also be applied as an exception, for it deforms the basic structure of association.

Thus we should be aware that we have but "wrong" options to make and that, therefore, it is essential to formulate loose general rules for transformation and to leave it to practice to evolve relatively appropriate arrangements.

Naturally there is nothing to prevent the Hungarian state from establishing new state enterprises in the form of joint stock company, with part of the so-called state allocation of funds to be used for this purpose. It appears to me that this is essentially the way to go in setting up holdings, that is public limited companies administering the different owner's shares of the state. It is chiefly commercial banks that may be shareholders in a holding, for it is not too fortunate that sectoral ministries or other state administrative organs also should be partners to a holding, although that possibility cannot be ruled out by law. Along with banks, a sufficient role should be reserved for insurance agencies or offices, different funds, foundations, non-profit community organizations, towns and villages. (It is theoretically conceivable that some of these central holdings should be owned 100 percent by the Hungarian state.)

State enterprises already operating may be converted into joint stock companies in any of the following main forms.

(a) The enterprises formally operating as joint stock companies, so named at present, should be transformed into real joint stock companies, namely they should revive the original organizational pattern of joint stock company, which it is obviously for any particular enterprise to do. This aspect can only be governed by general rules of law.

(b) State enterprises subject to management by state administration may be wound up without the need for liquidation, and the successor organization in title could be designated to administer the owner's share of the State and to take care of issuing shares under the general rules.

(c) In theory, it is possible for factory units of state enterprises to be invested with juristic personality in the form of, e.g., subsidiary company or to be declared legal entities by virtue of the Civil Code (Art. 30). Existing factory units should be converted to joint stock companies, which would be financially managed by the centre of the enterprise similarly in the form of public limited company. Under this arrangement, the enterprises and the centres would divide the majority of one another's shares among themselves. This form of conversion offers particularly great advantages in the case of trusts, since trust enterprises already possess juristic personality. In this case, therefore, it is primarily trust enterprises that would become joint stock companies and would place a certain part of their shares with the trust centre and could eventually have a share even in one another's assets. In

each of these cases there would emerge a "shareholders' concern" which should be given special treatment in respect to the protection of the minority and creditors. This makes it necessary for the Act on Economic Associations to include general anti-trust law rules similar to those of advanced stocks and shares laws in western countries.

(d) Conversion into joint stock companies on enterprises managed by the enterprise council or the general assembly presents more difficulties, but its possibility should be open and be governed by the voluntary principle. The basic procedure would be for conversion to be subject to a qualified majority decision of the enterprise council or the meeting of shareholders, but such decision would be approved by the founding organ. Then the enterprise's capital stock should be expressed in terms of shares and the organizations of joint stock company should be devised on that basis. It is chiefly in this way that the enterprise could acquire the majority of its own shares and also institute a scheme of employee shares as described above, but the enterprise's self-governing organ may also decide to assign most of its proprietary rights to another enterprise, a bank or other organization performing the function of a holding.

Drawing up the balance sheet, making a realistic assessment of enterprise assets is an essential question of transformation, indeed a critical aspect, since we do not even have the minimum of experience in this field. The experience of the Austrian public sector may be of particular value in establishing the liabilities and assets and developing the accounting system of associations, for, evidently, the value of an enterprise is not equal to that of its means of production as shown by book-keeping; a significant role is also played by enterprise goodwill, management value and market "chances". Of course, the partners are free to assess their investments in the deed of association, but it would nevertheless be necessary for certain guidelines to be provided by a basic regulation.

Pattern and Functioning of the Enterprise System

I. Pattern of the Enterprise System

A) Introduction

1) The established pattern of the enterprise system is naturally in close relationship with the economic policy concepts of recent years, which reveal numerous flaws of both substance and implementation.

As the past 40 years of Hungary's economic development are amply covered by Chapter I of this volume, an in-depth review is needed here only of the points of departure which, relevant explicitly to enterprises, should be presented to the reader for an understanding of the enterprise model prevailing in Hungary.

2) One of the bases, and perhaps the most important, for the established system of enterprises was laid by the reform of economic management which, launched in 1968, made an attempt to introduce a mechanism for an indirectly planned socialist economy.

That model, seen as the ideal one, implied the following.

(a) The macro- and micro-economic spheres, or state economic and enterprise management would be separated conceptually and hence in qualitative aspects.

(b) Organizationally, the separation of state economic management and enterprisa management meant that state economic management organs would be functioning as purely administrative agencies and enterprises would be operating as purely economic organizations, while, as a general rule, middle-management organs combining state and enterprisa management activities would be eliminated and self-accounting would not be extended to areas of vertical management.

(c) Owing to the lack of large economic and management organizations, this model of enterprise management would take the form of purely state administration through laws and regulations and through a system of economic regulation which would, for the most part, be also subject to legislation, with operative enterprise management activities being an exception in principle.

(d) Consequently, the socialist economic organizations (inclusive of state enterprises) would thus be distinct from the state administrative organs taking charge also of state economic management and would, in principle, be treated as economic undertakings.

(e) Under a system of planned market regulation there would be no plan breakdown, with the national economic plan ceasing to be directly binding on enterprises except "merely" on state economic management organs, which would, basically by legislation, devise the system of economic regulation directly applicable to enterprises.

(f) Inter-enterprise economic relations would be ones of market, competition

and contract which would come to evolve a market mechanism between enterprises.¹

It is of common knowledge that the implementation of the reform showed signs of slowing down in 1972, with much ground gained by trends of reversion to previous arrangements, but it should be emphasized that the process of reversion took place only on the practical plane, official policy statements always argued for a continual implementation of the reform.

3) Coupled with strongly felt demands for liberalization in domestic policy, the unfavourable trends in the world market—affecting as they did the entire national economy of Hungary in the early 1980s—brought about a pressing situation which allowed no further delay in the actual realization of the reform. Of course, the change in circumstances ruled out the full implementation of the concept of 1968 because, on the one hand, the intervening period of 20 years had revealed certain flaws of the reform concept and, on the other, it is understandable that changes should also have occurred in the very challenges that require present-day responses. Yet the basic concept, namely the need for creating, in principle and practice alike, a really indirect market economy geared to the laws of market conditions, was upheld in the main.

Quite understandably, this new wave of reform called for the modernization of the system of enterprise organization in the first place, because, on the one hand, this aspect was left untouched in 1968 for misconceived political reasons (the enterprise management staff is fundamentally affected by every organizational shake-up) and, on the other, the change in the method of state economic management was supposed in 1968 to entail an automatic modernization of the enterprise organization as well. However, as is known, that expectation was not met. Therefore the reform-oriented legislation, based on the political decision of 1984 and put into force with effect from January 1, 1985, was aimed first and foremost at remodelling the enterprise organization along with streamlining certain aspects of the state economic management system.

4) To be sure, this process, which was set in train in 1984, has far from run its course. Note, for instance, the preparation of a new Associations Act, the introduction of a completely new type of tax system, the most diverse efforts at the creation of a real market, and the plans for a comprehensive constitutional reform expected to bring the process to a head within a few years. For this reason the present writing cannot but snapshot the Hungarian system of enterprises, highlighting the situation as it obtained in June 1988.

B) The Enterprise

1) It appears to us that a brief survey of the changes in the relevant positive law will not be out of place before theoretically analyzing the concept of enterprise as known in Hungarian legal literature.

(a) The first source of law in the Hungarian People's Republic to use the term

¹ Tamás Sárközy: *A szocialista vállalatelmélet jogtudományi alapjaihoz*. (To the Juridical Fundamentals of the Socialist Enterprise Theory), Közgazdasági és Jogi Könyvkiadó, Budapest, 1981. A revised edition in German (*Zu den rechtswissenschaftlichen Grundlagen der sozialistischen Unternehmensrechtstheorie*) was published by Akadémiai Kiadó, Budapest, 1987.

"state enterprise" was Law-Decree No. 32 of 1950, which defined a state enterprise as one in which the state had a full and exclusive proprietary interest (para. (1) of Art. 11). For the obligations of a state enterprise the state assumed unlimited liability as surety (para. (2) of Art. 11).

At the same time, the Law-Decree repealed Act No. 37 of 1948 of the Republic of Hungary on National Enterprises and Act No. 10 of 1949 on Municipal Enterprises, providing that any reference of law to such enterprises must be construed to mean state enterprises. Thus, in effect, a state enterprise was successor in right to a national or municipal enterprise. This interpretation is supported by Art. 19, para. (1), of the Law-Decree, which stated that state and municipal enterprises must be regarded as state enterprises established in accordance with the provisions of the Law-Decree. Concurrently, however, para. (2) empowered the Council of Ministers to keep certain state enterprises operating in the form of joint stock company. Those "joint stock companies" were naturally state enterprises pure and simple. That arrangement was explained first by war damage compensation and then by market considerations.

(b) The next important stage of regulations on state enterprises was undoubtedly marked by the Civil Code of 1959, which, in accordance with the system of compulsory plan instructions, defined a state enterprise as follows:

"For the purpose of discharging its economic functions, the State organizes state enterprises. State enterprises shall be juristic persons.

In accordance with the relevant legislation and with a view to fulfilment of the national economic plan, state enterprises shall enjoy autonomy in administering the property entrusted to them.

State enterprises shall be liable for their obligations to the extent of the assets administered by them" (paragraphs (1) to (3) of Art. 31).

The ministerial motivation to this Article pointed out that the socialist state organized economic units, primarily state enterprises, in order to perform its economic and organizational functions. The activity of such units was based on the national economic plan, which, determining the working of the national economy as a whole, served as a means of satisfying the needs of working people to the fullest extent possible. At the same time, aimed as it was at plan fulfilment, the activity of those units, which were framed, organized, guided and controlled by the state, required the different organizations involved in implementation to enjoy a large degree of autonomy and to have their separate motivation created as an incentive for plan fulfilment. To that end, these organizations should be assigned a proper share of state property, be entitled to administer it in keeping with the interests of the national economy and be virtually left to take care of, among others, organizing cooperation with other economic units. This in turn called for recognition of their juristic personality.

Unlike Law-Decree No. 32 of 1950, the Civil Code made no mention of state suretyship for the debts of enterprises. The gap thus arising in creditors' protection was thought to be closed by the following reasoning of the ministerial motivation: on the one hand, during the previous 9 years (from 1950 to 1959) there had been practically no need to establish the state's liability as surety and, on the other, the statutory provisions of 1950 had restrained the implementation of the principle of responsibility for self-accounting.

Therefore, the security of creditors to state enterprises was guaranteed by the

Civil Code under a different, indirect arrangement. According to the ministerial motivation, Art. 31 referred to above, under which state enterprises were responsible for their obligations to the extent of the property entrusted to them, did not give creditors a separate subjective right to sue directly, because this rule governed the relations *inter se* of the state and its enterprises, but afforded a guarantee by implying that, should the need exceptionally arise, the state would go surety for its enterprises' solvency.

This line of reasoning was not pertinent, in our judgement, as the wording of the Civil Code was silent on the obligations of an enterprise eventually exceeding its assets (over-indebtedness), yet the conceptual approach of the ministerial motivation was acceptable within the full context of the Civil Code, since its Articles 170 and 171 reaffirmed the unity and indivisibility of socialist state property through the administration of that property and underlined the state's prerogatives of direction and control as well as of regrouping and reallocating enterprise "assets".²

(c) The early 1960s were marked by a drive of merger in Hungarian industry, the basic idea being to establish large enterprises typical of socialism. That concept of economic policy came to be reflected in law by the term "large industrial enterprise" in 1968. Although the concept was practically abandoned with the advent of the new mechanism of 1968, merger as an "efficient" economic policy tool still held its ground, as was evidenced by the second large wave of merger just after the reform had been called off in 1972-74, but it bore the stamp of change in circumstances inasmuch as its effect, at least with regard to the definition of enterprise, ceased to be traceable in positive law.

(d) Although Decree No. 11/1967. (V. 13.) of the Council of Ministers reflected a novel approach of the new economic mechanism of 1968 to the concept of enterprise as concerned the relationship between the state and the enterprise, it widened the known definition of enterprise to include no more than the phrase that the task of state enterprises was to contribute by their economic activity to the satisfaction of the needs of society.

(e) The Civil Code was profoundly amended in 1977. As noted earlier, the reform of 1968 practically lost momentum, and reverse processes were set in train, but they affected the daily aspects of economic and political practice in the first place. Since a return to previous arrangements was never professed either officially or conceptually during that period, there emerged a paradoxical situation in which legal development continued the course it had embarked upon and, towards the end of the 1970s, resulted in several enactments and legislative amendments

² "Art. 170. Socialist state property shall be one and indivisible."

"Art. 171. (1) The ownership of the State shall not be affected by the State entrusting the administration of certain assets to state organs, particularly state enterprises and state farms; the State shall direct and control the economic activity of its organs and shall be entitled to regroup and reallocate the assets entrusted to the administration of the various organs.

(2) State organs shall use the assets entrusted to their administration for their normal function, for the fulfilment of their plans and for the purposes specified by the state budget and shall be vested with the powers necessary for compliance with these obligations.

(3) No right on the assets entrusted to the administration of a state organ shall be acquired except by virtue of a disposition of the administering state organ to that effect or by an order of execution against that organ for the recovery of a debt. The rights acquired in respect of assets administered by a state organ shall not be affected by regrouping or reallocation of assets."

of great import, essentially suited to the reform spirit of 1968. Hence the amendment of the Civil Code conformed to the reform, as was also shown by the changing definition of enterprise. Under Art. 31 as reworded, the state "establishes and operates" state enterprises for the purpose of discharging its economic functions. That was not a mere change of terminology, but signalled a completely new concept by replacing the verb "organize" with the verb "operate", which suggested a more indirect form of state intervention *versus* the previous explicitly direct form of management. (Of course, this statement is valid only from a legal point of view, because, as mentioned above, the actual situation was just the opposite: the period 1968 to about 1972 was characterized by indirect elements, whereas the daily practice of economic management after 1972 came to be interlaced with direct elements again, but direct management was undoubtedly impossible to enforce in its pure form as it had been prior to 1968.)

The other paragraphs of this Article actually met certain ideological criteria by formulating principles of a general political nature, such as those governing the tasks of state enterprises (satisfaction of social needs, development of the socialist way of life and thinking of enterprise workers, etc.).³

(f) The current concept of enterprise was prefigured Act VI of 1977 on State Enterprises, under which the state established and operated state enterprises and other state economic organizations for the purpose of discharging its economic functions. A state enterprise as an economic — organizational unit of society was an economic undertaking of the state.

The wording of the Act indicated in effect an attempt to devise a legal formula corresponding to indirect economic management. What was involved was no longer direct action by the state through its economic organs in economic life, but discharge of this function virtually through enterprises, with their autonomy guaranteed in a form similar to undertaking. The attainment of this goal was also served by the provision that enterprises, though their assets were owned by the state, virtually enjoyed autonomy in using those assets and their workforce in the manner and with the responsibility defined by the Act.⁴

Special mention should be made of the new aspect that the operation of state enterprises was based on a combination of central management with enterprise autonomy (Art. 2, para. (4), of the Act).

(g) The current concept of enterprise emerged as a result of organizational modernization in 1984. A certain shift in the relationship between the Civil Code and other legislations on economic activities was indicated by the reversal of the order of regulation by the Civil Code and separate provisions of law. Previously, the principles laid down in the Code were concretized in a certain sense by detailed rules for enforcement, but this time the amendment of the Code was preceded by

³ Art. 31, paragraphs (2) and (3), of the Civil Code as amended read as follows:

"(2) State enterprises shall have the tasks to contribute by their profitable activity to the satisfaction of social needs in accordance with the objectives specified by national economic plans. For the purpose of attending to their tasks, state enterprises shall enjoy autonomy in using the assets entrusted to them in the manner and with the responsibility defined by law.

(3) It shall also be a task of state enterprises to organize and promote the development of the socialist way of life and thinking of enterprise workers, the improvement of their professional knowledge, and the satisfaction of the welfare, social and cultural needs of the workers' collective."

⁴ Art. 2, paragraphs (2) and (3), of Act VI of 1977.

that of the Enterprises Act, and, in the light of subsequent developments, it may be stated that the amendment of the Code did nothing more than codify the changes that had been necessitated, at least in this respect, by the modification of the Enterprises Act.

According to the Enterprises Act currently in force, a state enterprise is an economic—organizational unit of society, an economic undertaking of the state, with enterprise assets owned by the state, but with the enterprise using those assets and its workforce for discharging its functions autonomously, in the manner and with the responsibility defined by the Act (para. (1) of Art. 2).

A comparison of the original and amended provisions reveals a new element in contrast to the text of 1977, namely a reference to an economic—organizational unit of society and the qualification of enterprise resources as “assets”. It appears to us that both wordings point far beyond a mere difference in terminology since, on the one hand, the reference to the enterprise as a unit of a different type is suggestive of a certain elasticity in the treatment of state property and, on the other, the enterprisal right of disposal in civil law is recognized by the virtual replacement of state with enterprise assets. In effect, although the state remains the subject of the right of ownership, assets are disposed of by the enterprise, such right of disposal comprising all three elements of the proprietary triad under classical civil law. This autonomy in the exercise of proprietary rights (which in practice appears as independent standing in the law of property) is characteristic today of the overwhelming majority of state enterprises in Hungary.

The above provisions were incorporated in the Civil Code by Law-Decree No. 33 of 1984.⁵

2) The most complete summary account to date of the legal aspects of the enterprise theory in Hungarian literature is given by Tamás Sárközy in his work published in 1981. According to Sárközy, the legal concept of enterprise contains the following basic elements: “The enterprise is a lasting organization appearing externally united and relatively separated from its body of employees and its founders”.⁶ The author points out emphatically that organizational existence is a most important feature of the enterprise, for an enterprise that is not an organization simply cannot exist. It follows from this organizational criterion that there is also a technical—economic aspect of organization, namely that the enterprise organization may be broken down to workshop organizations.

However, an enterprise is not simply a technical—productive—technological organization, but also an economic unit combining technical—societal—economic relationships, with social work done in each and no longer being either private or directly of all society. This configuration underlines the relatively independent economic interests of enterprises, their separate economic policies.

⁵ “Art. 31. (1) The State establishes state enterprises for the purpose of discharging its economic functions. State enterprises shall be juristic persons.

(2) State enterprises shall enjoy autonomy in using the assets entrusted to them in the manner and with the responsibility defined by law.

(3) State enterprises shall be liable for their obligations to the extent of the assets entrusted to them.

(4) The State shall direct and supervise the economic and other activities of enterprises in a manner as defined by law.”

⁶ Sárközy: *op. cit.*, p. 282.

An enterprise administers its own assets, but also exercises rights of management and use, while its economic activity is characterized by business-like aspects. This is why a typical enterprise is referred to in economic literature as, e.g., a category of developed commodity and financial relations, since an enterprise is an economic undertaking and, though in different ways and in varying degrees, profit-oriented.

An enterprise is also a collective of workers. As is emphasized by Sárközy, separation of the workers' collective from the enterprise (which is consequent upon the so-called two-pole approach of labour law)⁷ is conceptually wrong in the case of all types of enterprises.⁸

Under conditions of socialism, an enterprise is not only an economic community, but also a societal, political, ideological, social, cultural and welfare one.⁹ Again, a certain measure of social activity is an attribute of enterprises and therefore, in this respect, an enterprise can also be conceived of as a "community of social groups".¹⁰

The enterprise being a concern of law is part of its being as such. Its presence in law is evidenced by the legislation in force investing the enterprise with juristic personality in civil law. In the view of the above author, however, the status of the enterprise as a subject at law includes additional attributes: the enterprise is a subject at law *vis-à-vis* state administration, in fiscal law relations, in its capacity as employer and, its defined scope of autonomy being constitutionally guaranteed, even in public law relations. From these factors the author draws the conclusion that an enterprise is not simply a juristic person in civil law, but a subject at law in its condition as a complex economic organization.¹¹

Summarizing the above criteria, we can define the enterprise as an organization representing the unity of economic and societal aspects and—given that its operation is subject to central economic management by the state and is based on national economic planning and that the enterprise is also a collective of workers—typically performing several functions, pursuing several goals and expressing a complexity of internal relations.

3) In the preceding paragraphs we have made repeated references to the perception of state ownership. This set of problems is understandably of great concern to legal science, since clarification of the ownership aspects of the relationship between the state and its enterprises would do much to facilitate the applicability of more up-to-date practical arrangements, too. Unfortunately there is as yet no uniform approach to this question, and the gap is to be filled by Hungarian civil-law science as soon as possible.

⁷ The labour code views the internal organizational pattern of enterprises basically from the angle of work and consequently regards members of the organization primarily as "workers" irrespective of their status, job and influence in the organization, while seeing the enterprise at the other pole, practically *vis-à-vis* "workers".

⁸ Sárközy: *op. cit.*, p. 290.

⁹ József Szabó: *A szocialista vállalat sajátosságai és az üzemi demokrácia. Társadalmi tulajdon és szocialista vállalat.* (Specific Features of the Socialist Enterprise and Workshop Democracy. Social Property and Socialist Enterprise), p. 84.

¹⁰ József Szabó: *op. cit.*, p. 86.

¹¹ Sárközy devotes an entire monograph to substantiating this thesis. See Sárközy: *A jogi személy elméletének átalakulása.* (Transformation of the Juristic Person Theory), Közgazdasági és Jogi Könyvkiadó, Budapest, 1985.

The following main theoretical trends can now be observed in this field.

(a) Among the advocates of the so-called single property concept Miklós Világgy (who created that school) proceeded from the premise that socialist state property was one and indivisible and that the status of enterprises could therefore be characterized by the category of operative administration, meaning that "an organ of the state is under obligation to use the assets administered by it in accordance with their function, in the interest of fulfilling its plan and for the purposes specified in the state budget and is vested with all the powers required for compliance with that obligation".¹² Consequently, the state appears as owner *vis-à-vis* third persons, and the enterprise is nothing more than a representative of the state in this situation.

(b) As was seen in analyzing the specific provisions, legal development has superseded the main components of the above theory. Therefore the divided property theories (Imre Sárándi, Tamás Prugberger) start from the fact that property relations at economic organizations directed from without show a dual feature: the state is vested with decision-making powers in matters of fundamental importance, whereas enterprises exercise the rights pertaining to them as commodity owners.¹³

(c) The so-called structured property theory was elaborated by Sárközy, who distinguishes state property in public law and enterprise property in civil law, the first embracing the entire economic management activity of the state, which, however, acts as wielder of political power rather than as commodity owner in civil-law relations (because it has delegated its latter condition to the enterprises).¹⁴

(d) Eörsi's synthesis theory results from a criticism of the above trends and asserts that though the right of ownership is vested solely in the state, the enterprise — on the strength of its economic autonomy — disposes of property in the exercise of rights derived from the state as the only owner. Strategic decisions are made by central organs, while the rights usually vesting in commodity owners are exercised by enterprises in virtue of their economic autonomy rather than of their own right of ownership. However, the limitation of the state's power to make strategic decisions implies also that enterprises "can no longer be considered to be the lowest executive-administrative organs of economic management by the state, do not form part of the state apparatus, but appear on the regulated market as economic organs which in law have virtual freedom of will, their everyday operation being governed by law just as citizens' activities are".¹⁵

A comparison of the prevailing concept of enterprise with the ownership theories, supplemented by the fact that the enterprise's own property appears as a separate category in several legislative enactments (see, e.g., Law-Decree No. 11 of 1986 on the Liquidation of Enterprises, which is in effect the Hungarian equivalent of bankruptcy law) and that, moreover, it is used explicitly in financial regulations, makes it evident that none of these ownership theories can be upheld in the forms outlined above, because today the enterprise is the actual owner of its

¹² Világgy and Eörsi: *Magyar polgári jog*. (Hungarian Civil Code), Tankönyvkiadó Vállalat, Budapest, 1973, pp. 281 — 282. (The section on this subject was written by Miklós Világgy.)

¹³ Imre Sárándi: *Polgári jog III. Tulajdonjog*. (Civil Code III. Law of Property), Tankönyvkiadó Vállalat, Budapest, 1982, p. 62.

¹⁴ Sárközy: *A szocialista vállalatelmélet jogtudományi alapjaihoz*, pp. 506 — 530.

¹⁵ Gyula Eörsi: *A gazdaságirányítás új rendszerére átérés jogáról*. (On the Law of Switch to the New System of Economic Management), Közgazdasági és Jogi Könyvkiadó, Budapest, 1968, p. 282.

assets, even though it is not within the meaning of the Enterprises Act, while the present-day methods of economic management are clear indications that the state is acting more and more as possessor of political power, while its "owner's" rights are shrinking, as it were, from day to day.

C) Types of Enterprises

1) The following types of enterprises are known to the Hungarian law currently in force.

(a) Under Art. 7 of the Enterprises Act (Act VI. of 1977), state enterprises may be established by a minister (head of an organ with nationwide competence), a local council and, exceptionally, another state organ empowered by the Council of Ministers thereto. (This explains the difference made between ministerial and council-run enterprises.)

(b) All enterprises (agricultural, industrial, commercial, etc.) are treated as such by the Cooperatives Act of 1971.

(c) In accordance with the Civil Code, economic associations may be formed by state enterprises and cooperatives under a contract of association. Economic associations lacking juristic personality (economic societies) and partnerships possessing juristic personality and performing representative functions and coordinating the activities of affiliated enterprises are not regarded as enterprises from a legal point of view. (The agricultural industrial union is a borderline case as it carries out economic activities itself in general.) By contrast, under Law-Decree No. 4 of 1978, the so-called joint enterprises (with affiliated companies assuming liability of surety) and limited partnerships (with the liability of affiliated companies limited to their deposits) are deemed to be enterprises established through associations.

(d) Under the Civil Code, enterprises may also be established by social organizations (e.g., the parties), representative organizations (e.g., the National Council of Cooperatives, Hungarian Chamber of Commerce) and associations.

(e) Enterprises in the form of affiliated company may be set up by state enterprises (including trusts and trust enterprises), cooperatives (except housing and small cooperatives), social organs, representative organizations, organs with budgets of their own, and economic associations having juristic personality.

The foregoing is an enumeration of enterprise categories in the wide sense, but cooperatives and economic associations will not be dealt with here, as they are covered also in this volume, which highlights the enormous shifts that occurred in this field after January 1, 1989. This chapter will be confined to a discussion of the types of state enterprise in the narrow sense as well as of their inner organization and external management.

Accordingly, state enterprises are of the following types:

- (a) public utility company;
- (b) enterprise managed by state administration;
- (c) "self-governing state enterprise";
- (d) trust;
- (e) parent company;
- (f) affiliated company.

The types of enterprises under (a) to (c) differ by function and line of activity. At the time of organizational modernization in 1984 there were distinguished two large groups of enterprises by function: enterprises operating in the competitive sector and non-profit enterprises. The latter operate under the general management of a director and are subject to supervision by state administration. The nucleus of this group is constituted by public utility companies set up in 1977, namely economic organizations which, given the nature of their activities, cannot be operated on an entirely non-profit basis (public works, communal services, health-care, social and cultural enterprises) and remain subject to strict management by state administration, that is to say that the founding organ may prescribe obligations for them, such as supplying certain services or regrouping their resources, and may instruct them to carry out any activity. However, these special rules are inapplicable to public utility companies subject to supervision by state administration, because under the general rules of the Enterprises Act they enjoy a larger measure of autonomy than public works, but, owing to continuing supervision by state administration, a smaller measure of autonomy than self-governing enterprises. They operate under the general management of a director appointed and relieved by the founding organ, the corresponding proposals to be coordinated by the organ exercising employer's rights with the competent organs. Nevertheless, the deed of foundation may prescribe the setting up of a board of directors vested with decision-making powers. The rules for enterprises subject to supervision by state administration are applicable, *mutatis mutandis*, to trusts and other special large organizations (parent companies) established by the Council of Ministers.

2) In the case of enterprises in the competitive sphere, the principle of organization is to eliminate the interlinkage of state administration and enterprise activity, which had been the concomitant mainly of the directors' appointment and the determination of their motivation by state administration as well as of the exercise by the founding ministry or council of other rights concerning supervision and direction. With these enterprises becoming self-governing, enterprise direction by the state as owner through supervision ended, most elements of that right were conferred on enterprises and, consequently, their directors turned from agents of economic management into real members of the enterprise's own staff. It should be stressed, however, that

(a) these developments do not mean the State's "withdrawal from the economy". It remains possible to affirm national economic interests, particularly through the (financial) regulatory system and new institutions of operative intervention (legality control, market supervision) now based on executive power rather than proprietary rights;

(b) one cannot speak of group ownership of an enterprise collective; enterprises exercise the state's ownership rights and after liquidation of an enterprise its assets revert to the state budget;

(c) daily enterprise activities continue to be managed by the director, who is now a member, pure and simple, of the enterprise staff. This is why we use the term self-government instead of self-management. (As is known, the Yugoslav system of self-management is based on entirely different principles.) The basic principle in our case is that questions of enterprise strategy should be decided by

collective bodies, but wider scope should be left for the directors's operative decision and responsibility in the direction of daily activities.

These preliminary remarks are also indicative of some fundamental changes that have occurred, on the one hand, in the relationship between enterprises and economic management and, on the other, in the internal organizational pattern mainly of self-governing enterprises. The related aspects will be discussed in detail in the section on the operation of enterprises.

3) However, in view of its conceptual relevance, the trust, which for a long time was the only large enterprise organization named in Hungarian law, needs a brief discussion at this juncture as well, because, as will be seen, it is precisely the type of enterprise which is, as it were, always a safe guide to the status of an economic policy concept prevailing at any given time.

Under Art. 34, para. (1), of the Civil Code, the founding organ may establish a trust to promote the profitable operation and the development of several enterprises under its supervision and to manage the same. The trust and the trust enterprises (enterprises operating within the framework of a trust) are juristic persons.

The fact that apart from a short period the trust was the only large enterprise specifically covered by law gave rise to anti-large-enterprise sentiments, which were spearheaded against trusts. (As noted earlier, Hungarian economic policy started two strong waves of centralization and, explicitly or implicitly, considered centralized large organizations to embody the ideal type of socialist enterprises.)

The aforementioned role of trusts is also clearly reflected in its changing definitions by positive law.

(a) In the wording of the relevant legislation of 1957, the trust is an economic organization destined for the joint central management of larger state enterprises.

(b) In 1963 the trust was defined as a state economic organ managing state enterprises and other organizations, but the change in terminology hardly showed any change in requirements as the trust was intended for management by that legislation as well. The only reason for the change in wording was that, with the exceptions stated in a separate Government Decree (No. 2/1963. (I. 29.)), the provisions of the Civil Code on state enterprises were also applicable to trusts. On the other hand, the changes introduced by this Government Decree were clearly indicative of the trust's nature as a middle-management organ: the minister was empowered to exercise his management rights through trusts as well or to confer generally on the industrial enterprises, the industrial large enterprises and the trusts under his direction the functions performed by his ministry's industrial directorates, which were to be abolished gradually (Art. 3).

As is provided for in the Council of Ministers' Decree of 1967, a trust may be established for the purpose of promoting the profitable operation and the development of several enterprises and increasing the efficiency of their economic activities. The Decree does not use the terms "economic organization" and "managing body", but its provisions make clear that a trust is an enterprise-like organ and as such belongs to the enterprise sphere; so it is not a middle-level management organ by any means.

The Enterprises Act of 1977 widened this definition by the above Decree of 1967 to include the phrase "economic organization operating on the model of an enterprise". Accordingly the trust changed from a middle-management organ into a special complex of enterprises, but its organizational set-up was, in the name of

enterprise autonomy, radically reshaped by the regulation of 1984, which reduced the powers of the trust to a minimum.

Earlier we have referred to the anti-trust mood. Now we must qualify that statement to pinpoint that the anti-trust sentiment was limited virtually to the trust centre, which was logical in view of the fact that previously only the centre had operated as a trust, since enterprises were economic organizations attached to the trust alone.

This situation was radically changed by the regulation of 1967. Although the trust centre continued to wield full powers over their enterprises (Art. 30 of Government Decree No. 11/1967. (V. 31.) authorized them to issue instructions concerning the economic activity of enterprises), the economic goal of their operation changed. Considering that under the Decree of 1967 the main task of enterprises was no longer the fulfilment of economic plans and that the trust ceased to be an executive organ of the ministry, it really became the goal of trusts to promote the efficient economic activity of trust enterprises. This is supported also by the Decree's phraseology: no mention is made of the trust's separate office apparatus and even of trust centres. True, it was not spelled out either that the trust should be construed to mean the totality of enterprises attached to it, but the wording allowed such an interpretation, too.

The Enterprises Act of 1977 brought regulations more into line with the realities: the trust centre retained its right to give instructions, but the rule that the necessary economic autonomy and responsibility, including the right to independent decision on investments, must be secured for trust enterprises even within the frameworks of the trust created certain guarantees for the autonomy of trust enterprises. The decisive change in respect to management consisted in that while the director-general's one-man management was maintained, it became mandatory to set up a board of directors composed of the directors of trust enterprises, and that the cases in which the board exercised decision-making powers and the right to give opinion must be specified in the deed of foundation.

The Act too omitted a reference to the trust being the totality of its enterprises, but a comparative analysis of other provisions makes it evident that this was the case because the decision-making powers of the directors of trust enterprises would be meaningless if the trust were to mean the centre only.

Unfortunately, the altered role of the trust failed to receive due emphasis during the preparation of the legislation of 1984, and, therefore, the regulation practically created guarantees for more autonomy for trust enterprises, thus jeopardizing the economic substance of the trust. So the Enterprises Act as amended upheld the earlier definition of the trust and, with it, the authorization of the founding organ to establish a trust for the purpose of promoting the profitable operation and the development of several enterprises under its supervision as well as of directing them through the coordination of their activities. The trust remained an economic organization operating on the model of an enterprise.

As the Enterprises Act still fails to give a clear definition of the trust, logic remains the only way of deducing it. Also maintained is the rule that the trust and trust enterprises are juristic persons, the deed of foundation and its modification are subject to approval by the Council of Ministers, and the latter's consent to the liquidation of a trust is also a requirement.

Art. 53, para. (2), of the Enterprises Act empowers the Council of Ministers to

specify a form of management different from that prescribed in Chapter VIII of the Act (on the trust) for the purpose of carrying out definite tasks and facilitating the activity of particular enterprises in keeping with the principles and objectives set forth in the Act. So far the Council of Ministers has established no enterprise of a different type, but has used its powers to devise three other forms of management, all known as the Centre. The specific features of these forms will be discussed in the section on the operation of enterprises.

By virtue of Art. 24, para. (1), of the Civil Code the establishment of an affiliated company is subject only to the relevant decision of the economic organization concerned. An affiliated company is a juristic person by operation of law, and the deed of foundation must specify, along with the general requisites of foundation, the mode of cooperation between the affiliated company and the founding organ as well as the rights and obligations of both.

II. Operation of the Enterprises

A) Pattern of Vertical Relations

1) Public utility companies

Under Decree No. 33/1984. (X. 31.) of the Council of Ministers on the Enforcement of the Enterprises Act, public utility companies and other enterprises specified by the Council of Ministers are directed by state administration, but the mode of direction is essentially different from the general pattern: this category of enterprises is governed, in addition to the general provisions, by the special rules laid down in Chapter VII of the Enterprises Act.

The enterprises included in this category are expressly enumerated by the Enforcement Decree (para. (1) of Art. 47).¹⁶

In the exercise of its aforementioned extra powers the founding organ may order the public utility company to provide certain services and, as noted earlier, to regroup its assets and to carry out any economic activity.

Similarly, the approval of the founding organ is required for the medium-term (usually five-years) development plan of the public utility company and, if so

¹⁶ The public utility companies are those concerned with providing the following services:

- energy supply (electricity, gas);
- water supply (canalization, sewage, public baths);
- local mass transportation;
- public sanitation;
- sanitation in settlements;
- parks and municipal gardens;
- chimney sweeping and heating;
- management and maintenance of state-owned tenement houses and other real estates;
- other municipal and communal services;
- district heating and hot water supply;
- health services;
- cultural services;
- undertaker's business.

provided for in the deed of foundation, even such approval is subject to prior comments by the sectoral minister.

2) Enterprises directed by public administration

The general management of these enterprises is assigned to the director, who is appointed and relieved of office by the founding organ after consultation with the works union organ.

The deed of foundation may prescribe the setting up of a board of directors attached to the director. Enumerated in the Enforcement Decree, the members of the board include the director, the deputy director(s), the heads of organizational units as specified in the organizational and operational statutes of the enterprise and a number of workers as also specified by the statutes and elected by the trade union, but their number must not exceed the total number of enterprise executives.

The actual number of board members is ultimately determined by the founding organ. Board decisions are adopted by a simple majority of votes, the director having a casting vote in the event of a tie except in two cases.

The function of the board of directors is

- to determine the medium-term plan of the enterprise and to approve the main indicators of the short-term plan (to be valid, a decision must be adopted by a two-thirds majority of votes);
- to approve the balance-sheet and the performance record;
- to determine the main directions of business and price policies, the pattern of products and services, and the priorities of technical development;
- to impose significant shifts in the line of activity as laid down in the organizational and operational statutes;
- to decide on the establishment of an affiliated company and on participation in an economic society or association;
- to adopt the organizational and operational statutes and to set up, within the framework thereof, separate organizational units (to be valid, a decision must be adopted by a two-thirds majority of votes);
- to determine the principles of income distribution.

This enumeration is not exhaustive. Other matters may also be referred by the deed of foundation to the province of the board. Precise determination of the board's powers is of decisive importance to enterprise management for the added reason that the board has both the right and the duty to decide on the matters referred to it. Decision on matters outside the board's province is reserved for the director.

If the deed of foundation does not provide for the setting up of a board of directors, the organizational and operational statutes may do so, but in that case the body so-called has advisory powers only.

The state direction of enterprises in this category is realized through the exercise of the founder's rights:

- (a) As was pointed out, an enterprise may be established by a minister, the head of an organ with nationwide competence, a local council, and other state organ empowered thereto by the Council of Ministers. The establishment of an enterprise by a minister is subject to the prior consent of the Minister of Finance or,

by a minister other than the sectoral, to that of the sectoral minister of competence by the line of enterprise activity. The council organ of territorial competence must also be consulted prior to the establishment of an enterprise in every case.

(b) As mentioned above, the director of an enterprise is appointed by its founder.

(c) In contrast to self-governing enterprises, an enterprise may, at variance with the general rule, be wound up by the founding organ even if its activity is not needed for the national economy or it can be carried out at a higher economic yield within the framework of another enterprise.

B) Supervision and Control

At present, supervision over enterprises is exercised by the founding organ or, within the meaning of the Enterprises Act, another authority. (The Council of Ministers may delegate some of its supervisory functions to another organ.) Within the framework of supervision the founding organ is empowered

- to organize and control the implementation of government decisions;
- to assess and control, on a comprehensive scale, the activity of the enterprise;
- to help synchronize the goals and means of economic development and facilitate the enterprise's flexible adaptation to the internal and external conditions of its operation;
- to exercise functions of personnel management in respect to the director and to evaluate his work;
- to control the functioning of the board of directors.

Should the director fail to comply with his duties to such an extent that his action or omission seriously prejudices or jeopardizes the attainment of national economic goals, the head of the founding organ may suspend him and designate, for a period of up to 6 months, a commissioner to manage the enterprise as directed and instructed by that organ.

The founding organ may set up a supervisory committee to control the operation of the enterprise.

It is to be noted that these powers (in respect to the commissioner and the supervisory committee) have not been exercised except under special circumstances present.

As regards instructions for the enterprise to carry out a specific economic activity, the head of the founding organ is vested with the additional right to issue written instructions, after prior notification to the Council of Ministers, for a significant restructuring of the production pattern.

The founding organ may order the transfer of an organizational unit of the enterprise to another enterprise under supervision by state administration, but in that case it must designate some other enterprise for the exercise of related rights and the fulfilment of the obligations already assumed. (However, a guarantee protecting the self-governing state enterprises is provided by the rule which requires the consent of such an enterprise to its designation.)

Also, essentially on the same logic, the founding organ may, with a view to a significant restructuring of the production pattern and an improvement in the

supply of prime necessities to the population, regroup certain assets of the enterprise to another one under supervision by state administration. Attention should be called here to an important difference: whereas the right of the founding organ to regroup enterprise assets is unlimited in respect to public utility companies, the same right in respect to this category of enterprises is confined to the two goals mentioned above and its exercise, together with the transfer of an organizational unit to another enterprise, is subject to the prior consent of the Minister of Finance, the head of the central organ of market supervision (see later) and, if the founder is other than the sectoral minister. As can be seen, the exercise of this right is not absolute on the one hand and is subject to the consent of the heads of the highest organs on the other.

1) Self-governing enterprises

As has been noted, the powers of public administration have been affected by the further development (modernization) of the economic management system mainly in respect to self-governing enterprises.

The founding organs have retained only a fraction of supervisory powers, namely

(a) to take measures concerning the organization of enterprises, such as establishment of an enterprises and related administrative acts (e.g., entry in the register of enterprises).¹⁷

In the period of changeover (1985 to 1987) the exercise of these powers involved considerable tasks for the founding organs as it devolved upon them to adopt a preliminary position regarding the switch of enterprises under their direction to self-government. In the course of "normal" operation, however, decision-making powers concerning demerger and merger will be delegated to the management organ of self-governing enterprises, and the founding organ may not, in fact, deny approval of a deed of foundation except in case of violation of law.¹⁸

(b) to give or deny prior consent to the election and removal of the director.

¹⁷ Enterprise registration dates back to 1951, when it was professedly introduced to replace the register of firms kept at the registry court. Under the contemporary legislation, still applicable to the enterprise sphere, registration was of constitutive effect, namely an enterprise came into being legally with entry in the register. As against the register of firms, that of enterprises is not public, and is kept by the Ministry of Finance. The effort to abolish the register of firms failed essentially because in the early 1950s foreign partners generally insisted on registration in view of war damage compensation and on grounds of maintaining a minimum of external relations.

As a matter of fact, it was not until the early 1980s, when forms of economic association of citizens emerged, that registration began to regain its significance, and the new Associations Act basically requires the restoration of the previous status of registration, all the more so since entry in the register of firms will have constitutive force in respect to all forms of association. Provided that the reform process does not lose momentum, it appears likely that the institution of registration of enterprises, and of cooperatives performing similar functions, will be abolished in the longer run.

¹⁸ Approval of a deed of foundation may not be refused by the founding organ except if the relevant decision

- is likely to result in the establishment of an enterprise subject to supervision by state administration or to affect such an enterprise as well;
- is prejudicial to a significant interest of the national economy or national defence (e.g., transformation or demerger would entail restriction of economic competition or jeopardize compliance with international contractual obligations).

The director is elected by the enterprise's collegiate body, but regulations invest the founding organ with the right of prior consent to the director's election and removal. Prior consent means that only a candidate acceptable to the founding organ may be proposed for election by the collegiate body. The same holds for the directors's removal;¹⁹

(c) to instruct the enterprise to attend to tasks of national defence. (For more detail, see subsection 3 on other elements of the right to give instructions.)

A review of these powers leads us to state that, in contrast to enterprises under supervision by state administration, where exercise of the founder's right really implies direction by the owner (appointment of the director, regrouping of assets, etc.), here we have a case of state power inasmuch as certain activities may also be required of cooperatives and artisans whenever interests of national defence are involved. Therefore the current system of founder's rights cannot be regarded as completely established in respect to self-governing enterprises, and it is conceivable that most of these rights will, in the longer run, become part of the powers of supervision over legality or the market. (The ongoing process of revamping direction by the Government is clearly indicative of this trend.)

2) Supervision over legality

In accordance with Art. 30/C of the Enterprises Act, the state exercises control, through supervision over legality, to see that the organizational and operational statutes and other internal regulations of enterprises are in conformity with legislative provisions and the deed of foundation and that enterprises observe the law, the deed of foundation and the organizational and operational statutes in adopting decisions.

Legality control accordingly extends to two large areas of enterprise activity: consistency of internal regulations with legislative provisions (which concerns the static condition of enterprises) and observance of the law during operation (which concerns the dynamic aspect of enterprise processes).

It is specifically stated in the Act that supervision over legality must not extend to observance of criteria of profitability or expediency of enterprise activities and decisions. In other words, it cannot be identified with the previous supervisory

¹⁹ One of the most controversial issues during the preparation of the Enterprises Act was whether the founding organ should exercise its right of consent to the director's election and removal before or after the corresponding decision of the enterprise's competent collegiate body. In the end, the Act opted for prior consent. We are of the view that this solution is more in keeping with the principle of enterprise self-government, because consent *a posteriori* would in essence amount to approval, refusal of which would "invalidate" the decision of the enterprise's collegiate body, creating a contradictory situation by nullifying the decision on grounds other than a breach of the law, with the "prestige" of the decision-making body also likely to be impaired. On the other hand, with the right of prior consent vested in the founding organ, the enterprise's collegiate body is free to select the director from candidates who have the prior consent of the founding organ or to accept none of the candidates. Similarly, the collegiate body is free to refrain from removing the director despite the prior consent of the founding organ to removal. Gyula Haitich: *Az állami vállalatok új formái: önkormányzó vállalatok* (New Forms of State Enterprises: Self-Governing Enterprises), Chapter II, in: *A gazdaságirányítási rendszer továbbfejlesztésének joga, különös tekintettel az új állami vállalati formákra* (Legislation on the Further Development of the Economic Management System, with Particular Emphasis on the New Forms of State Enterprises), Eötvös Loránd Tudományegyetem Jogi Továbbképző Intézet, Budapest, 1984.

management of enterprises or with supervision over non-self-governing enterprises. In essence, it is virtually equal to legality control previously exercised over cooperatives as it may be concerned only with the conformity of decisions with legislative provisions and not interfere with substantive matters of enterprise activity.

It should be emphasized that supervision over the observance of legality, being as it is a form of organizational control, must not take over the supervisory functions of other specialized authorities. Thus, for instance, compliance with fiscal and financial laws is overseen by the Office of Financial Control and with regulations on price formation by the National Price Authority. Also, there are other special supervisory organs (fire-protection, policing, etc.) the functions of which are performed by authorities with a separate apparatus. Finally, individual matters such as labour disputes or cases amenable to court action are not of concern to legality control.

Supervision over the observance of legality is exercised by the founding organ within the framework of supervisory departments set up mostly at sectoral ministries. At the level of local councils this function is performed mainly by the special public administrative agencies of competence by line of enterprise activity.

During the preparation of the relevant legislation there was much controversy about vesting the power of legality control in the founding organ as it was thought to carry the danger that the founding organ might easily attempt to "regain" the lost part of its proprietary rights. As a matter of fact, the arrangement adopted was one of compromise. It was only on a temporary basis that the political leadership authorized the ministries to exercise supervision over legality, and the concept of a final solution is currently in the process of elaboration. What is visualized is a dual purpose to pursue. Perhaps in the near future, supervision over legality will be removed from the province of ministries and assigned, in respect of all enterprises, to an office to function under supervision by the Ministry of Justice. Of course, with regard to associations, this right will continue to be exercised by the registry court. In a longer-term perspective (of 3 or 4 years) the idea is to abolish that office and to vest full supervisory powers in the registry court. For that to happen, however, it will be necessary to frame the entire system of registry courts and to recruit the required staff of experts. In point of fact, it will not become possible to eliminate the registers of enterprises and cooperatives and, with them, the current system of parallel registration until this scheme has been put into effect.

The supervisory measures applicable in cases of violation of law are expressly enumerated in the Enterprises Act. Accordingly, if the enterprise violates a legislative provision, the deed of foundation or an internal regulation, the supervisory organ may take the following actions:

- warn the director in writing;
- propose the competent enterprise body to call the person(s) involved to account (namely the enterprise council in the case of the director and the director in the case of other workers). The competent body must consider the proposal, but is not obliged to accept it;
- annual the contested decision of the body concerned (enterprise council, general assembly, delegates' assembly, board) or the director and call upon it/him to adopt another decision;

— convene the enterprise council, the general assembly of workers, the delegates' assembly or the board for the purpose of restoring the legality of enterprise operation;

— suspend the director or the board of an enterprise under the general management of the general assembly or the delegates' assembly (but not the enterprise council or the delegates' assembly!);

— propose the Council of Ministers to place the enterprise under direction by state administration. This is a quite exceptional measure (which is therefore reserved for the Council of Ministers), since the classification of enterprises is based on functions, or objective criteria, and cannot be used as some sort of a punishment. Hence the first step is to call upon the enterprise in writing to restore the legality of its operation. This provision was virtually intended to leave scope, during the period of transition, for the Government to correct any wrong classification. One may actually agree with this recourse, but its form is not very fortunate since, in the wording of the Act, it appears clearly as one of punishment.

Under the Enterprises Act, application of more severe supervisory measures is subject to preconditions serving as a guarantee for enterprise autonomy. To annul a decision of the enterprise council, the general assembly of workers or the delegates' assembly, the board and the director (as well as the control committee, which—though also mentioned in the Act, but, given the nature of its function—hardly takes any decision), the supervisory organ must have called upon the enterprise body violating the law to take corrective action on its own authority. In case of annulment, the enterprise body must adopt a new decision within 30 days. If the wrongful decision was in the process of implementation, any damage resulting therefrom must be repaired. If a decision is likely to be annulled, and its implementation would cause considerable damage or a grave injury, the founding organ may, on one occasion, suspend its implementation for a period not exceeding 30 days (in the case of the general assembly or the delegates' assembly, until its next session, but may also propose the convening of its session).

The supervisory organ may not suspend the director or the board except if he/it has gravely violated the legal order of enterprise operation and management and has failed, despite a written notice, to end his/its wrongful behaviour or to remove the consequences thereof. A further guarantee is provided by the rule under which the enterprise council (general assembly or delegates' assembly) must be convened in such a case within one month. During the period between suspension and the convening of the session of the elected board, the rights of those suspended are exercised by a person designated by the supervisory organ. There is, of course, no legal bar to the enterprise council or the general assembly (delegates' assembly) electing a new director or board, but use of that recourse obviously involves a grave conflict between the enterprise and state administration, which should be resolved with the participation of social organs as soon as possible.

The supervisory organ must perform its functions *ex officio*. It is mandatory to invite its representative to attend the sessions of the enterprise council, the general assembly and the delegates' assembly (but not of the board). The supervisory organ may inspect only the decisions and documents which it is authorized to review. On the other hand, the organizational and operational statutes must, even in case of modification, be transmitted by the director, without a request, to the supervisory organ within 30 days of the adoption of the relevant decision.

In practice, the question arises of whether the enterprise body involved may appeal against a measure of the supervisory organ. As a general rule, a complaint may be lodged, through administrative channels, with the superior organ, the only exception being that in case the organizational and operational statutes are annulled the enterprise may resort to court and request repeal of the decision of annulment.

A radical change in this field can be expected to occur in the very near future, with enterprises to have direct recourse to court action in all cases.

3) Market supervision and the right to give instructions

Market supervision is the responsibility of the Government forming an integral part of economic management and to be met chiefly by indirect means of (market) regulation. In the present difficult economic situation and in a context of imperfectly developed and distorted market relations, exceptions to this policy had to be allowed, but operative intervention in enterprise activity is subject to predetermined conditions. The main function of market supervision is to promote the smooth development of market processes and economic competition.

In 1985 market supervision was assigned to the National Materials and Price Office as a central organ with nationwide competence, but supervisory powers were also vested in other national high authorities (Post of Hungary, Ministry of Transport, etc.) in specific areas.

As of January 1, 1985, with the partial reorganization of the ministerial system, the central direction and coordination of market supervision was transferred to the Ministry of Trade, and the National Materials and Price Office also started to function as the National Price Office. Existing experience is insufficient to allow an assessment of the work of these organs, but there is theoretical evidence to support the statement that the Ministry of Trade should exercise a great measure of care in attending to this task or that it is indispensable to set up an organ, equivalent to a cartel office, within the framework of either the National Price Office or another organ. (The law of competition currently in force failed to create appropriate organizational and legal frameworks for the struggle against cartels that might emerge.)

Under the relevant legislation, market supervision is concerned

- to keep under review and to analyze market processes, the balance of demand and supply, and the operation of the contractual system;
- to analyze the situation with regard to competition on the market and to submit proposals for strengthening such competition;
- to combat economic behaviours generated by monopolistic position and prejudicing national economic interests;
- to oversee compliance with regulations prohibiting unfair economic activities and to take the necessary measures in case of their violation (e.g., to propose imposition of an economic fine on defaulting enterprises);
- to propose central rules for the marketing of products (central management, fixing of quotas, etc.), to control their implementation, and to attend to tasks of central stock-building and central warehousing;
- to decide on resort to financial intervention, within the limits set by the national economic plan and the state budget, for the purpose of influencing market processes.

In the exercise of market supervision the Ministry of Trade may give compulsory instructions to all enterprises whenever the unhampered development of market processes cannot be secured by other means (e.g., indirect regulators or agreement with enterprises). Such instructions may affect virtually the entire sphere of enterprise production and all of its aspects, not only production itself, but also its discontinuance. Nevertheless, an important guarantee is provided by the rule which requires the prior consent of the Council of Ministers to the issuance of an instruction affecting a longer period or having greater import. Also, the Minister of Trade is under obligation to inform the Council of Ministers periodically of any instruction for an enterprise to carry out a specific economic activity.

Initially the power of market supervision in the narrow sense did not extend to compliance with economic obligations under international agreement. In respect to the implementation of such agreements the Minister of Foreign Trade was empowered by the Foreign Trade Act of 1974 to issue instructions to all economic organizations, including cooperatives. Of course, with the assignment of market supervision to the Minister of Trade, the issuance of instructions and the exercise of market supervision, as provided for in the Foreign Trade Act, became prerogatives of one minister. (As is known, with effect from January 1, 1988, a single Ministry of Trade was set up after the merger of the Ministries of Foreign and Home Trade.)

Finally, under the Act on National Defence and the Act on State Enterprises, the founding organ may instruct an enterprise to attend to tasks of national defence, but this prerogative is exercised, not as an owner's right, but as public power, and the instructions so issued are subject to the same conditions and have the same legal consequences as other instructions.

An instruction to an enterprise may be issued in writing only by the head of the organ empowered thereto (this is, in our view, a personal prerogative by all means). However, administrative decisions based on law (expropriation, demolition of buildings, etc.) and relative to cases of obligatory contract-making as specified by law are not deemed to be instructions.

The legislator's intention to compensate enterprises for any financial loss eventually resulting from compliance with an instruction is in the nature of guarantee. (The only exception to this rule, allowed by Law-Decree No. 23 of 1984, is an instruction issued directly by the Council of Ministers.) Before an instruction is issued the competent organ must, with the participation of the economic organization concerned, estimate the extent of potential material damage resulting from compliance with the instruction, and the enterprise may request compensation within one year of the occurrence of damage.

The amount of compensation may be demanded from the issuer of the instruction, which must decide on such demand within 30 days; in case of its silence or its rejection of the demand wholly or in part the enterprise may resort to court action. The amount demanded by way of compensation may include reduction in the value of enterprise assets, the profit lost in consequence of compliance with the instruction and the costs incurred in repairing the damage suffered.

4) Conclusion

The forms of supervision and control discussed above are present in all types of enterprises, since the trusts and the centres are directed by public administration, while affiliated companies are neither self-governing nor subject to direction by public administration and, being essentially one-man societies of the founding enterprise, have a special status.

As can be seen, the relationship between economic management and enterprises has undergone a radical change. This is true particularly in the light of figures. At present some 80 percent of enterprises are self-governing, against only 20 percent still directed by state administration. However, statistics are known to be always deceptive, while it is equally true that the 20 percent mentioned account for over 70 percent of Hungary's industrial potential. There is no doubt that legal regulations are not yet enforced in full and that direct instructions are also issued in a number of cases. The advocates of operative intervention by the government keep arguing that in the existing economic situation such intervention is inevitable in the interest of meeting international obligations or of repaying debts as scheduled. It is to be hoped that this practice will be ruled out by the full implementation of the reform. To be sure, for this goal to be achieved it is necessary not only to enact legislation, but also to develop the required methods of work. In the last analysis, the comprehensive reform of governmental direction will bring about shifts in the inner power structure as well, which alone will make it possible to fully observe the principles postulated by legislation.

C) Internal Organization and Functioning

1) Enterprises directed by public administration

As a general principle, the Enterprises Act requires enterprises to devise systems of internal management, accounting and motivation which guarantee constant increase in economic efficiency and create material and moral incentives for the enterprise staff. It is for the organizational and operational statutes, the "constitution" of enterprises, to determine the organizational pattern most suitable for the performance of tasks, the management prerogatives, the spheres of decision-making competence and the systems of internal accounting, motivation and control, and, at enterprises with separate organizational units, the scope of autonomy and responsibility of such units, the mode of their participation in decision-making, the incentives for their efficient economic and developmental activities, and their own systems of accounting and motivation.

The deed of foundation (as an expression of the will of public administration) may provide for the establishment of a board of directors attached to the director.

Unfortunately, the organizational pattern of this type of enterprise is the best reflection of what does not necessarily fit the finest traditions. As a matter of fact, there are as many internal organizational set-ups as there are enterprises, so it is next to impossible to form a general picture of them. Nevertheless, inquiries have found that, for instance, the legislative provisions concerning appropriate systems of internal motivation have not been enforced. In our judgement, this situation

can be expected to change profoundly under the impact of the Associations Act, since, on the one hand, some enterprises will presumably transform into associations and, on the other, the rest cannot choose but to streamline their internal structures in such a way as to make for higher efficiency.

The special status of trusts justifies separate treatment of their problems.

The powers of the board of directors and the director-general must be specified in the deed of foundation. The most profound change has occurred in this respect. Formerly (before 1985) it was typical of a trust to give instructions, and this right could be limited by the deed of foundation, whereas today it is specifically stated in the deed of foundation, meaning that in the absence of such a provision the director-general or the board of directors must not instruct a trust enterprise either to carry out a specific activity or to regroup its assets. Also in keeping with the spirit of new legislation is the general rule under which trust enterprises today figure as independent units in the state budget, the trust losing its financial unity in relation to the budget. The financial unity of several trust enterprises must be expressly stated in the deed of foundation.

In considering this typical trust, which is intended by the legislator to constitute the general pattern, we are left with a rather unusual picture: trust enterprises have independent links to the budget, so the trust has no financial source of its own, but the deed of foundation may also provide that the powers of the trust over trust enterprises must be exercised exclusively by the board of directors. In that case one may ask which functions are vested in the director-general and the central organization of the trust, for it can be imagined that there is no need either of the director-general or of the central organization of the trust as the trust is managed by the board of directors. Of course, the board cannot be meeting all the time nor should it, because this type of trust is, in our view, virtually an association-like organization where it is for the participating enterprises to decide what to do.

Thus, in summary, the basic pattern is one of a trust made up of a number of enterprises enjoying full autonomy in an economic and legal sense, with the managing organs of the trust wielding no effective decision-making power over them.

In theory, this conception of the trust has a single advantage, namely if the trust is managed solely by the board of directors, the trust can only be construed to mean clearly the totality of trust enterprises.

Consequently, the trust so conceived returns to the starting point where it was seen as an organ explicitly separated from and superordinate to enterprises, conforming again to the pure formula under which the trust is identical with its enterprises or appears as a special organization and order thereof. Under this approach the legal guarantees for enterprises can be conceived of as the guaranteed rights of an individual *vis-à-vis* members of a group to which he also belongs and embodies the rights of that group.

Any departure from this general formula must be spelled out in the deed of foundation as it may authorize the board of directors or the director-general

- to instruct trust enterprises to carry out a specific activity;
- to issue mandatory directives for the operation of trust enterprises;
- to regroup the assets of trust enterprises with a view to a more efficient operation of the trust;

— to regard certain trust enterprises as constituting economic units for purposes of fulfilling obligations towards the state budget.

In the case of such powers, however, it is necessary to set up and operate systems of internal accounting and management leaving scope for the economic independence and responsibility of a trust enterprise, including investments subject to its own decision and its motivation for profitable economic and developmental activities as well as its share in trust profits in proportion to its contribution thereto.

The director-general of the trust is appointed and removed by the founding organ after consultation with the board of directors, whereas in respect to the directors of trust enterprises the employer's rights, inclusive of appointment and removal, are exercised by the director-general. In accordance with the relevant provision of the Enforcement Decree, the director-general must consult with the founding organ before appointing or removing the director of a trust enterprise. The founding organ is not vested with the right of prior consent in respect to the director of a trust enterprise so, within the meaning of law, the director-general may also appoint a person to whom the founding organ has denied consent. However, considering that the director-general is, in a certain sense, subordinate to the founding organ, he is unlikely to name someone not having the support of the founding organ.

On the whole, the current normative regulations on the trust may be stated to leave wide scope for departure from the general rule in specific cases, since all essential economic, organizational and legal matters are governed by the deed of foundation. In view of the fact that the trusts in Hungary number less than a dozen today special arrangements are unlikely to cause any problem to the Council of Ministers. At the same time, we have to refer again to the unfortunate persistence of the anti-trust mood. While some trusts and large enterprises consider the idea of transformation into associations, the cases are many in which trusts are liquidated by administrative means even today. The practice still survives of trusts being liquidated, not for reasons of economic expediency in the first place, but for the purpose of increasing the number of competing enterprises. So, after all, the desirable market equilibrium which should characterize the ratio *inter se* of large, medium-sized and small organizations in every national economy is yet to be attained. We may safely add that any kind of administrative intervention is bound to retard this process or to give it a wrong direction.

As noted earlier, the Council of Ministers is empowered by the Enterprises Act to devise forms of directing the trusts different from that specified by the Act. So far there have evolved 3 such forms, each known as the Centre. The features common to them lead us to state that, on the one hand, the Centre is vested with less powers than a trust with limited powers and that, on the other, the director-general of the Centre exercises, in expressly enumerated cases, the right to give instructions, or considerable extra powers on that ground. This explains, in effect, the special status of the Centre.

At the same time, it is clearly seen today that the Centre may appear no more than a fleeting dream in the organizational life of Hungary. One of the 3 Centres has vanished already, the second will probably share the same fate. The third is under strong pressure to turn into an association. As can be seen, the practical situation shows that this form has not quite worked out. Nevertheless, we maintain that, theoretically, such appraisal is not entirely accurate, for it should also be kept

in mind that this form of organization was not allowed as much time, and at the right moment, as would have been absolutely necessary to prove its viability in economic as well as legal aspects.

2) Internal Structure of Self-Governing Enterprises

a) Enterprises under the general management of the enterprise council

aa) Status and composition of the enterprise council

The enterprise council is a body charged with the general management of an enterprise. Its functions are specified by law and cannot be widened except by the Council of Ministers, whereas the director is entitled to decide on any matters outside the province of the enterprise council. The basic idea of regulation was to reserve the right of decision for the enterprise council on matters of long-term strategy and to assign operative management to the director within the context of such decisions. This arrangement does not allow the council's organizational and operational statutes to extend its powers by derogating from those of the director.

The principle that only the essential matters affecting the self-government of enterprises are governed by law, with wide scope left for internal regulation making allowance for the particular conditions of individual enterprises, prevails in respect to each self-governing enterprise.

The enterprise council is of a quadripartite structure, its members being the elected delegates of workers, the representatives of two different groups of enterprise executives, and the director. At this juncture attention should be called to the fact that the enterprise council as a whole is not an elected body, since at least 50 percent of its members are elected by workers, two-thirds of the remaining 50 percent being permanent in the sense that membership is automatically open, not to concrete persons, but to the leaders at any one time of the organizational units specified by the statutes, whereas one-third are delegated by the director. The director sits on the council in his own right as part of managerial representation. The Decree on the Enforcement of the Enterprises Act determines only the maximum number of members, stating that it must not exceed 50, while the number of the members of a given council must be fixed by the organizational and operational statutes of the enterprise concerned. Under the existing practice, the number of council members ranges in general from 20 to 30, obviously determined by the need to ensure the council's proper functioning, as a more than 50-strong body is hardly capable of working efficiently.

(bb) Functions of the enterprise council

The Enforcement Decree expressly enumerates the matters within the council's sphere of competence, namely

- adoption of the medium- and short-term plans;

- approval of the balance-sheet and the statement of profit and loss;
- substantive modification of the line of enterprise activity;
- important decisions on investment, credit-taking, bond issue, transfer or acceptance of an organizational unit, money and means of production;
- decision on transformation of an organizational unit into an independent enterprise, establishment of an affiliated company, and participation in an economic society or association;²⁰
- adoption of the organizational and operational statutes and establishment, within their framework, of separate organizational units;
- important decisions on the employment of labour;
- determination of the principle governing the distribution of income available to the enterprise;
- election of the director, requesting him to render account of his work, his removal, characterization, assessment of his work and, with the exception of the powers vested in the council chairman, exercise of other employers' rights over the director;
- transfer of general management to the general assembly or delegates' assembly of workers, that is, transformation into another form of enterprise;
- decision on demerger or merger;
- decision on such other matters as may be referred to it by a decree or a decision of the Council of Ministers.

The regulation of these aspects is based on a conceptual approach different from that of the framework legislations on other matters. The functions of the enterprise council as expressly stated by law cannot be extended by any internal regulation of enterprises. (This rule differs from the regulations relating to enterprises managed by the general assembly or delegates' assembly of workers.) The underlying reason is that the enterprise council is a decision-making body with respect exclusively to strategic matters concerning the general management of the enterprise, whereas operative management remains the director's prerogative and one-man responsibility.

(cc) Convening of the enterprise council

The enterprise council is convened by its chairman or, in case of his being unable to perform his duties, his deputy. The council may be convened at any time, but, in accordance with the law, it must meet at least once a year. It must also be convened at a reasoned request on one-fourth of its members.

(dd) Quorum of the enterprise council

The presence of two-thirds of council members, inclusive of three-fourths of workers' delegates, is required for any decision to be taken. (The special rule relative to the presence of workers' delegates is likewise aimed at enhancing the democratism of self-government.)

²⁰ The last two types of enterprises are naturally expected to be abolished by the new Associations Act that entered into force on January 1, 1989. Following the corresponding legislative amendment, both economic society and association should be construed to mean economic association.

Decisions are generally taken by a majority of votes, the chairman having a casting vote in the event of a tie. On certain matters the law requires a two-thirds majority of votes, which may be extended to any other matter by the organizational and operational statutes. However, an essential difference in the qualified majority between the two regulations consists in that a qualified majority required by the organizational and operational statutes should not necessarily be a two-thirds one, but may depart from it in either direction.

(ee) Decisions of the enterprise council

It is a basic principle that the enterprise council has not only the right, but also the duty to decide on matters within its competence. However, this obligation is no bar to postponing adoption of a decision.

In general, the council takes decisions by a simple majority of votes and by open ballot. As mentioned earlier, the matters on which a qualified majority is required are specified by the law, but a qualified majority on certain matters may also be required by the organizational and operational statutes.

The council's responsibility for its decisions is primarily moral and political (e.g., workers may recall a delegate before the expiration of his term), and the material interests of council members are necessarily affected by a wrong business policy decision. There had also been proposals to the effect that council members should, just as the director, have a stake in both the success and the failure of business policy and development-related decisions. Those conceptually correct proposals were not embraced by the government in 1985, but we believe that two-way motivation should inevitably be introduced in a few years or else the council's standard of work is bound to collapse.

b) Status of the director

Development of an appropriate pattern of cooperation between the director and the council and regulation of the director's status and powers are questions of fundamental importance in the case of council-managed enterprises. Delimitation is easy in theory, since the Enforcement Decree on the enterprise council provides that decision on matters outside the council's sphere of competence must be the directors's prerogative, but in practice it is rather difficult and, in particular cases, impossible to distinguish between actually strategic and operative matters. We, for our part, maintain that the law cannot provide any further guidance on this point since an appropriate technique of daily cooperation can only be devised by those concerned, with no readily applicable "advice" given by any legal principle which, however, excellent, is couched in legislative commands.

The status in labour law of the directors of council-managed enterprises has undergone a radical change. Formerly the employers' rights over the directors of all state enterprises were exercised by the founding organ, but now the director is an employee of the council, with the exercise of employers' rights over him delegated to its chairman.²¹

²¹ Under Hungarian labour law, "other employers' rights" generally mean decisions on matters of lesser import like grant of leave, rewarding, etc.

The directors' employment relations are established for a definite period, which is 5 years under the general practice. (Election for a definite period does not by itself imply rotation, for the same person may be reelected several times.)

When electing the director the enterprise council must determine the most important long-term conditions for the economic activity of the enterprise, which will be the criterion for the evaluation of the director's work (his characterization).

The rights to elect the director, relieve him of office, request him to give account of his work, characterize him and evaluate his work must be exercised by the council itself, while the other employers' rights were, following the council's establishment in 1985, generally exercised by the chairman, who as an employee was subordinate to the director. That situation was rather odd, since the director was, in theory and law alike, to obtain the permission of the council's chairman, that is, his subordinate, to attend, say, an important conference.

Hungarian legislation was exceptionally quick to realize and correct this anomaly. As early as August 1985 the Council of Ministers passed Decree No. 38/1985. (VIII. 27.) providing that the director must, subject to the rules on employment relations, be entitled to act, without the employer's special consent, on matters concerning his own employment relations except

- modification and termination of the labour contract;
- periods of rest in excess of ordinary holidays, official travel abroad or determination of any remuneration, benefit or contribution;
- such other matters as may be specified by the enterprise council in the organizational and operational statutes.

It is worth noting that this last section of the aforementioned Decree virtually empowered the enterprise council to restore, as it thinks fit, the director's complete subjection to labour law. (Fortunately, this was not to be the case in practice.)

If the director proves incapable of performing his functions or fails to meet the requirements as determined at the time of his election, his employment relations may be terminated by relief of office before expiration of the definite period.

Relative to the director's status is the very essential rule under which the procedure for the settlement of labour disputes is different from that applicable to other workers in senior positions (executives). Under the Decree, the director of a self-governing enterprise may refer any of his labour disputes directly to the labour court. Formerly the director was entitled to file a complaint against the senior executives of the founding organ only with the "service superior", an arrangement which left the director without legal protection.

When the self-governing enterprises came into being, the director's legal protection was provided for by regulations of a new spirit in cases where the director was relieved of office through other than a disciplinary procedure. Accordingly, it was a requirement particularly for the founding organ, social organizations and the enterprise itself to facilitate the director's employment at another place of work or on another job and to create a social climate (a rather difficult task to accomplish) under which a director not reelected is not regarded as a "fallen man", but people will learn to live with the fact that a senior post is not an "entail" until one's retirement. Moreover, the enterprise council may decide to grant the outgoing director, for a period not exceeding 6 months, the difference between his new and previous basic wages in one amount. It may also grant him a special benefit amounting to 6 months' average wages in order to assist him in finding a new job.

c) Status of the members and officers of the enterprise council

Legislation does not accord special status and protection under labour law to the members and officers of the enterprise council; they receive no extra remuneration, but are naturally entitled to their average wages for the period of preparing for and participating in the council's meetings. In addition to conducting the meetings, the chairman has administrative responsibilities in connection with the director's election.

The status of council members differs according as they are elected or delegated. The same holds for recall. Members elected by workers may be recalled by the electors at any time under the same procedure applicable to election, namely the delegates' assembly should be convened, with the quorum to be constituted by the presence of two-thirds of delegates and with the vote to be taken by secret ballot.

Two-thirds of the senior executives sitting on the council are constituted by the heads at any given time of the organizational units specified by the organizational and operational statutes. Consequently, as regards their status, they may not be removed from the council unless they have previously, or at least simultaneously, been relieved of their posts at the head of the respective units as well. But if, in consequence of the statutes' modification, an organizational unit headed by the particular executive is no longer represented in the council, the executive concerned naturally ceases to be a member of the council.

Members delegated by the director may be recalled at any time without any special reason stated.

D) Enterprises Managed by the General Assembly (Delegates' Assembly) of Workers

The general management of this type of enterprises is entrusted to the general assembly or delegates' assembly of workers. Although these enterprises draw heavily upon the experience of cooperatives, they differ essentially from the latter in that whereas the delegates' assembly at cooperatives is elected by the general assembly as its substitute organ, the two bodies cannot function alternately at enterprises, because the deed of foundation determines which one is to manage the enterprise.

The general assembly is composed of the enterprise workforce from the commencement of employment relations. The situation is different with regard to delegates. As recommended by the Decree enforcing the Enterprises Act, delegates' eligibility for election should be subject to at least 6 months of service with the enterprise (or its predecessor in title). This is indeed a permissive provision as it allows other arrangements to be laid down in the organizational and operational statutes. Nevertheless, practical experience indicates that the statutes are in general more restrictive by narrowing the scope of eligibility. In other aspects delegates are elected under the same procedure applicable to members of the enterprise council.

The transformation of such enterprises is subject virtually to the same procedure as council-managed enterprises. It is important to note that the organizational and operational statutes of enterprises managed by the delegates' assembly of

workers are drafted by a committee headed by the existing director and are put into final shape by the delegates' assembly or the general assembly, as may be provided for in the statutes.

The management of the enterprise differs to some degree from that of council-managed enterprises. The functions of the general assembly or the delegates' assembly as specified by Art. 14 of the Enforcement Decree are essentially the same as those enumerated in the Enterprises Act, but—and this is a very important difference—the organizational and operational statutes may refer any matter to the province of the general assembly or the delegates' assembly. Thus, in contrast to council-managed enterprises, there is practically no limit to extending the powers of the collective management body. Yet it would be inexpedient to carry such a course to inordinate lengths as it might paralyze operative management, with the ensuing disadvantages suffered by the enterprise collective.

The second element of this form of management is the board, which it is mandatory to set up. The board is elected by the general assembly or the delegates' assembly for a term of 5 years, and its responsibilities include several matters that are within the power of the enterprise council at self-governing enterprises, namely

- characterization of the director, evaluation of his work, and exercise of employer's rights over him, with the exception of his election, requesting him to render account of his work and relieving him of office;
- determination of the enterprise's short-term plan;
- important decisions on investment, credit-taking, bond issue, transfer or acceptance of an organizational unit, money and means of production, within the scope determined by the organizational and operational statutes;
- decision on such other matters as may be referred to it by legislative provisions or the organizational and operational statutes.

However, this latter prerogative is limited by the Enterprises Act in one aspect: nothing but approval of the balance-sheet and the statement of profit and loss and determination of the principle governing the distribution of income available to the enterprise may be removed by the organizational and operational statutes from the competence of the general assembly and referred to that of the board. Accordingly, the general assembly or delegates' assembly of workers is vested with the following functions that must not be impaired:

- adoption of the medium-term plan;
- substantive modification of the line of enterprise activity;
- decision on transformation of an organizational unit into an independent enterprise, establishment of an affiliated company, and participation in an economic society or association;
- adoption of the organizational and operational statutes and establishment, within their framework, of separate organizational units;
- important decisions on the employment of labour;
- election of the director and the board, requesting them to render account of their work, and relieving them of function;
- transfer of general management to the enterprise council, from the general assembly to the delegates' assembly or from the delegates' assembly to the general assembly;
- decision on demerger or merger.

Decision on matters not reserved for either the general assembly or the board lies with the director.

As can be seen, the managerial chain consists of three links: the right of decision is exercised by the general assembly (delegates' assembly) on matters of longer-term strategy, by the board on shorter-term matters that are nonetheless of strategic relevance as well as on certain labour matters concerning the director, and by the director on matters relating to the implementation of the decisions of collegiate bodies and to operative management.

The size of the board as well as the rules for its election and relieving of function are determined by the organizational and operational statutes. The meetings of the board are chaired by the director (unlike the arrangement for the previous type of enterprises, because the director cannot be the chairman of the enterprise council), who is a member *ex officio* of the board. However, legislation expressly provides that the director must not participate in the adoption of board decisions on matters concerning his own person; in such cases the exercise of employer's rights over him—except for his election, relieving him of office and requesting him to render account of his work—is delegated to the board. The organizational and operational statutes may stipulate an arrangement under which a member of the board has the standing duty to act for the board in coordinating matters in advance and chairing the meeting.

Finally, the Enforcement Decree provides for the establishment of a control committee, though not in mandatory terms. In view of the specific situation of the enterprise, however, the statutes may spell out the need to set up one.

Once its establishment has been decided, the control committee is naturally elected and relieved of function by the general assembly (delegates' assembly) of workers. This power is vested exclusively in the assembly, which may—although this aspect is not specifically governed by the law—obviously choose to relieve of function, not the control committee as a whole, but certain of its members and to replace them by others.

Legislation specifies only the main functions of the control committee by providing that it must exercise continuous control over the entire activity of the enterprise, thus leaving all related matters (size, mode of election, rules of procedure) to the organizational and operational statutes to regulate.

Nor does the law make any reference to the term for which the control committee must be elected. In our view, it follows clearly from the elective nature of its function that it should be elected for a definite period and, logically, for the same term as the board.

Most of the enterprises managed by the general assembly are small ones. Although Law-Decree No. 22 of 1984 amending the Enterprises Act abolished, with effect from January 1, 1985, the institution of small enterprise introduced in 1981, it allowed state enterprises (not excluding those managed by the general assembly of workers or by the enterprise council) or affiliated companies which in their particular line of activity employ much less workers and dispose of much less assets—or, given the nature of their activity, find it otherwise appropriate—to operate simplified systems, subject to the consent of the Minister of Finance, of price regulation, accounting, book-keeping and supply of records. (This is, in effect, the counterpart of a small cooperative in the public sector.)

1) *Affiliated company*

The institution of affiliated company has recently grown in importance among economic organizations. As noted earlier, decision to establish an affiliated company lies solely with the parent company, which enjoys complete freedom of action, without the prior consent either of the Minister of Finance or of the sectoral minister, in establishing or liquidating an affiliated company and determining or modifying its line of activity.

The requirement to consult the metropolitan or county council of competence by line of activity of the future affiliated company and, if the founder is a trust enterprise, the trust concerned before the establishment of an affiliated company is, in effect, contrary to the above rule, and amounts, in our view, to an undue restriction, for it could safely have been left to the founding enterprise to decide whom to consult and how or to obtain or not the views of any organ in order to substantiate its own decision.

The starting assets of an affiliated company are provided by the founding parent company against a share in the former's future profit available after payments into the state budget, with the percentage of share to be fixed by the deed of foundation.

At the same time, the founder goes surety for the liabilities of the affiliated company. The close relationship between the two organizations is likewise shown by the fact that if the affiliated company operates at a loss and assets fall short of meeting its debts or cannot be used for that purpose, the founding enterprise is under obligation to cover such loss by using its own assets.

From the relevant legislation it becomes clear that an affiliated company is, in point of fact, a state enterprise of the traditional type. Its existence and fate are very closely linked to the founding enterprise, while its autonomy and freedom of business depend primarily on the nature of its relationship to the founding enterprise.

In 1983 the Council of Ministers widened, by decree,²² the range of juristic persons authorized to found enterprises, extending this right also to budget-dependent organs, but making their foundation of an enterprise subject to the prior consent of the Minister of Finance and the heads of the supervisory organ. If an affiliated company founded by a budget-dependent organ goes into the red and its own assets fall short of meeting its debts, or the founding budget-dependent organ is unable to cover them out its own assets, the affiliated company must be wound up.

Another benchmark in legal development was Decree No. 65/1984. (XII. 29.) of the Council of Ministers, which entered into force on January 1, 1985 and empowered cooperatives to establish affiliated companies, specifying the range of founding cooperatives and laying down uniform conditions for the foundation of affiliated companies. Accordingly, an affiliated company may be founded by

- state enterprises (inclusive of trusts and trust enterprises);
- cooperatives (except housing and small cooperatives);

²² Decree No. 23/1983. (VII. 25).

— enterprises of certain juristic persons as specified in Art. 70, para. (1), of the Civil Code;²³

— budget-dependent organs;

— economic associations possessing juristic personality.

Subjecting the Decree to closer scrutiny, one must state that the prevailing practice concerning the foundation of affiliated companies is violative of enterprise autonomy and free will, since the Decree specifically requires prior consultation

— with the sectoral minister (head of the national high authority) of competence by the line of activity of the future affiliated company;

— with the executive committee of the metropolitan or county council and, if the founder is a trust enterprise, with the trust; or also

— with the sectoral minister of competence by the company's line of activity, if the affiliated company is established by a public utility company, whereas an enterprise of a juristic person is required to obtain the prior consent of its own founding organ.

Conditions have become more stringent for foundation by budget-dependent organs, an added requirement being the prior consent also of the Minister of Finance and the heads of the supervisory organ of the budget-dependent organization concerned, whereas the establishment of a joint venture with foreign participation is subject to approval by the Minister of Finance.

In recent years it has been argued, especially by practising specialists, that restrictions concerning affiliated companies should be lifted, that the same should be granted full independence of the parent company, including the right of independent decision on, e.g., relinquishing their status as such. Other specialists have complained that no form of enterprise self-government is applicable in the case of affiliated companies.

We, for our part, do not share these ideas. Since a parent company establishes an affiliated company in order to make its own operation more profitable, it follows that an affiliated company should not be entitled to determine its line of activity and business policy contrary to the intension of the founding organ (keeping in mind the existence of this possibility in case of self-government). Should the law grant this right to affiliated companies, the very interest of founders in establishing such an organization would be extinguished forthwith.

If looked at from another angle, the basic task of a self-governing enterprise is to take decisions on matters of enterprise strategy and to exercise quasi proprietary rights. In the case of an affiliated company such decisions are obviously taken by the parent company or perhaps its self-governing organ, whereas in the case of cooperatives introduction of a double track system of self-government or owner-management similarly appears to be out of the question.

²³ The national representative organizations of cooperatives, social organizations, and associations are authorized to found enterprises, which are juristic persons.

2) Conclusion

In sum, it may be stated that, on the one hand, the operation of the current system of enterprises in Hungary is governed by legislative provisions which guarantee and protect enterprise autonomy (even though regulation is far from complete, but legal development is perceivable and moving in this direction with some record of achievements) and, on the other, numerous elements of regulation are not always translated into practical terms. The reasons are both objective and subjective. The objective reasons include operative government measures justified by particular aspects of the economic situation, although our own "contribution" to the emergence of a need for such urgent measures is strongly questionable today, for once a concrete situation has occurred, it is hard to dispute the necessity for operative measures. In a large number of cases, however, Hungary's attitude has also contributed to the emergence of situations calling for urgent measures. (This is well-illustrated by the system of intra-CMEA cooperation. For long years it has been an open secret that reforming the operation of CMEA is indispensable. Several international committees have been set up for that purpose, but a real breakthrough still must be achieved.)

A prominent place among the subjective reasons is occupied by fear of unpopular measures. For several years now no one in Hungary has contested the need for restructuring the economy, but no genuine progress has been made so far, as is evidenced, among many other things, by our practical record of enterprise wind-ups. Since September 1, 1986, when the legislation on the liquidation of enterprises (or the bankruptcy law) entered into force, only one large enterprise has been liquidated, and so-called state refloating proceedings have been instituted against numerous large enterprises facing a rather serious financial plight. The goal of such proceedings would be to reorganize a given enterprise by the provision of state funds, but, given the inadequate level at which programmes have been implemented as well as the accompanying problems of organization and factors of personnel, unfortunately no single project has succeeded after all, and such schemes of "assistance" have been confined to allowing additional time for payment.

Thus, in the light of the foregoing, to allow the enterprise system a wider scope for manoeuvre requires above all the solution of fundamental economic questions, each of which calls for a conscious political decision. Cases in point are the concept of property, state intervention and its economic tools, as well as full establishment of the market. At the same time, it is naturally necessary to bring about a change of mentality at all levels. Obviously enough, the latter cannot be achieved overnight, and it is probable that, even if economic conditions improve, the market automatism will take long years to come into play.

As regards the legislative frameworks, the Associations Act will be a decisive step in the direction of the reform as it will offer a wide spectrum of forms for enterprises to choose from in the quest of the most adequate arrangement for their operation.

In brief, the legislative framework has largely been created, and what remains to do is to make use of the possibilities at hand. It is true, of course, that efforts in this direction cannot be enforced by legislation.

III. Operation of Joint Ventures

A) Introduction

The inclusion of this Chapter in our volume calls for some explanation. This may seem to be a contradiction, since questions concerning the establishment of joint ventures naturally merit discussion in a book intended for foreign experts. At present, however, a situation has emerged in which a comprehensive recodification of the law of joint ventures is highly probable, just as it may prove unnecessary for this type of legal material to be given separate treatment as related regulations will be incorporated in the Associations Act.

The working group on codification has formulated a proposal to abolish the system of concessions in respect of capital shares of up to 50 percent, namely, to require no permit for a foreign company to obtain the capital or business shares of Hungarian economic organizations, and to make the ratio in excess of 50 percent, which may rise up to 100 percent under the Associations Act subject to nothing but grant of permission by the Ministry of Finance.

The exponents of another view insist on a permit for the establishment of a joint venture, but under a much simpler procedure.

Therefore, in these circumstances, we cannot but confine ourselves to a discussion of the essential aspects of the prevailing regulation, naturally adding our critical remarks. We believe that, even if the system of concessions is abolished, knowledge of the current situation will not be without interest to foreign experts, who will thus be enabled to trace the benchmarks and pitfalls of the road travelled.

B) Statutory Provisions

1) The legislation currently in force is based on Decree No. 28/1972. (X. 3.) of the Minister of Finance as amended several times and on the ordinance of the Minister of Finance on its enforcement.

Hungarian economic organizations may accordingly establish joint stock companies, uplimited mercantile partnerships, joint enterprises and deposit companies. (Of course, with effect from January 1, 1989, the Hungarian term *társulás* (association) is replaced by *társaság* (company), and the institution of deposit company as a legal entity will likewise ceased to exist. Consequently, mixed companies take the form of limited liability company, joint stock company, unlimited mercantile partnership or joint venture. It is to be noted, however, that an unlimited mercantile partnership is not a legal entity and is not deemed to be an enterprise.)

A joint venture may be set up, on the basis of the members' common interests, for producing, trading and servicing activities aimed at a profitable improvement of technological and economic standards.

Hungarian law provides that, in principle, the foreign partner must be a recognized firm of sufficient means, reliable in business management and possessing adequate know-how in its future line of activity.

2) The legal device is one of licencing procedure. Formerly, the intention to form a joint venture had to be notified to the Minister of Finance and the prepara-

tory negotiations were subject to preliminary permission, which in practice involved numerous difficulties and an almost constant pressure of time, for most of the exploratory talks failed while swelling bureaucracy to no purpose. The current regulation has therefore abandoned that arrangement and requires only the start of substantive negotiations to be notified to the Minister of Finance. Most important in this respect is the legal criterion of substantive negotiations. The wording of the law makes clear that substantive negotiations mean the phase preliminary to contract, that is, a Hungarian firm may, with no permit whatever, agree in advance with a foreign partner to form a joint venture, the only requirement being to apply for a permit before the contract is signed.

The notification by the Hungarian economic organization concerned must indicate

- the name and seat of the Hungarian partner as well as those of the foreign partner(s);
- the scope of activities of the joint venture;
- the extent to which the operation of the joint venture is to contribute to improving technological and economic standards, widening the existing market network, and increasing foreign exchange receipts and export earnings;
- the planned legal form of the joint venture, the main terms and conditions concerning its organization and operation, and the planned number of workers;
- the types of licences and know-how to be purchased by the joint venture as well as the terms and conditions of such purchase;
- the amount of funds required for the start of orderly operation as well as the ratios and forms of contributions (cash, quotas of material and intellectual non-cash contribution of the Hungarian and the foreign partner);
- income and expenditure in hard currencies in relation to the economic targets of the joint venture as well as the achievement of estimated gross profit.

Practical implementation is facilitated by the fact that the notifier is not required, in effect, to wait for a reply of substance from the Ministry of Finance, but may continue the negotiations initiated. On the other hand, the Ministry of Finance is under obligation to pass its comments and notes on the notification within 30 days of receipt thereof.

The regulation is so liberal because the validity of the deed of association is subject to approval by the Minister of Finance, with sufficient time thus left for a final decision to be taken. It is to be noted that time is needed for the Ministry of Finance to forward the notification or its copy to the members of the so-called Inter-departmental Committee of Experts for their views.

The permanent members of this Committee include the Minister of Finance, the Minister of Trade, the President of the State Office for Wage and Labour, the Chairman of the National Committee of Technical Development, the permanent representatives of the major departments and the Hungarian National Bank appointed by their respective heads. The representative of the minister responsible for sectoral direction of the Hungarian partner to the joint venture must be invited as full-fledged member to the meetings of the Committee. It is very probable that this requirement will be waived in the future, whichever concept will be finally adopted.

Once concluded, the deed of association must be sent again to the Ministry of Finance for approval, the related documents to provide information, in addition to the above aspects, about the economic activity (e.g., investment resources and the probable gestation period, the position of the creditor bank regarding the creditability of the Hungarian partner if it intends to cover its deposit wholly or in part from credit, and the financial plan of the joint venture for the first three years of operation, showing the planned receipts and outlays separately in hard and non-convertible currency).

The application for approval must be submitted in 10 copies, together with the contracts, agreements, minutes and other documents, all in the original language and in Hungarian translation, which, regardless of their designation, govern the establishment, internal order and operational conditions of the joint venture as well as the rights and obligations of the partners, not covered by the original documents, concerning the establishment and operation of the joint venture, their relationship *inter se* or with the joint venture.

The Minister of Finance adopts his decision after consultation with the Interdepartmental Committee of Experts. Once the decision has been adopted, the joint venture can be entered in the registry of firms.

A review of these rules reveals that approval must be supported by an enormous quantity of data. It is equally clear that decision on the authorization of substantive negotiations as well as on the deed of association lies in effect solely with the Minister of Finance, who relies on the Interdepartmental Committee of Experts as his advisory body.

Experience shows that the inadequate competence of Hungarian partners, poor knowledge of the relevant legislation and overestimation of their own economic possibilities and capacities were frequent factors in causing delays in administrative procedures. Obviously enough, it is primarily for the Hungarian partner establishing a joint venture to be familiar with the economic and market environment and the possibilities arising from it, a requirement which will be maintained in the period following the new regulation. Yet the past years have seen several cases in which Hungarian partners expected a "decision" from the Minister of Finance, one not required by his Ministry, even on these aspects of the market, although it is evident that no one can take such a decision for them.

3) The shares of capital to be contributed by members are determined by a restrictive rule of principle, namely the share of the foreign partner must not exceed 49 percent of the capital stock. Departure from this rule in areas of finance (banking) and services as well as in other domains deserving special consideration is subject to permission by the Minister of Finance. A joint venture is required to pay a tax of 40 percent on profit, the only type of tax, after deduction of the contribution to the social insurance fund (such contribution is regarded as cost). Several exceptions to this general rule are permitted in order to increase attractions for the investment of foreign operating capital in Hungary. Thus, for instance, if the capital of a joint venture amounts to 25 million forints and the foreign share is 30 percent and half of the annual income of the joint venture comes from productive activity or from operation of jointly owned hotels the joint venture is entitled to a refund of 60 percent of the tax during the first 5 years of operation and 40 percent from the sixth year on.

If the joint venture re-invests the profit realized, it is entitled to a refund of 100 percent maximum of the tax paid.

Joint ventures established in special lines of activity (high-tech) of utmost importance to Hungary are tax exempt for 5 years and are to pay a tax of 40 percent, from the sixth year of operation. Apart from this, the Minister of Finance is vested with general powers to grant tax exemption in special cases essentially without limitation.

The security of foreign investors is strengthened by the rule under which they may, parallel to concluding the deed of association, request a bank guarantee from the Hungarian National Bank for transfer abroad of their contributed share of capital, with its due accrue, in the currency specified by the contract. In case of liquidation of a joint venture, the foreigner's share of capital left after payment of debts may also be transferred abroad, tax free, in the currency specified by the contract. A similar rule applies to foreign employees of the joint venture, who may remit abroad, in the currency specified by the contract, 50 percent of any income received from the joint venture.

4) A joint venture operating in a customs-free zone may be regarded as a special category introduced in 1982. As is indicated by its designation, a given area is regarded as foreign for customs, foreign currency and foreign trade law, with those entering and leaving such an area to be accorded the same treatment as passengers entering and leaving the country at border-crossings.

An application for declaration of an area to be a customs-free zone may be submitted by a domestic legal entity owning, administering or using an estate to the National Commander of the Customs and Revenue Guards, who grants a permit in concurrence with the Ministry of Trade, the Ministry of the Interior and the Ministry of Transport. The operator must enclose a customs-free zone with a fence at least 3 meters high.

The procedure for notification and approval as outlined in para. 2) may be started by possessing such a preliminary permit.

An association operating in a customs-free zone

- must keep its accounts in the currency specified by the contract of association and according to accounting system determined by the Minister of Finance and must, as a general rule, carry out transactions in convertible currency;

- must keep its currency and foreign exchange funds, up to the amount of its paid-up share of capital (original stock) at an inland bank, and its funds in excess thereof may be kept either with an inland or with a foreign bank;

- may draw loans both from inland and from abroad;

- may, within the aforementioned limits, freely dispose of its assets deposited in Hungary in convertible currency;

- may purchase, against convertible currency, the foreign amount needed for its operation from a Hungarian bank, and that amount must naturally be kept in an account with a Hungarian bank.

As a rule, associations in a customs-free zone are subject to Hungarian law, except statutory provisions concerning, e.g., enterprise income and wage regulations, price regulation, the regime of investment, state control, and purchase and use of motor vehicles.

The legality of operation of such associations is supervised by the Minister of Finance.

C) General Assessment

From January 1, 1989, as noted in the introduction, the conditions for the operation of joint ventures and the licencing procedure underwent significant changes. The national economy of Hungary naturally has an elementary interest in the import of foreign operating capital, but it is equally obvious that one area of the economy cannot be isolated from the rest and be governed by completely different rules. On the other hand, this means that the general state of the Hungarian economy has inevitable repercussions on the operation of joint ventures as well and that foreign investors cannot escape the general effects, whether positive or negative. Therefore foreign investors have a vested interest in getting acquainted with the operating mechanism of the Hungarian economy. Knowledge of the relevant legislation is unfortunately not enough, because real-life processes often depart from statutory provisions. Thus, in effect, it could also be stated point-blank that the relevant legislation aimed at modernizing the system of economic management and the order of economic activity reflects a desirable state of affairs in which the possibilities of really dynamic growth can emerge. In practice, however, a desired state is attained only in general, although what matters in business life is the working of concrete forces in daily work rather than general principles of a declaratory nature. No single joint enterprise is able to escape the interplay of the above factors.

At the same time, taking into account the law of action and reaction, the relatively modest sphere of joint ventures in terms of size and available capital exerts at present a weak effect on the Hungarian economy as a whole. On the evidence of statistical data, the intensity of labour and its degree of organization at joint ventures show a better average than at Hungarian enterprises. (If we take the units of input per job, the respective figures are 1 for the United States, 3 for Hungary and 1.6 for joint ventures in Hungary, meaning that joint ventures operate about 50 percent more efficiently in this respect. This is not surprising, for it is of common knowledge that the organization of work in Hungary is still below the level of a modern market economy today.)

National wage regulations are not applicable to joint ventures even today. Thanks to, among others, the positive influence of this sphere, national wage regulations have virtually abolished upper wage limits and notable progress has been made in the wage reform, at least with respect to salaries as predetermined on the basis of economic criteria. Next year our enterprises may supposedly find themselves in a legal position to give any salary to their employees but for lack of finance. Nevertheless, this is, in essence, of advantage to the sphere of joint ventures, because it will be free from legal restrictions to implement the principle of performance-related remuneration.

We believe that if administrative restrictions are lifted or reduced to a "tolerable level" the greatest problem and retarding factor will remain to be the inadequacy of intellectual resource management at Hungarian economic organizations.

Sociological surveys have found that Hungarian enterprises are unable to prepare serious feasibility studies of an acceptable business or market standard, although they are evidently a point of departure for any undertaking other than fraudulent. The underlying reason is, of course, not only in that the competence of

experts at our enterprises leaves much to be desired, but—and this should also be kept in mind—in that for 40 years these experts have been expected to meet quite different requirements. Therefore, in point of fact, they are now supposed to be capable of managing a completely new area under a completely new approach, and, quite understandably, it takes them no short time to acquire such capabilities.

On the other hand, there already operate joint ventures working efficiently and with highly qualified Hungarian specialists. This process has got under way and will hopefully be advancing rapidly. The chances are practically there, even though opposite trends can also be observed.

This question will be decided by the future power and political struggles, or their outcome, but each joint venture setup serves to increase the chance of continuing the policy of renewal and reform.

Legal Means of Protecting Foreign Investments

I. Foreign Investments and Protection of Investments in General

§ 1. Function of the export of working capital (foreign investment) and its appearance in the socialist countries, including Hungary

1. The export of working capital (or the practice of international or foreign investment by acquiring equity share in an economic entity against payment in cash, kind or industrial property rights in a foreign country, for what we use the term working capital in this study) has been a well-known phenomenon of the world economy for centuries. In developed countries it is known to play a prominent role in worldwide enterprise strategy as well as in the economic strategies of these individual countries. The magnitude of this phenomenon, its underlying causes, economic rationality and significance for the world economy are well-known, as are the numerous contradictions generated by foreign capital investment, particularly large corporate empires (multinational corporations), contradictions such as the too strong predominance of foreign capital in some countries, its negative political influence especially in developing countries, and so on. Today, of course, national economic policies, economics and jurisprudence, domestic and international legislations favour and encourage the export and import of working capital for its contribution of positive values (while believing in the possibility of restricting its negative elements). The world is aware of such values, which include, first and foremost, a high degree of internationalization of science and technology, applications of up-to-date technology and the interdependence of its development. These values, operating as an objective law, necessitate and entail the internationalization of investment capacity, the flow of mobile capital; expansion of enterprises and national economies, reflecting the security of domestic enterprise activity and growth and promoting the stability and growth of national economies; placement of surplus capital and its efficient utilization with comparative benefits; implementation of more profitable and more efficient strategies through operation near markets and raw material bases; provision of credit by host countries, which serve as a source of investment capacity and offer possibilities for technological advance, facilitate the growth of domestic economies and participation in international economic processes, and so on.

It is equally known that working capital is moving mainly from advanced countries to the other developed ones and that the reasons include social, political and economic stability, namely security of investment; strong purchasing power, namely calculability of returns on invested capital; developed economic, technical and legal infrastructures; skilled and mobile labour; developed banking, currency and payments systems; traditional interconnection and mutual knowledge of the markets and countries involved, to mention but the most important elements. It is

mainly these factors that account for the phenomenon that a large part of working capital from several developing countries is likewise invested in advanced capitalist countries, as was and is the case even with the petro-dollars of the oil-producing countries.

Finally, it is common knowledge that the socialist countries—to refer to them in abstract terms—have not participated for a long time in this process of the international division of labour, either in general or in the domain of intra-CMEA relations. We will not enter into discussing the reasons and the consequences here and now, as they are amply covered by literature in East and West alike. It will suffice to refer briefly, in this context, to the rigid confrontation of the two world systems, to political and economic mistrust in the past, and, as regards CMEA, to autarkic economic practices, a mechanism for economic cooperation at nothing but state and interstate levels, the virtually absolute preponderance of trade directed from above, the lack of market and genuine market actors, the ensuing lag behind world standards and the ills we all suffer, and the pressing need to recover somehow from this situation.

2. However, the past two decades have seen a new spirit, that of cooperation at all levels, penetrating international economic relations in both the East-West and intra-CMEA contexts. The wisdom of words usually refers to that spirit as “cooperation” (in the East-West relations) and as “economic integration” (in the intra-CMEA domain).

This has induced significant practical developments. The traditional forms of foreign trade have widened in scope, with new vistas and channels opened for different investment strategies in the socialist countries as well. Mention may be made of long-term agreements on cooperation emphatically aimed at developing technology, effecting investments and widening the market; establishment of foreign enterprises and partnerships; investment projects through genuine joint ventures; and joint international economic organizations of CMEA-countries. These and other forms add up to a new phenomenon and, in the socialist countries, express a new concept and faith regarding the possibility of thereby securing the fertilization of technology through mutual cooperation, a more efficient economic development in modern production processes, an intensive interaction of management skills and practices as well as of marketing strategies and, consequently, a faster rate of development in the international division of labour. In terms of impact, all these may combine to promote, and will certainly promote, improvements in political stability and in cooperation, as is set forth explicitly in the Final Act of the Conference on Security and Cooperation in Europe.

The interdependence of national economies has become a recognized or rather an admitted thesis, one that sensible action is possible and necessary only in awareness of this reality.

Though in this writing we shall discuss the appearance of foreign investment in socialist countries (which is part of the general external economic reform processes), one should not overlook the fact that the concept and practice of working capital operating internationally and domestically naturally presupposed the occurrence of developments that would be bound to draw up the curtain (or, as one might as well say with an association of ideas not entirely unfounded, the iron curtain) before a new act in the theatre of international politics and the world economy. That new act is embodied in the new era of détente, in peaceful coexistence and, even more so, in international cooperation.

As regards the values of a more "technical" nature appearing in foreign investment embraced by new socialist national and enterprise strategies, or the concepts about the acceptance of and reliance on those values, one may formulate the following theses now commonly propounded in the professional world.

Mutual and long-term interests contribute to improving the chances of peace and the international climate. International investment is a significant means of developing and transferring modern technologies and management skills. This is of advantage to investors, too, because they have a particular interest in seeing improvements in the quality of partner economies, which are known to constitute an essential condition for sound and dynamic international economic cooperation. Working capital secures a better position for the market strategies both of foreign investors and of new enterprises set up through investment. Investment is a form of capital import where capital is needed or, e.g., credit is hard to come by for various reasons. The difficulties of obtaining credit may include shrinking sources of international credit or more stringent credit conditions in view of great demand or less willingness to provide credit for considerations having to do with indebtedness or credit-worthiness. Enterprises where capital is directly present open for investors fresh natural resources and other comparative benefits, such as lower production costs owing to more favourable fiscal and labour conditions in the recipient countries. On the other hand, recipient countries can make more efficient use, through joint investment projects, precisely of these resources for the implementation of their economic development plans. Foreign investments enable recipient countries to enlarge the industrial base of their economies and to speed up their regional development programmes. The potentially greater benefits accruing from foreign investment projects to the foreign partners result from, among others, the possibility of exercising direct control in favour of their invested capital, which allows for a more reliable management of their assets, with the promise of more gain than would be yielded by other forms of cooperation (under the law of obligations). Also important to the foreign investor is his gaining access, easier in geographical terms, to markets sought and procurable in different regions of the world, such as Europe, the Middle East and the Far East. These factors operate to intensify foreign exchange mobility between participating countries, to increase organic linkages in worldwide international economic processes, and to strengthen the positive effects of a united world market, with more benefits accruing to recipient countries as well.

In the relations *inter se* of CMEA countries, international and joint investment projects have a special role to play, on the one hand, in developing the CMEA mechanism for cooperation and, on the other, in consequently improving the expected efficiency of inter-enterprise links.

§ 2. Facts and developments: the first decades of foreign investment

3. A sensible programme of action dictated by the economic premises as well as those of economic and legal policies outlined above naturally could be, and had to be, translated into practical terms by way of regulation. As noted in the introduc-

tion, the practice of foreign investment and its legal regulation of varying intensity have, in point of fact, been known for centuries.

As concerns legal regulation, no separate laws (so-called 'foreign investment codes') have been passed in the advanced market economy countries. Foreign capital has adapted itself to domestic law, to the laws of recipient states, that is to say, it operates in accordance with their internal company law, whereas the recipient countries have applied their internal company law (with occasional amendments or restrictions of usually lesser import) to foreign investors without discrimination, maintaining, as a rule the principle of national treatment (*régime national*). The foreign investment codes, designed specifically to govern international (foreign) investments are products of this century and have a dual role to play: to encourage import of capital, on the one hand, and to create legal conditions for the operation of foreign capital, on the other (adjustment to the internationally prevailing standards of company law, elimination of differences between the mechanisms of foreign and domestic company laws, affirmation of certain principles concerning the protection of national interests, etc.). Such investment codes can be said to have appeared and spread from the 1940s onwards. Separate international investment codes first became common in the non-socialist countries, with many (over 60) of them, mainly developing, applying them in the late 1970s and early 1980s. By comparison, the investment codes (laws on joint ventures) of socialist countries were not as belated or as undeveloped in the late 1960s and early 1970s as they were supposed.

4. The history of investment codes in the socialist countries began with the first joint investment code of Yugoslavia in 1967 and continued with those of Hungary and Romania in 1970–1972. Poland opened its gates in 1976, first to small investments, and in 1986 to larger investments by the adoption of a general law on joint ventures. The Vietnamese law on international joint ventures was passed in 1977. The next important developments were marked by China in 1979, to be followed by Bulgaria in 1980, Cuba in 1982 and Ethiopia in 1983. While the laws on joint ventures that appeared with a relative delay could rely on the experience of previous legislations, the forerunners made essential improvements during the intervening period.

The second larger wave of legislation on joint ventures, of codification on international investment in general, can be traced to the end of the 1970s. The new Polish legislation has been noted earlier. In the early 1980s Hungary took significant steps by liberalizing its first law on joint ventures and allowing the establishment of associations in customs-free zones. Legislations on joint ventures were further streamlined by Yugoslavia in 1984 and China in 1981 and 1983. The latest development, namely the admission of foreign capital to the Soviet Union in 1987, is of outstanding importance and deserves particular attention with its novel features. On January 13, 1987 the Presidium of the Supreme Soviet adopted a law-decree on joint ventures to be set up with foreign participation in the territory of the Soviet Union. That act of legislation was followed by two decisions of the Council of Ministers laying down more detailed rules to govern the establishment of joint ventures with enterprises of western and socialist countries, respectively.

The Czechoslovak practice shows specific features. There is no legislation on joint ventures in that country, where the general character of economic and legal policies has so far failed to cover this form of cooperation. In the past few years,

however, the situation has changed in certain aspects. Public opinion in the professional world has argued for the practicability of forming joint ventures, emphasizing that, albeit there is no codification of positive law on the subject, the setting up of joint ventures is not prohibited by law. Moreover, from Article 20 of Act 142 of 1970 (on foreign exchange) it clearly follows that, subject to permission by the Minister of Finance, persons to be considered aliens under the Foreign Exchange Act may participate in the activity of Czechoslovak enterprises. An essentially new phase of development will materialize once the draft of the first Czechoslovak legislation on joint ventures finalized in 1988 will enter into force.

For the time being, the question of joint ventures is not the order of the day in the German Democratic Republic. "Although the GDR Constitution recognizes private property and its participation in numerous areas..., there are no foreign interests operating (in the country)..., the decisive reason being that the external economic policy of GDR is not oriented to joint venture as a form of mobilizing foreign capital."¹

The main thrust of legislative development concerning joint ventures is, in addition to having opened the gates, towards, promoting modernization and the increase of really intensive transactions through those gates, while securing appropriate transparency and formulating normative rules along with legal guarantees for such operations. It was necessary to lift initial restrictions under the hallmark of modernization and to allow scope for a more flexible and faster mobility of capital. This end was served by, e.g., opening the sphere of production to joint investments in areas where the road had not been blocked; allowing foreign majority control in numerous countries; creating clearer and better positions for foreign investors in joint management bodies; securing more favourable fiscal conditions as a means of increasing the efficiency of incentives and competitive capacity in regard to preferences granted by other recipient countries; simplifying and expediting the often complicated licensing procedures; introducing in certain countries associations in customs-free zones as a new form of undertaking, etc.² These developments and new ideas have been spelled out now in Hungary by a modern and fairly liberal (capital-inviting) law, the Act No. XXIV of 1988 on "The investments of foreigners in Hungary". Similar ideas are represented in the Polish Foreign Investment Law of 1988 and the new Yugoslav Law No. 1023 of 1988 on "The foreign investments".

5. The relevant figures show a modest but promising rate of progress. The case of Yugoslavia can be regarded as typical: there were 5 joint investment projects in 1968 against 73 in 1973, and up to 1983 there were signed 187 contracts for investment with a total capital of 200 million dollars. Whereas recent years saw a sharp decline in the trend of foreign investment (down to 14 projects in 1984), the amendment act of 1984 on liberalization and modernization resulted in an increase of new investment projects (over 50 in the first ten months of 1985). Figures for other socialist countries could also be cited which are promising to varying degrees, but are rather modest for the time being.

¹ Maskow and Stolpe: *Doing Business in the German Democratic Republic*, in Campbell (ed.): *Legal Aspects of Doing Business in Eastern Europe and the Soviet Union*, Deventer—Antwerp—London—Frankfurt—New York—St. Paul, 1986, pp. 111—112.

² Mádl: *A külgazdaság és a nemzetközi beruházások joga*. (The External Economy and the Law of International Investments), Budapest 1988, paragraphs 40 *et seq.*

The number of joint ventures in Hungary was close to 200 under the pre-1988 legislation, a relatively modest result (particularly in comparison to the volume of foreign capital actually invested). Joint ventures in the other CMEA countries number even less. The mentioned new law is surely one of the incentives of the recent increasing flow of investment capital into Hungary. A similar statement may hold true for the Soviet developments.

It is impossible not to notice the headway made by China in this respect. According to some figures, foreign investments (effected partly under contracts for cooperation in investment subject to the law of obligations, partly in the form of joint venture) amount to about 8 billion dollars in China, and the number of joint ventures, with a total invested capital of 500 million dollars, has exceeded 350. The figures for the end of 1985 show 2,300 joint ventures, 1,200 enterprises 100 percent foreign-owned, and 3,700 enterprises operating under cooperative arrangements (and governed by the law of obligations) with an invested capital of more than 30 billion dollars. In connection with these figures it should be noted that a major role in that rapid run-up was played by the so-called special economic zones which absorbed a large volume of investments. Obviously, partly for this reason, partly in view of China's size, these figures can only be matched by a probably similar practice of the Soviet Union, which showed keen interest, as it was expected to, right at the outset. The process of forming joint ventures got under way in Hungarian-Soviet relations as well. Investments from the West are expected to be undertaken particularly by American firms. In April 1987 Western offers in the Soviet Union totalled 200, several of which reached the stage of negotiations and 12 projects were actually started. The latter include an Italian-Soviet joint refrigerator factory, which is to have a workforce of 2,500 and to be equipped with complete technology by the Italian firm, TATA; the large American Occidental Petroleum Corporation; and an interesting business represented by the West German fashion-magazine BURDA, which is jointly published in Russian in Moscow. The figures on the total volume of invested capital are not yet available, but, in view of the Soviet market and demand, a significant rate of expansion can be taken certain, even if there is a great deal to be done to remove the scepticism of Western firms.³

6. Developments within CMEA frameworks should also be noted in connection with international investments. As is known, the importance of joint investment projects, mainly on the inter-enterprise plane, received increased emphasis for the first time under the Comprehensive Programme and took the form of joint, or international economic organizations.

Before the Comprehensive Programme was launched there had been set up numerous joint economic organizations like *Intermetall*, *Intransmas*, *Agromas*, the even more important *International Bank for Economic Cooperation* and the *International Investment Bank*, which followed the former, but, in the wake of that Programme, which embodied the idea of economic integration, there arose a need for a legal regulation, uniform in its main elements, covering joint economic organizations, which it appeared desirable to be given greater weight, or for a kind of coordinated socialist law on economic associations. Since the aforementioned international economic organizations were all set up under separate intergovernmental

³ *Ibid.*: para. 40.

agreements, each of them is governed by separate statutes of its own, representing as many enclaves in the law on economic associations in accordance with the sets of rules laid down in the relevant agreements. This situation could not be any different in the absence of a general international law on economic associations (companies). The variety of separate legal enclaves constituted by these international economic organizations obviously failed to provide the most appropriate legal arrangements for the association of a larger number of enterprises. Moreover, a codification of uniform rules was dictated by the fact that, as noted earlier, the provisions of domestic laws in CMEA countries, which governed economic associations (companies) and juristic persons in general, differed widely in both legal policy substance and doctrine, as did the national economic mechanisms in their background. All these aspects combined to call, in addition to appropriate company forms, for the establishment of legal principles to govern the association of economic units (generally enterprises) in different positions and to make for an easier incorporation of emergent economic units in the internal economies and laws of the countries involved, chiefly the host countries. Related efforts led to the adoption of the "Model Rules on the Conditions for the Establishment and Operation of International Economic Organizations in CMEA Countries" in 1973, the "Model Rules on the Further Development of Financing and Accounting Systems for International Organizations—International Economic Organizations, International Economic Management Organs and International Economic Associations—of the CMEA Countries Concerned" in 1975, and the "Uniform Regulations on the Establishment and Activity of International Economic Organizations" in 1976. These Rules are not sources of law in the legal sense, because they were not framed in international treaties and hence were not subject to ratification. This character of them is shown by the very designation "Model Rules". Nevertheless, they may be regarded as normative instruments; for, in terms of legal sociology, they represent important sources of enterprise behaviour and enterprise action: they resulted from codification at the CMEA level, formally assumed the character of statutory provisions, were accepted as a recommended form in CMEA organs, and were promulgated (as were, e.g., the Model Rules by Hungary in *Külkereskedelmi Értésítő* (Foreign Trade Journal 1974/2). Their character as sources of law in terms of legal sociology is also indicated by the fact that the statutes of international economic organizations set up subsequently, such as *Interatomenergo*, *Interielektro* and *Intertextilmas*, follow the pattern established by, and the guidelines set out in, these "sources of law".

While international economic organizations can boast of a widening practice and a growing literature,⁴ they have so far failed to meet expectations. Few such organizations have been formed, mainly at interstate level. The idea and hope that the inter-enterprise level would produce "redeeming" results in furtherance of progress appeared to be in need of more "sustenance", of new and more general change in national economies and CMEA-mechanisms (real prices, market, convertibility, a sufficient degree of enterprise autonomy, etc.). The fact that CMEA countries are making efforts, even in relations *inter se*, at devising and launching

⁴ Ficzer and Sárközy: A KGST-országok nemzetközi gazdálkodó szervezeteinek alapvető jogi kérdései. (Principal Legal Questions Concerning the International Economic Organizations of CMEA-Countries), Budapest, 1978.

joint enterprise schemes under domestic law can be seen as a criticism of the existing CMEA situation and concepts (as is illustrated by, e.g., the above-mentioned legislation of the Soviet Union). The very fact that possibilities and the exigencies of rational development are thus emerging with increasing clarity is a great achievement by itself.

7. Finally, among developments in this domain, mention should be made of a although slow, growth of investments by enterprises of socialist countries in non-socialist countries as well. This element of more enterprise dynamics has been recognized as a necessity. Establishment or acquisition of firms abroad, creation of enterprise motivation for joint operations and formation of joint ventures in foreign countries have become part of economic strategies in socialist countries. The core and substance of such arrangements is in their inner contents rather than in the addition of a new form to international economic relations, for they, too, express an essential law of motion of these relations, namely a high degree of internationalization—a well-known axiom we have referred to earlier—of development and production processes and related trade processes. Direct foreign investments by enterprises and their enterprise-like international movement (an external market organization evolved along these lines) are indispensable requisites of a workable strategy on the world market, give significant impulses to enterprise competitiveness and contribute to a rational development of the industrial structure, to the growth of enterprises themselves, and thereby to the strengthening of national economies in the domestic sphere. An essential element is their subser-viency to trade within industrial sectors and enterprises and hence to a more efficient expansion of enterprise markets in the international arena. The movement of or trade in goods within an enterprise empire (insider-trading) is known to be largely instrumental in the international efficiency and expansion of the economies of modern industrial states and even in their internal economic growth. The significant role of capital export in advanced capitalist countries is also of common knowledge. Nevertheless, it is worthwhile to notice the decisive role played by this element of economic strategy in working new “economic miracles” like those experienced in Finland, where the fast rate of growth can be ascribed to, among others, steep increases of investments by Finnish firms abroad (such projects numbered 200 in 1972, whereas the number of Finnish enterprises and associations abroad rose to 1,600 by 1985). As can be seen, Finland earns its economic results and thereby its “economic miracles” mainly in other countries. One-way streets in international investments are not enough by a long chalk.⁵

The past decades have seen enterprises of socialist countries taking growing strides forward in respect to the aforementioned forms of relations. The number of firms operating jointly, in full or partial cooperation, with socialist enterprises in advanced market economy and developing countries is on the increase (unfortunately at a slow rate) and runs into several hundred.⁶ Their share in this form of cooperation on the world market is far from optimal and a particularly long way from drawing the “deserved” criticisms levelled against multinational corporations in the sphere of international enterprise-like movement.

As regards foreign investments by enterprises of socialist countries in the con-

⁵ “Introduction to the Finnish Economy”. *Trade with Finland*, No. 87/88, p. 14.

⁶ For figures, see Mádl: *op. cit.*, para. 35.

text of legal frameworks and regulations, the following brief statement may be made. By virtue of, e.g., Art. 13 of the Hungarian Foreign Trade Act, enterprises with a foreign trade licence are empowered and left to make use of this form, and the requirement today is to make it a more general practice. Of course, the concrete set of conditions for investment abroad is determined by the law, normally the rules of the company law, of the recipient country.⁷

§ 3. Necessity for the protection of investments —

A “philosophy” of contradictions

8. As can be seen from the foregoing review, the number of foreign investments has increased considerably in comparison with the start-up of such projects. Under the impact of liberalization measures, too, foreign capital flow into nearly 100 joint ventures in Hungary during the past two years was twice the volume (\$ 100 million) of the capital invested into 47 enterprises that had been set up over the previous 15 years. However, compared with China's rapid rate of development (which is naturally explained by the size of its market in addition to its much less restrictive law of investment), the socialist countries of Europe have so far failed to reach the tempo found desirable everywhere. The volume of foreign working capital in countries roughly the size of Hungary (such as Austria, Finland and Ireland) is on the order of several billions of dollars. Reflecting about the slow increase in propensity to invest, the trade press characterizes the situation, not without any foundation, with titles like “Non-Working Capital...”⁸

Slowness, or failure to live up to expectations in full can be explained with several factors. Potential foreign investors, institutions like the World Bank (the investment centre of IFC attached to the World Bank) are largely known from economic and legal literature. If we are to draw a positive balance of the major factors—in terms, not of what is going wrong, but of what is to be, or should be, done—, reference must and can be made to these: more confidence and faith in an improving and still better international political climate; strengthening, stabilization and better institutionalized publicity of comparative advantages (relatively high expertise, cheaper labour, a predictable economic policy environment developing in a favourable direction, modern and transparent regulations, guaranteed transfer of profit, proximity of market, tax allowances, etc.); effectively operating capital market; security of conversion and ultimately real convertibility; lifting of restrictions on (a 49 percent limit to) shares to be held by foreign investors; a commitment to pursue goals of the domestic market along with the previously dominant export orientation; removal of obstacles to acquisition of immovable property and availability of mortgage loan for financing; building of “bridges” for access to larger CMEA markets; granting of foreign trade right; offer of districts with communal, or infrastructural facilities and several other forms of support.⁹

⁷ *Ibid*: para. 35/1.

⁸ Hirschler: “*Nem működő tőke... Külföldi beruházások Magyarországon.*” (Non-Working Capital... Foreign Investments in Hungary), *HVG*, June 25, 1988, pp. 50–52.

⁹ Mádl: “*Beruházások és gazdasági társulások külföldiek részvételével Magyarországon.*” (Investments and Economic Associations with Foreign Participation in Hungary), *Állam- és Jogtudomány*, 1982/2, Vol. XXV, pp. 270–320, 310. See also “*Kedves tőke, várva várunk*” (Dear Capital, We are Expecting You Eagerly), *HVG*, June 25, 1988, p. 52.

It is commonplace to say that recipient countries are competing for capital import today. This is one of the areas where Hungary is also hard pressed to meet the objective exigencies of the pressure for adjustment.¹⁰ What is needed is to take more resolute steps in tackling the tasks just outlined in order to secure a faster rate of growth, to achieve a breakthrough to the realm of billions of dollars invested (a volume capable of giving a serious impulse to speeding up the renewal of the Hungarian economy, the process of full-scale development and the efforts to catch up with other countries in general), thus holding out in the competition for capital import or taking the lead in the competition. Had Hungary been more determined for liberalization right at the outset in respect of opening to capital import, it would now register better results and could potentially enjoy an especially advantageous starting position in any new competitive bid.

9. Appropriate sets of conditions, as outlined earlier, for promoting and accelerating capital import are created largely through legislation, including adoption of modern laws on joint ventures, as is usually the case, in the form of investment codes referred to above (in subparagraphs 3 *et seq.*). Here we shall not deal with legislation in joint ventures, its essential aspects and development trends, and the new developments likely to take place in, e.g., Hungary in connection with the Associations Act, but refer the reader to literature on the subject.¹¹ Against this background, this study will focus in the protection of investments, which represents a wider range of questions of detail. Protection of investments is a particularly important chapter of legal regulation. The causes are obvious. The investor seeks for security, wants to implement within guaranteed legal frameworks an investment strategy he thinks economically rational, tries—and is better able—to evaluate the commercial risks of his planned undertaking, although he looks for and finds protection against them as well (by formulating statutes and building patterns of decision-making powers in keeping with his endeavours, exploring markets and sources of supply, etc.). There are, however, risks that defy any measure of precaution and go beyond the scope of planning and management. Such risks, called non-commercial, or political ones,¹² include war, uprising, radical economic and social transformations, state bankruptcy, restrictive state intervention or nationalization in recipient countries, which may happen to cause serious damage to investors or to the invested assets of foreign partners. It is understandable that investors should seek protection against such risks, too, in order for working capital to move more boldly toward companies holding such risks (mainly in “stirring” developing countries deficient in funds and hence in need of capital import). And investors come along if there is protection, but hardly do so if there is none or little. The risk to which potential investments in socialist countries are exposed constitute a separate problem, chiefly in view of the object, history and motive of fear ingrained in people’s minds. In the course and on the experience of long decades the image of socialist countries in Eastern Europe lingering in the economic and legal thinking of western capital investors has been notionally one, historically justified, of a rejectionist attitude to private capital, inasmuch as these systems became what

¹⁰ For competition, see Hirschler: *op. cit.*, p. 50.

¹¹ See Mádl (fn. 2), paragraphs 40 *et seq.*, and pp. 310 *et seq.* of the Mádl article in fn. 9.

¹² For political risks in general, see Mádl: “Politikai kockázatok a külkereskedelmi szerződések körében.” (Political Risks in the Domain of Foreign Trade Contracts), *Állam- és Jogtudomány*, 1984/2.

they are, socialist economic systems, precisely through expropriation of private capital. The very term "capital" was banished from the economic armoury and theoretical fabric of socialism, and now it is the very same countries that invite foreign investors and, *horribile dictu*, foreign capital, a wealth even they call capital, and promise profit and, on top of all, they themselves invest abroad. What guarantees are there then here?

10. Indeed, this is a "philosophy" of contradictions, an arena of action charged with diverse energies, a mix of theses and antitheses calling for some sort of a synthesis.

We are naturally aware, and so are western investors in general, that the world has undergone profound changes. The world economy has become civilized. In the North—South relationship, colonialism has been replaced by the multiformity of a Third World in a slow process of stabilization, with some developing nations achieving considerable progress and growing in world economic significance. This group of countries has become an active agent of change in the political and legal configuration of the international economic order. The historic "rollback" of the cold war in East-West relations was followed by the predominant trend of economic and political cooperation, which is expressed in Europe by the Final Act of CSCE in the most general way. For all its periodic reversals, that is the objective trend of development. What countries with market economies seek in cooperation is market, raw materials, and trading partners that grow stronger in other areas, too, with a view to improving the operation of their own economies as well. This holds also for surplus capital, the objective substance of which is in reaching out for market and expansion. Attitude-shaping values of historical and cultural traditions that bind countries together have been upgraded (particularly in Europe). The different global agreements (from GATT through the World Bank to trade agreements and various agreements on the unification of trade laws) and the well-established regulatory systems of regional, interregional and bilateral cooperation embrace the entire large family today, with the world, North and South, East and West summoning the will to work towards some sensible and secure scheme of international economic cooperation. Europe is aware of there being no other alternative. It is hard to act against the mainstream of the chief laws of historical and economic development. The domestic and international systems of legal regulation are workable and promising in so far as they follow and reinforce that mainstream. Part of this is, and also generally known to capital-exporting countries, the historic change that is taking place now in socialist countries and reflecting a rethink not only of East-West relations, but also of socialism and its economic order. The prevalent trends and the main aspects in which theory is seeking to break free of the *status quo* are well known. Let us dwell in the economy here. As for capital import (and the way it is looked at abroad), categories like commodity and money relations, market, capital, efficiency (profit), material incentives, individual and group interests, and enterprise (entrepreneurial) autonomy have been "re-established in their rights" even under conditions of social ownership prevailing. Expressing its substance, enterprise autonomy is virtually growing into proprietary responsibility and power (with the abstraction of state ownership becoming a theoretical background to and serving to set the stage for a new kind of normative economic management). All these developments combine to enhance the equal status of enterprises as partners with foreign investors, with investing partners to

joint ventures. And, finally, as regards the most important of guarantees, East-West cooperation, including unimpeded operation of prospective foreign capital, is dictated for socialist countries by motives little short of survival, or, in simpler terms, by the need to catch up with world economic development, by the existential demands of domestic economies. It is this force and this pressure for adjustment which prevent socialist countries turning against themselves and changing their minds after some years and taking the road back to nationalizing foreign assets or stifling the normal operation foreign investments in the old way. This is the real force of protecting foreign investment in these countries.

Everyone is aware of this in general, but it is precisely this general pattern that dictates the need for investment protection to be provided for, with this background and as a reflection thereof, by positive law, with legal institutions supporting it, turning it into concrete reality and making it applicable in practical terms, for investors can do nothing with *détente* or with any principle, however strong, of East-West cooperation on the general plane, this being insufficient for them to sue a state, to get a free bank guarantee or a permit to transfer gain on capital. As can be seen, syntheses signalling solutions to the aforementioned contradictions and constructive schemes for investment protection which are expressions in positive law of a new spirit of cooperation as outlined above and which offer routine remedy in case of dispute are indispensable for a mass increase in the volume of invested capital. Yet, for all obvious progress and cooperation, the world in motion may happen to witness political risks in the recipient countries (risk that still are not infrequent, though not in socialist countries). And it is also a fact — and rightly one, along with the general principles of human and societal development and of (international) law — that no single state may hamstring for all time its legislation on the domestic economic system. This is an added reason to support the need for a legal mechanism of investment protection: should change in the domestic economy affect foreign investments as well, there should be an appropriate mechanism for a solution to be weighed on the other scale of the balance. Both parties should have security and act in security. In simplified terms, this is the *raison d'être* of legal institutions devised for protection of investments.

This *raison d'être* has gained general acceptance today, but it was not always the case either in general or in developing nations or in socialist countries or in Hungary.¹³ Understandably, the capital-exporting western countries were the first to press for investment protection, including demands for the proorest recipient countries to provide for security of investments, to submit to court action if they touch invested assets, perhaps nationalize them, and or to bear the burden of guarantee. On the other hand, developing and socialist countries have argued that tying their hands with some sort of ban on nationalization or transformation would derogate from their (economic) sovereignty and that giving guarantees was not their business, because it is always for the party fearing risk to take out an insurance. After all, however, capital flow is in the vital interest of recipient countries, too, even if in some concrete cases it starts from the foreign partner, from the profit-oriented strategy of capital. Well, it is these conflicting interests and their

¹³ For more in this, see para. 11 below, and for suggestions, made only in literature as late as the early 1980s, that it would be practicable also for Hungary to conclude international agreements on investment protection, see fn. 9 (Mádli).

gradual accommodation which the development of investment protection presents to us in the now large complex of disputes, international initiatives, and domestic and international legislations.

II. International Systems of Regulation on the Protection of Foreign Investments

§ 4. Multilateral half-successes and successful multilateral agreements

11. Of course, the first multilateral initiatives were motivated by efforts of the advanced market economy countries to secure early protection, definite and effective, under international law for capital export by them, while the failure of initial attempts can be attributed to the reluctance of capital-importing countries (mostly developing nations at the time), enjoying significant support from members of the legal profession in socialist countries, to subject themselves to arrangements conceived in a context of dominant position maintained by capital. In spite of this, namely the fact that the draft agreements recommended were not accepted and ratified, the multilateral moves can be regarded as half successes because they played a positive role in the following three aspects: first, the need for some rational solution of the problem came to the fore more prominently in international legal thinking; second, the debates that followed clarified the interests of different groups of states and revealed the viability or inviability of the devices sought; third, certain elements of the lessons learnt and the ideas put forth were to provide a background to, and to lay the groundwork for, subsequent successful drafts.

(a) The "ideal" arrangement for protection as a compromise between different interests was first elaborated by the International Law Association, an important international forum, in the form of ILA drafts which received majority support from western delegates to the ILA Conference at Hamburg in 1960. In a "resolution" adopted at its previous Conference in 1958 the ILA had emphasized the significance of the subject, calling for the preparation of drafts to be submitted to the Conference in 1960. There were two drafts drawn up. It is worth taking a closer look at the ILA drafts and the debates over them in order to form an idea of the legal instruments and the mentality of discussants at the time.¹⁴

The two draft agreements were intended, in effect, to achieve the minimum goal, that of winning general support for the first agreement, by offering two choices. To begin with the second agreement, in Art. 24 it sought to establish a Permanent Foreign Investment Court with specified functions, procedure, independent powers to hand down judgements, and so on. Thus even the more naive drafters were probably mindful that such a draft was particularly impossible to sell in 1960. It was predictable that the consent of either developing or socialist countries was impossible to obtain to a scheme under which states were to accept

¹⁴ For a fuller analysis and for sources, see Schwarzenberger: *Foreign Investments and International law*. London, 1979, and for the ILA Drafts, see the volumes of the ILA Conferences (Draft Convention on Nationalization and the Protection of Foreign Property).

mandatory recourse to court, an international judicial forum at that, and in a procedure enabling private persons to be subjects thereof in a par with states and to dispute with states, as it were, at the same level and in the same position, and thus were to proscribe, in advance and voluntarily, practically inevitable state action in connection with nationalizations.

A "refined" version of this idea, the first Draft Statute of the Arbitral Tribunal for Foreign Investment, was meant to meet the "eventuality" indicated above. The Draft of 37 articles contained detailed provisions on procedure, appointment of judges, conduct of proceedings, taking of evidence, secrecy, etc. The gist of the problem is found in Articles 1 and 2, which sought to turn states and private persons into partners and to make nationalization and its method contestable in law. (As articulated in the Draft, the parties agree to submit to the Arbitral Tribunal as provided for herein or to The Hague International Court any dispute that may arise between states and private persons from any unreasonable or discriminative state action affecting foreign investment and property.) The two fora were to be optional. To relax the above provision the Draft stated that local remedies must have been exhausted before recourse was had to either international forum. Should the parties accept this system of fora for the settlement of disputes, the draft agreement would then go far to respect international law and the principle of *pacta sunt servanda* as it stated that, with regard to the applicable law, the Arbitral Tribunal was bound in every respect to the contract of the parties provided that it was not contrary to international law. If the parties disagreed on the applicable law, the Arbitral Tribunal must apply the relevant international conventions, usages, general principles of law accepted by civilized nations, judicial practice, and scientific tenets.

So many phrases almost so many moot points, a reason why the resolution in question stated that the draft agreement needed to be considered further. The main objectives were rather clear, and neither the Draft nor the views supporting it tried to conceal them, as it appears from, e.g., the motivation that recourse to the international forum should be open to foreign investors, too, in order for such legal disputes to be thus "depoliticized" so far as possible.

The British international jurist Lauterpacht argued that there had been legal disputes between private persons and states before, and at the fora of third states at that, but agreed with the proposition of Halfina of the Soviet Union that the existing international judicial forum (The Hague International Court) was also suitable for the settlement of such disputes. Again Schwarzenberger pointed out that even in the memorable serious dispute between the British-Iranian Oil Company and Iran the relevant agreement left scope for invoking the competence of The Hague International Court, indeed that and nothing more. Seidl-Hohenfeldern of Austria, who submitted the Draft, argued along the same line, saying that private persons were free to refer a case to the Commission for the Protection of Human Rights in Strasbourg, it being thus a known international legal mechanism which enabled nationals (private persons) to sue states as such.

The arguments advanced by the British and German working parties were meant to bring an influence to bear on the Conference by relying in a theoretical approach, along with references to agreements in compensation between socialist and capitalist states, starting from the thesis of Stammler that *das Recht ist die Form, die Wirtschaft der Inhalt des gesellschaftlichen Lebens* (Law is the form, and

the economy the substance, of social life), which was claimed to be particularly true of foreign investments and hence implied the need for an adequate legal *quid pro quo* to foreign investment (i.e., protection from expropriation) or else Stamm-ler's thesis of legal philosophy did not work. Reference was also made to violation of sovereignty, claiming that by nationalization on its own territory a foreign state sought acquisition of ownership on assets belonging to nationalized enterprises in a third state, namely to take them away from the foreign owner, which was equal to intervention in the property regime and ultimately the sovereignty of the state of *rei sitae*.

The American advocates of the Draft (J. N. Hyde, N. R. Doman, C. J. Olmstead) felt that the developing countries had an interest in such a legal solution as they, rather than the socialist countries, were interested in investments at the time and were certain to realize, as it were, the need for some protection to be accorded to capitalist private investors as well; that the investors in socialist countries were the states and the already known international legal mechanisms and fora for the settlement of investment disputes were available to them as indisputable subjects at international law, while financial resources from capitalist countries flowed through private investors, who could not be caused to become states when seeking protection. It was further argued that if no international legal mechanism were adopted and expropriation were left under the exclusive control of domestic law, room would be allowed for the states concerned to virtually take the law into their own hands. It would therefore be necessary to start from the premise that the international flow of investment resources, just like watercourses, should not be controlled solely by domestic law; domestic law was entwined with elements of international law, and a combination of the two would constitute the code of law to govern the set of problems involved.

The opponents and counterarguments, relying chiefly on the position of socialist jurisprudence, represented a posture of critical negation in respect to most of the above arguments.

As regards, e.g., the "depoliticization", through the proposed international forum and legal mechanism, of disputes about nationalization, emphasis was laid on its self-contradictory nature. It is common knowledge that in most of the countries where nationalizations took place this question became a political one of the highest importance, nationalization being for the most part a significant benchmark in the political struggle. Seen against this background, attempts at depoliticization were viewed, in point of fact, as negative political action against nationalization.

In connection with the British-Iranian oil dispute between 1951 and 1954 the existing agreement was also commonly known to include a clause on dispute settlement through arbitration, but no recourse was had to it and, despite British insistence, Iran refused to submit itself to a decision of The Hague International Court. As can be seen, that was not a pertinent argument in favour of the ILA Draft, but rather one against it, the opponents asserted.

The arguments pro and con continued, even after the discussants had pointed out the political nature of nationalization as illustrated also by the example of Iran. Knapp of Czechoslovakia contended that the fullness of the recipient state's sovereignty included the right to be free from any external restriction in economic policy actions, and Kalensky, also of Czechoslovakia, added that there was no in-

ternational legislation on the protection of private property, which was not an inborn right of anyone, but depended entirely on economic and legal developments in each particular country, and that the dominant trend was that of complete decolonization in this respect. Both Kalensky and Halfina of the Soviet Union marshalled the argument that private persons could not be subjects at international law and that no effort should be made to create that status by way of international agreement. The reference to "civilized nations" (namely the claim that in the absence of a law stipulated or otherwise applicable settlement would be governed by legal principles accepted by "civilized nations") was challenged by Réczei, asserting it was likely to lead to arbitrary judicial awards and political discrimination, for the judge would be guided by his own criteria in considering this or that country to be "civilized", according as he thought its law was more or less favourable, although no country could be regarded as uncivilized any more. In its memorandum to the International Law Association the Soviet Union enumerated a series of British-American judgements in evidence of the fact that nationalization was a recognized institution even in the West and formed part of state sovereignty.

It can be seen that representatives of socialist countries argued very much in favour of nationalization, ignoring the fact that what the Draft envisaged was voluntary submission to arbitration anyway and the whole debate about the question was consequently beside the point. And today it would be easy, but unjust, to blame them for failing to realize at the time that even socialist countries were some day to endorse an arrangement for dispute settlement under which foreign private persons would be allowed to take action against states under international law.

It is interesting to note that during the debate the delegate of Egypt (El-Erian) representing the truly interested states was not opposed, in principle, to the Draft, starting from the proposition that the suggested mechanism for arbitration was to be optional and did not as such restrict states in taking measures for nationalization either. He saw no problem in that nationalization without compensation was placed by the Draft, directly, or indirectly, under an anathema in international law. Moreover, he recognized the need for some arrangement regarding state responsibility for damage caused to owners of foreign assets situated on the territory of a state and considered it to be a "legitimate" aspiration to create appropriate legal sources covering cases of this nature. There is little doubt that his position was also motivated by an intent to encourage investments expected from abroad, because nationalization as a right of the sovereign was not called into question. Also, Bartos of Yugoslavia adopted a similar position of principle in saying that the arbitration mechanism provided for in the Draft was not contrary to the fullness of sovereignty as it was to function as an optional recourse.

In 1962, ILA submitted the Draft to the Brussels Conference for further consideration, but the Hamburg text of 1960 had not been revised except perhaps for the omission of the compulsory acceptance of the jurisdiction of The Hague International Court. After not much debate the result of the vote was 75 to 15, with 5 abstentions, enough to carry the resolution to the Diplomatic Conference in The Hague. The resolution recognized arbitration as a means of protecting the property of foreign private persons and enforcing the fulfilment of contracts (for foreign investment between states and private persons).

However, the Draft was not, even in this second version, submitted to the Diplomatic Conference and did not become an agreement in force.

(b) The problem and idea of providing some institutionalized legal guarantee for capital-exporting countries, primarily capitalist investors, were raised through other channels as well, indeed at large banking institutions which were real interested parties *a priori*. The legal instrument drawn up by them is known as the Abs-Schawcross Draft of 1959, "Abs" standing for the Managing Director of Deutsche Bank, who was regarded in American financial quarters as the greatest financial expert of the western world.

As for its substance, the Abs-Schawcross Draft contained the following main provisions: the property of nationals and subjects at law of foreign states needed fair and equitable treatment; the property of foreign nationals must not be subject to unreasonable and discriminative measures; as worded in particularly strong language, there must be no exception to the spirit and provisions of the Draft (Art. 5); for any eventual exception to be made thereto states may only invoke a state of war, being victim to acts of hostility of threatened by an emergency of different nature; and, as a culminating point, expropriation or nationalization effected even under such circumstances must not be without full compensation, with states to guarantee due process of law to that end, under a procedure for submission by recipient states of disputes to the forum of arbitration as provided for in the Annex to the Draft.

It is clear without a detailed analysis of these and other provisions that the concept of the Draft was even more capital-oriented than the ILA concept had been, and it did not have much success either. Even the western press admitted that the Draft was, despite repeated attempts, impossible to save for international law because, among other things, it relied on, and was conceived in the context of, conservative measures and legal solutions all too known from previous periods. For all these reasons the Abs-Schawcross Draft did not but offer another lesson and represented a further stage in the effort towards a more "acceptable" instrument.¹⁵ Such an instrument was to be the Washington Convention we shall discuss in para. 12 below.

(c) The new and "harder" OECD Draft was elaborated to offset the "softness" of the Washington Convention, which was more liberal and of a new spirit. The latter was seen by many as being one of a completely procedural nature, much too free from restrictions, and providing, after all, no sufficient guarantee in substantive law for the protection of foreign investment of foreign property. It was, therefore, felt necessary to return to the idea of an international agreement in the nature of substantive law similar to the Abs-Schawcross or the ILA Draft. Such an attempt was made by OECD, which, strongly influenced by the advanced market-economy countries, prepared and published in 1967 its Draft on the "protection of foreign property" (the phrasing itself not being a mere accident). OECD, too, had the feeling that it had set out on an enterprise that was not to be too promising. Although the Federal Republic of Germany, which reluctantly undertook to submit the Draft, presented to the OECD a thoroughly modified and face-lifted one, everyone knew it was in attempt to revive the Abs-Schawcross Draft and that the result was also likely to be the same, namely, general abstention. However, the

¹⁵ Schwarzenberger: *op. cit.*, p. 137.

trouble with the new initiative was not only in its being essentially an attempt at reviving the Abs-Schawcross Draft, but also in drawing criticisms for obscurity and occasional gaps. Nor did it become an international agreement either.¹⁶

12. It is noteworthy that the above multilateral draft agreements for the protection of foreign investments met with strong opposition in general and could not count upon acceptance by developing and socialist countries, but that the interests of the advanced capitalist countries strove for some system of protection, while some reasonable arrangement was sought by other countries as well. In 1965, the International Bank for Reconstruction and Development (World Bank) elaborated the Washington Convention on the "Settlement of Investment Disputes between States and Nationals of Other States". With its few rigid restrictions, its liberal flexibility and no prohibitive substantive-law provisions on nationalization, and its pursuance of the Bretton Woods spirit, the Washington Convention could hope *ab initio* for more success than its aforementioned predecessors. Securing as it did a minimum level of investment protection under procedural law, the Convention, which offered dispute settlement only at request, became over time a common denominator between states often having adverse interests. It was ratified by nearly 100 states (mostly developed market economy, but also many developing countries), and Hungary, too, acceded to it recently.¹⁷ Thus it became a living law and an important instrument of investment protection in the socialist legal thinking and practice of Hungary as well. This is an added reason for its fuller discussion here. Therefore, and in view of the interrelationships involved, it is worthwhile to mention at this juncture that several bilateral agreements of Hungary in investment protection are clearly based on the Washington Convention, as will be discussed in Section 7 below, in so far as they place disputes under the control of its rules in general. Such bilateral agreements turn the Washington Convention into a law of directly mandatory application (by Hungary, too), while in other cases the Convention operates on the basis of voluntary submission thereto (for a fuller discussion see subparagraph /b/ hereunder).

Otherwise the Convention is open for signature by World Bank member states and, subject to specified conditions, by any other state party to the Statute of the International Court of Justice (Art. 67.).

(a) The Convention set up an International Centre for Settlement of Investment Disputes (hereafter referred to as the Centre) with headquarters at the principal office of the World Bank (Art. 1.). The Centre establishes an Administrative Council and a Secretariat and attends to the nomination of persons to be invited to act as conciliators or arbitrators sitting in a "panel" (Art. 3.). As it follows from the foregoing, the Convention opens two channels for the accommodation of conflicting interests, subject to agreement between the parties to a dispute: (i) a conciliation commission seeking clarification of legal matters and mutually acceptable agreement between the parties (Art. 34.); and (ii) an alternative arbitral procedure with a consequential award having binding force on the parties and even the Contracting States (Art 53.).

The Convention, which may also be regarded as a kind of international code of

¹⁶ *Ibid*: p. 153.

¹⁷ For Law-Decree no. 27 of 1987 promulgating the Convention on the Settlement of Investment Disputes between States and Nationals of Other States, done at Washington on March 18, 1965. see *Magyar Közlöny*, 1987/66.

procedure in respect to investment disputes, covers and regulates the designation of proceeding persons (conciliators/arbitrators), the stages of proceedings, the conditions for handing down judgements and the availability of legal remedy. However, in addition to this highly important set of questions, it devotes particular attention to conflicts-of-law problems such as jurisdiction, determination of the applicable law or the recognition and enforcement of awards. Considering that the special difficulties of dispute settlement in international legal relationships emerge chiefly in this respect, it is not accidental that the majority of painful practical problems likewise have their roots in this same domain.

(b) The definition of central jurisdiction established by the Convention calls for a thorough analysis of the scope of the Convention as to persons and objects. It is practicable to begin with making some statements from a negative approach. Not covered by the Convention are not conflicts of interests between states, because disputes arising between Contracting Parties in connection with the interpretation or application of the Convention and insusceptible of settlement by way of negotiations must be referred, at the request of either party (i.e., state) to the International Court of Justice (Art. 64.). Thus, on the one hand, such conflicts, specifically in the nature of public law, between sovereign parties to the Convention are not decided by the fora (conciliation commission/arbitral tribunal) thereof. On the other hand, investment disputes between private persons (physical or juristic) are also outside the scope of the Convention, because cases governed by classical private and commercial law are to be submitted to ordinary courts or mainly to arbitral tribunals attached to chambers of commerce. The above cases not covered by the Convention are, *argumentum a contrario*, excluded by the rules on jurisdiction, which provide that the jurisdiction of the Centre must extend "to any legal dispute arising directly out of an investment, between a Contracting State (or any constituent subdivision or agency of a Contracting State designated to the Centre by that state) and a national of another Contracting State, which the parties to the dispute consent in writing to submit to the Centre. When the parties have given their consent, no party may withdraw its consent unilaterally". As can be seen, like its predecessors with more moderate success,¹⁸ this Convention offers its procedural rules for the settlement of conflicts of the most complex nature, of differences between a recipient state and a foreign private investor. The complexity and sensitivity of disputes stem mainly from the fact that, as often, the state appears as "economic-commercial political power" in legal relationships of this kind, with its contradictory personality spinning the threads of public and private law into a web hard to untangle.

The many times conditional nature of jurisdiction can also be explained by the presence of the state as "litigant". The accession to the Convention by the state party to the dispute and by the other state of which the investor is a national is a prerequisite (though not sufficient) for the fora of the Convention dealing with the case. However, either at the adoption of the Convention or at any time thereafter, states may make reservations removing from the Centre's jurisdiction a narrower or wider range of investment disputes (para. 4 of Art. 25.). Furthermore, as is particularly stressed in the Preamble to the Convention, jurisdiction is ultimately based in the parties' declaration of its acceptance in a concrete matter.

¹⁸ See § 4 (1).

Procedural jurisdiction based on the parties' autonomy of will thus results in an elastic jurisdiction with a changing scope, narrowing or widening case by case. Yet a guarantee for the success of the Convention laid undoubtedly in the small degree of the normative potential of regulation, as it allowed states holding opposing views and representing conflicting interests to show goodwill toward investors by undertaking a minimum of obligations.

The parties' freedom is, in effect, restricted by only one provision under which an agreement of the parties to submit their case to the Centre's jurisdiction must not be withdrawn unilaterally by either party (para. 1 of Art. 25.). It was precisely the interpretation of this rule that became a key problem in numerous litigations, such as the *Alcoa Minerals of Jamaica v. Government of Jamaica* case.¹⁹ In 1968 the above-mentioned American firm concluded with Jamaica a long-term contract of concessions for the mining of bauxite and the production of aluminium. In the basic contract the parties expressly submitted any dispute to arbitral procedure under the Washington Convention, but after the lapse of a few years, immediately before the adoption of the Bauxite Act effecting a radical change in the economic environment, the Government of Jamaica modified its original declaration of accession and communicated to the International Centre for Settlement of Investment Disputes a reservation removing investment disputes arising in connection with the mining and processing of minerals from the jurisdiction of the Centre. Under Art. 25, para. 4, of the Convention, states have the right, in theory, to take such action at any time. In the concrete case, however, when the foreign firm—invoking the irrevocable contractual agreement on submission to jurisdiction and an approximately tenfold increase in tax burdens—resorted to the arbitral tribunal of the Convention, Jamaica challenged the jurisdiction of that forum on plea of its reservation made subsequent to its accession.

Like the ocean in a drag, that dispute is well illustrative of the contradictions arising out of the economic activity of a state. Seen from the investor's angle, surrounding the agreement with private-law guarantees (e.g., irrevocability of the clause on jurisdiction) is useless and hence a risk factor, because his commercial partner is a sovereign power, which may, by means of public law (see modification of the legal system, making of a reservation concerning the Washington Convention) get rid of its burdensome obligations. On the other hand, states would see an abridgement of their sovereignty in any restriction on their freedom of action.

To come back to our example, we must note that the arbitral tribunal rejected the objection of the Government of Jamaica, keeping in view the principle of *pacta sunt servanda* and the integrity and operation of the Washington Convention. Accordingly, it declared the state's subsequent declaration of reservation to be null and void and upheld the former agreement between the parties. In other words, in the tribunal's interpretation, the irrevocability of submission to jurisdiction enjoys priority over the possibility of making reservations, and, although the decision's purity in terms of legal dogmatics is contestable, we must agree with the tribunal in that a different decision would have stripped the Convention of most, if not all, of its practical values.²⁰

¹⁹ "Alcoa Minerals of Jamaica, Inc. (USA) v. Government of Jamaica." *Yearbook Commercial Arbitration*, Volume IV, Deventer/The Netherlands, 1979, pp. 206–209.

²⁰ "Would largely, if not wholly deprive the Convention of any practical value"; see fn. 3, p. 208.

To follow up on the dilemmas posed by practice, it appears necessary to deal also with the definition of the term "juridical person of the other Contracting State", another element of the Convention's rule on jurisdiction. The question arises from the fact that host states often expect foreign investors to carry out their activity in form of a "domestic" undertaking, one established in accordance with the law of the recipient country. Not infrequently, this arrangement affords appreciable benefits to foreign working capital as well. There is no doubt that such undertakings are deemed to be inlanders from a legal-technical point of view, yet the foreign capital invested would also lay claim to devices of international investment protection such as the procedure provided for in the Convention. If the viewpoints of foreign capital and management were not taken into account, a significant part of foreign investments would fall outside the scope of protection under the Convention, but if they are, foreign investments stand to gain, as it were, dual nationality, since they will be considered inlanders in general, but aliens for purposes of protection. The question, therefore, arises whether the personal statute of a legal entity depends exclusively on its attachment to the state in question or is, in certain cases, also determined by the nationality of owners (e.g., shareholders). In the 20th century this question has been formulated in the United States by the so-called control theory, though with a different sign, i.e., in an effort to secure strict control over, and to place restrictions on, investments. During World War Two the Alien Property Custodian Authority was set up to exercise control over firms registered in the United States; it brought under strong financial and economic control the firms and rights in the United States of the juristic and physical persons of Germany and Japan at war with the USA. In our case, however, this old theory is fortunately filled with a positive substance, emphasizing the economic role of foreign owners mainly with a view to obtaining wider guarantees.

The Washington Convention regulates this set of problems by the so-called "foreign clause exception", an optional device extending the scope of the Convention to any juridical person which, though it is a national of the state party to the dispute, the parties have agreed, because of foreign control, should be treated as a national of another Contracting State for the purposes of the Convention (para. 2, subparagraph /b/, of Art. 25.). Since the Convention offers rather than prescribes this arrangement, it makes concrete decision subject to agreement between the parties; in case of disputes, it is for the arbitral tribunal to ascertain the intent of, and the existence of an eventual agreement between the litigants, all the more so since the Convention is silent on the formal requisites for giving the above-mentioned consent. Consequently, under the existing practice, which does not form a *stare decisis* system, it merely provides orientation towards future arrangements: a simple, formal agreement of the parties is sufficient for the establishment of jurisdiction over domestic firms set up with the participation of foreign capital.²¹ As a general rule, however, such agreement must be express; implied agreement is to be recognized in exceptional cases only.²²

Obviously in view of its complex and varied meaning, the concept of investment

²¹ Szasz: "A Practical Guide to the Convention on the Settlement of Investment Disputes.", see *Cornell International Law Journal*, quoted by *Yearbook Commercial Arbitration*, Volume X, Deventer/The Netherlands, 1985, p. 76.

²² "Holiday Inns v. Morocco." *Yearbook Commercial Arbitration*, Volume X, 1985, Deventer/The Netherlands, p. 77.

is not defined by the Washington Convention, which uses a single adjective (in the Preamble) to refer to the role of international private investments in economic development. However, if it has a normative force at all as a preambular provision, this term excludes from the scope of the Convention only the economic activity of sovereigns considered as alienes (in the recipient state) in accordance with the rules on jurisdiction (Art. 25.). This statement is of relevance to state enterprises, namely to answering the question of whether the jurisdiction of the International Centre for Settlement of Investment Disputes extends, with other conditions prevailing, to state enterprises of another state. The answer can only be affirmative, since Art 25., in defining the attributes of the Centre, refers to "juridical persons" in general, a status which, required of subjects at law, is possessed by state enterprises as well, whereas the separation, or independence of the state and its enterprises in the domain of international economic relations as a whole has been spelled out, even in respect to socialist countries, by numerous court judgements over the past decades, in parallel with the retreat of the *alter ego* theory, which stated the contrary.²³ The foregoing becomes of practical relevance by reason of the fact that, as is also pointed out in this study, profitable capital export is, along with the import of working capital, a condition for the economic growth of Hungary. The possibility of the former is bolstered by Hungary's accession to the Washington Convention, which not only involved assumption of obligations, but also opened the way to increased protection for Hungarian investments abroad.

(c) Although the Washington Convention is originally concerned with questions of procedural law, its scope of application as to object embraces international investments, and, therefore, the pattern of legal relationships evolved by the gravity of the legal systems of several states required the Convention to cover another basic aspect of the law of conflicts, the definition of the applicable law, as it does in Art. 42., which reads in part as follows: "1) The Tribunal shall decide a dispute in accordance with such rules of law as may be agreed by the parties. In the absence of such agreement, the Tribunal shall apply the law of the Contracting State party to the dispute (including its rules on the conflict of laws) and such rules of international law as may be applicable... 3) The provisions of para. 1)...shall not prejudice the power of the Tribunal to decide a dispute *ex aequo et bono* if the parties so agree". This Article thus recognizes three main options as a basis for a decision in substantive law: the law chosen by the parties (their autonomy being subject to no restriction in this case); the rules of equity (*ex aequo et bono*); and, in the absence of other provisions, the law of the Contracting (host) State party to the dispute. In the latter case, however, the rules of the national system of law are understood to include the *conflict-of-laws rules* of the "host State". Consequently *renvoi*, i.e., reference to another system of law, is regarded as permitted by the applicable law. So there is a possibility, at least in theory, that, owing to remission, an investment dispute may not be decided, in this case either, under the national system of law of the host state.

The picture is even more varied in light of the last sentence in para. 1 of Art. 42. expressing that the basis for deciding a dispute is provided by the law of the Contracting State together with the rules of international law as may be applicable. This "international law clause" raises several questions of interpretation in prac-

²³ For the theory and practice of *alter ego*, see fn. 1 (MádI), para. 29.

tice. Thus, for instance, this enigmatic provision fails to define the concept of international law and its position even in respect to investment disputes, so states tend to see the legislative instruments of international law as well as its usages, already very difficult to reconstruct, in the context of the rather diverse legal systems of their own.

The advanced market economy countries, projecting on the international domain the expropriation rules of their own legal systems based on the private property regime — lay claim to fair and equitable treatment in addition to non-discrimination and equality before the domestic law,²⁴ such treatment to include immediate compensation, appropriate and effective. On the other hand, the developing countries in the grip of various economic and political pressures are reluctant to recognize the absolute primacy of this principle and prefer to invoke the more permissive rules of the Charter of Economic Rights and Duties of States, adopted by the United Nations in 1974, which make the question of compensation subject to the provisions of domestic legal systems. Thus, willingly or unwillingly, the brief reference to international law has smuggled all dilemmas of international investment protection back into the articles of the Washington Convention, which otherwise seeks neutrality and consensus.

Such is the case all the more so, since Art. 42. of the Convention does not define the relationship between the applicable domestic law and the rules of international law as may be applicable. Is it that the "international law clause" merely seeks to supplement the law of the Contracting State party to the dispute, as if to fill eventual gaps therein, or tries to serve as a guide some kind of minimum protection in the world of extremely divergent and variable national systems of law? Can international law, despite its nature contradictory in itself, function as a kind of etalon, a stabilizing factor in the domain of investment protection? The arbitral tribunals established under the Convention have given affirmative answers to this question in numerous cases. Thus, for instance, in the *AGIP v. Government of the Popular Republic of the Congo* case the arbitrators found that although the constitution of the state party to the dispute made nationalization subject to no particular restriction, the reference of the Convention (and of the contract between the parties) to international law was sufficient for stating the irregular nature of the nationalization effected,²⁵ which is to say that the government was under obligation to pay fair compensation to the contractor injured. It would be impossible not to mention on this score that while the socialist countries previously shared the reluctance of developing countries to interpret compensation required under due process as being deniable under international law, their more recent international legal instruments postulate due process and appropriate compensation as norms to be observed (see *infra* Section 7 on bilateral agreements concerning investment protection).

(d) The cases analyzed in the course of interpreting the Washington Convention on the settlement of investment disputes were concerned mostly with questions of private international law such as the irrevocability of consent to jurisdic-

²⁴ Martonyi: "A külföldi beruházások jogi kérdései." (Legal Questions of Foreign Investments), *Külgazdaság*, 1987/8, Vol. XXXI, pp. 113—122.

²⁵ "AGIP Company SpA (Italy) v. Government of the Popular Republic of the Congo." *Yearbook Commercial Arbitration*, Volume VIII, Deventer/The Netherlands, 1983, pp. 133—143.

tion, the personal statute of foreign capital operating in the form of domestic legal entity, and the applicability of international law. However, this group of matters are linked together not only by an identical point of departure in the law of conflicts, but also by a common endeavour of the proceeding arbitral tribunals, namely their recurring intent to add the method of judicial interpretation to the valuable, but originally limited means of protection provided by the Convention, which was born in the context of opposing political interests. It is certain that the motives for decisions can be provided not only by the influence exercised on the mentality of arbitrators by this or that system of law, but mainly by the realization that the most effective protection possible of entrepreneurs is one of the chief guarantees for a smooth process of international investment. It appears that the need for such protection not only led to the adoption of the Washington Convention, but also gave its provisions a substance that has significance far beyond the narrow range of procedural devices envisaged.

13. In chronological order, the next multilateral instruments of a normative character are the Declaration on the Establishment of a New International Economic Order and the Charter of Economic Rights and Duties of States, both adopted by the United Nations in 1974. As is known, both instruments are General Assembly resolutions and as such are not considered to be sources of international law in the classical sense, to be compulsory norms in the legal – technical meaning of the term, but they express the views held by the family of nations on questions specifically enumerated in the relevant (norm-like) resolutions. By virtue of their form and content they add much to the influence brought to bear on national and international legislation as well as in legal practice. Since they affect the legal status of investments, too, they deserve a brief discussion at this juncture by way of indicating a modern approach to this evidently broad spectrum of political interrelationships and the substance of compromise it was possible to reach between North and South as well as East and West.

These instruments of the United Nations formulate in essence a general economic policy programme for the establishment of a new international economic order (particularly for the advancement of developing countries) and a general system of legal thinking adequate to it. Among the main elements thereof they refer to the sovereign right of each state to exercise control over its natural resources and their exploitation with means suitable to its own situation, such control extending to all economic activities in their territories. Accordingly, the rights of each state include “the right to nationalization or transfer of ownership to its nationals, this right being an expression of the full permanent sovereignty of the state”, the Declaration reads. This naturally applies (also) to foreign investment, expressing one aspect of the questions under discussion here, namely that, as against the rationale for the protection of foreign investment, states have the sovereign, or “inalienable” right (as the text reads, meaning that it is not subject to restriction without their consent or against their will) to freely exercise authority over their internal economic order. What is, then, the status of investment protection, which is largely intended to devise a mechanism precisely for protection from nationalization? In this scenario of thesis and antithesis (another element of which is the sovereign right of states to leave scope, at discretion, for the operation of foreign capital as well, with a set of legal conditions to be created therefore, the synthesis (however, esoteric, but still and expectation of a normative character

embracing investment protection, too) is devised by the aforementioned Charter in para 2, subparagraph (c), of Art. 2., which contains the following provisions: 1) each State has the sovereign right to nationalize foreign property; 2) but in case of nationalization "appropriate compensation should be paid"; 3) taking into account the relevant laws and regulations of the nationalizing State and all circumstances considered pertinent; 4) a controversy should be settled by the fora of the nationalizing State under the domestic law; 5) unless the States concerned mutually agree to seek other peaceful means of settlement.²⁶

This is clear: first, each state is entitled freely to choose its economic system, including nationalization; secondly, foreign investment is accepted for internal development and effective international economic cooperation; thirdly, in case of nationalization, appropriate compensation is a desirable means of investment protection; and fourthly, the states concerned will act in this respect in accordance with the domestic law and parallel international legislation. These points can be said to constitute, in effect, the theses which have appeared, with a chance of success and operate effectively, in the various international and domestic systems of normative regulation discussed above and to be dealt with below.

14. The Multilateral Investment Guarantee Agency (MIGA), established by an international agreement in Seoul in 1985, has added a new colour and a new actor to the stage of investment protection. As will be discussed extensively in Section 9, protection against political and other risks to foreign investment by means of the law and insurance practice (contract of insurance, taking out an insurance policy, and payment of insurance charges) is no novelty; its history goes back to 1985, but what is new is the creation of an international agency to strengthen insurance as an institution of protection. Its novelty is in its emergence within the framework of the World Bank and as worldwide institution to have regard for the interests of developing countries (in general and as recipients). Another new feature is the endeavour to promote capital flows to countries deficient in funds through investment protection and in other forms. Finally, a fundamentally new element—compared with the multilateral systems in investment protection discussed above as well as with the regional and bilateral arrangements to be considered below—consists in that this arrangement, rather than encouraging the investor by promising subsequent compensation and offering a legal mechanism for fulfilling such a promise, provides for depositing in his hand in advance a letter of guarantee that can be turned into ready cash in compensation for eventual damage (entitling the investor to claim an amount of damages), as though giving with it a few assets of invested property and saying, "go and invest, and should you still lose your money, here you have the same amount for cover". Needless to say that under a well-devised insurance mechanism the "normative potential" of an insurance contract, or its guarantee-creating force is much greater than that of a promise of investment protection under any international convention, however well elaborated.

(a) The history of the making of MIGA can be summed up, with reference to

²⁶ UN Charter of Economic Rights and Duties of States (adopted by the General Assembly, Twenty-ninth Session, 3281-XXIX, 1974), Articles 1 and 2.

sources,²⁷ as follows. The idea to facilitate and intensify, also through an international insurance agency, the flow of investment capacities, chiefly to developing countries, emerged at several fora, including the World Bank, as far back as the early 1960s. In the early 1980s, after many abortive initiatives, the matter came to be tackled by the World Bank in a more definitive way. With much expenditure of energy and after consultations with numerous fora, the Draft Convention establishing MIGA was elaborated in the Bank's Committee of the Whole at scores of meetings by September 1985 and was approved by the Board of Governors at its annual ordinary session in Seoul on October 11, 1985 on the understanding that the Board would invite the member states and the Government of Switzerland to sign the Convention so as to open it for ratification. The conditions for the entry into force of the Convention are specified by Art. 61. as follows: 5 instruments of ratification deposited on behalf of signatory states in Category One (advanced market economy countries) and 15 such instruments deposited in behalf of signatory states in Category Two (all other members of the World Bank), provided that total subscriptions of these states amount to at least one-third of the authorized capital of the Agency, which must be one billion (exactly 1.028 billion) dollars as specified in Art. 5. Signature and ratification proceeded at a pace much quicker than customary, signalling the great interest of states in MIGA. By the end of 1987, the Convention was signed by 50 developing and 12 advanced countries, of which 20 (exactly 5 advanced and 15 developing) countries had also ratified it by that time, but subscriptions did not yet amount to one-third of the authorized capital stock (about 360 million dollars). In the first months of 1988, however, the Convention was ratified also by the United States (subscribing a quota of \$ 205.19 million) and Great Britain (subscribing a quota of \$ 48.6 million), a number of additional developing countries acceded to it, and several others are on the verge of ratifying it.²⁸ The essential point is that the MIGA Convention has entered into force, and MIGA becoming a reality is a matter of days. In accordance with Art. 62, the President of the World Bank must call the inaugural meeting of the MIGA Council (representatives of the acceding states) within 60 days from the entering into force of the Convention. That meeting is empowered to decide on the elaboration of additional instruments governing MIGA's operation (by-laws, policy rules and regulations) and such other measures (e.g., election of the Board of Directors) as are necessary for the Agency to start actual operations. With these conditions met, MIGA has started operations.

(b) MIGA is seeking to attain its aforementioned general objective under a two-fold strategic approach.

(aa) The first approach is that of guaranteeing foreign investments under favourable terms against non-commercial risks. The main aspects of this arrangement are the following.

(i) The possible scope of covered risks is clearly defined as including 1) state re-

²⁷ Shihata: *MIGA and Foreign Investment*. Nijhoff Publishers, Dordrecht—Boston—Lancaster, 1988, pp. 61 *et seq.* ("The Making of MIGA"); as Vice-President and senior jurist of the World Bank, the author played a leading role in the elaboration of the MIGA Convention and its planned strategy. His work is a complex manual of MIGA.

²⁸ For figures, see Shihata (fn. 27), pp. 98—99; Löke, András: "A védelem a szó — Új nemzetközi beruházásbiztosítási ügynökség." (A New International Investment Guarantee Agency Established to Provide Protection), *HVG*, June 11, 1988, p. 15.

strictions on currency transfer; 2) nationalization and similar measures; 3) "repudiation risk", i.e., repudiation by the host country of a contract with the investor, when the holder of a guarantee receives no legal protection and does not have recourse to a judicial forum to determine his lawful claim; 4) war, armed conflict, civil disturbance; 5) extension by the Board of coverage to other risks upon the joint application of the host country and the investor (Art. 11.).

(ii) Eligible investments are made subject by Art. 12. to several conditions such as these: investments may include capital transfer, in monetary form or in kind, necessary (proprietary) share in capital, short- and long-term loan guaranteed by the investor in the enterprise concerned and such other forms of direct investment as may be determined by the Board;²⁹ an investment must be economically sound and contribute, in the Agency's judgement, to the economic development of the host country; investments must comply with the host country's relevant laws and regulations, including the availability of equitable treatment and legal protection, and be consistent with the priorities of the host country.

(iii) Investors eligible to receive the Agency's guarantee may be juridical persons incorporated in a member state other than the host country, whether or not privately owned, and operating on a commercial basis, and natural persons who are not nationals of the host country. However, exceptions may be allowed in favour of nationals of the host country and of juridical persons incorporated in that country, if the assets invested are transferred from outside the host country.

(iv) Investments may be guaranteed by MIGA only if they are to be made in the territory of states in Category Two (usually developing countries under this scheme) (Art. 14.),³⁰ and only after host government has approved such guarantee against the risks designated for cover (Art. 15.).

(v) The terms and conditions of contracts of guarantee are determined by MIGA's general conditions (rules and regulations),³¹ and contracts of guarantee must be approved by the Agency's President (Art. 16.).

(vi) The right of the Agency's subrogation is recognized by member states. This means that upon paying compensation to the investor under a contract of guarantee MIGA is subrogated to such claims as the holder of a guarantee (investor) may have had to the guaranteed investment under the law of the host country (Art. 18.).

(bb) The other strategic thrust of the MIGA arrangement for attaining the general objective is general investment promotion (Art. 23.), which may assume various aspects in actual operations, such as collection and flow of information and knowledge concerning the opportunities and conditions for and the modalities of investment; efforts to remove impediments to investment; cooperation with national and international agencies concerned with facilitating investment, partic-

²⁹ For more detail, see Shihata (fn. 27), pp. 115—116.

³⁰ The developing countries to receive preferential treatment in Category Two are listed in Schedule A annexed to the Convention. Category One includes all advanced capitalist countries totalling 21. Listed in Category Two are the other (128) members of the World Bank, including Hungary and an additional 12 socialist countries. Newly acceding states are classified by the MIGA Council, which is also empowered to modify classifications (Shihata, 121—122).

³¹ It is planned that the annual charge of insurance against any of the four types or risk under Art. 11 (see para. 14 /b/, aa /i/) will be 0.3 to 1.5 percent, while that of a package insurance covering all four types of risk will be relatively less (0.6 to 6 percent) (Shihata (fn. 27), 1968—1969).

ularly the International Finance Corporation, of which Hungary is also a member within the framework of the World Bank; provision, on the request of a member, of technical advice and assistance and organization of investment missions (conferences, consultative programmes) for the elaboration of national investment strategies; promotional efforts and devising regulatory systems of internal and bilateral investment protection; etc.

(c) In respect of resources — apart from the general promotional efforts just discussed, the means of which vary by the nature of programmes and call for the mobilization of the Agency's personnel capacities — MIGA relies basically on its authorized capital and receipts (insurance charges) and reinsurance schemes (Articles 19. and 20.). The initial aggregate amount of contingent liabilities may not exceed 150 percent of the amount of the Agency's subscribed capital stock plus reserves (receipts) and reinsurance cover. From time to time, the Agency's Council may decide to increase such maximum amount not more than five times its subscribed capital (Art. 22.). If the total subscriptions plus other available assets amount to, say, 2 billion dollars, the total value of contingent liabilities which may be assumed by the Agency may increase to 10 billion dollars. However, the subscribed capital and reserves are calculated by MIGA to rise considerably over the years, while 10 billion dollars are already allowing the assurance of 1000 (!) investments worth 10 million dollars each. Accordingly MIGA may supplement its own resources with those of the Sponsorship Trust Fund; under sponsorship arrangements member states make available and assume insurance cover, and MIGA concludes contracts of guarantee with sponsoring members in favour of investors (Art. 24., Annex I). MIGA's capacity to assume investment guarantees under such arrangements will evidently increase, probably in excess of the above figures.

(d) In respect of its status, MIGA is independent of the World Bank legally and financially, or materially (Articles 4 to 9, 25 to 29, 30 to 37), although it links up with it, as is manifest in its process of establishment (see para. 14/a above) and in that its Board of Directors is chaired by the President of the World Bank (Art. 32.), etc. In accordance with its constitutional order as defined in the Articles referred to above, MIGA is an independent entity operating under a separate mechanism (Council, Board, administration, office) and exercising functions and powers determined by the Convention. The principal office of MIGA is located in Washington (Art. 36.).

Membership in MIGA is open to World Bank member states and Switzerland, subject to ratification of the Convention in accordance with their constitutional procedures (Art. 61.).

The Council, vested with powers to decide on questions of strategy, consists of Governors designated by member states, each designating one Governor. The Council selects one of the Governors as Chairman (Articles 30 and 31).

The Board of Directors, composed of not less than 12 members, is responsible for the general operations of MIGA, and its Chairman is the President of the World Bank (Art. 32, Schedule B).

The President of MIGA is appointed by the Board on the nomination of its Chairman. He conducts the operative business of the Agency and is responsible for the organization, appointment and dismissal of the staff (Art. 33.).

The core and substance of the detailed regulations on the decision-making

mechanism is that the principal share-holders well-provided with capital (advanced market economy countries in Category One) should not have, through their shares of stock, majority voting power over the others. Therefore, within the first three years, for instance, all decisions of the Council and Board must be taken by special majority or, in specified cases, by a higher majority (Articles 39 to 42).

(e) The authorized capital stock of MIGA is constituted by member states' subscription and payment of shares. The quotas payable by members are determined by Schedule A and consist of 1 billion special drawing rights, each unit having a value of 1.082 US dollars. The Council may, by special majority, increase the capital stock, which is divided into 100.000 shares, each having the same par value (Art. 5.). The number of authorized shares to be subscribed by members (each of the 21 advanced market economy and 128 other countries members of the World Bank) is determined by Schedule A, such shares representing 59.473 percent of the total for the advanced countries and 40.427 percent for the other countries (e.g., 20.519 percent, or 205.19 million units for the United States; 0.775 percent or 7.75 million units for Austria; 0.564 percent, or 5.64 million units for Hungary). The members of the World Bank acceding to MIGA after October 30, 1987 may subscribe shares less than the number specified for them in Schedule A, but not less than 50 (Art. 6.), which involve 50x100,000, or 500,000 drawing rights or equivalent payments. The payment of subscriptions is due within 90 days from the date of accession 10 percent to be paid in cash, an additional 10 percent in the form of securities (e.g., promissory notes), and the remaining 80 percent being subject to call by the Agency when required to meet its obligations (calls on any portion of unpaid subscriptions are uniform on all shares); payments by developing countries are to be made in their own currencies up to 25 percent of the paid-in cash portion of their subscriptions, all other payments to be effected in convertible currency; the liability of members is limited to the unpaid portion of the issue price (Articles 7 and 8).

(f) After all this it is naturally impossible not to inquire into the particular interests and considerations which prompted Hungary to take an active part in MIGA, with the first step taken by its accession to the Convention.^{31/a}

(i) MIGA has become a generally accepted, and may prove to be a useful, institution for Hungary's effective involvement in the flow of working capital now forming part of our economic strategy, not simply in respect of the external economy, but also of the entire national economy (namely the endeavour to catch up with the advanced capitalist countries).

(ii) Hungary became a member of the World Bank in order to secure an important channel for meeting capital and credit needs (it acceded to the International Monetary Fund and the World Bank in 1982 by Law-Decrees Nos 6 and 15 of 1982). As a member of the World Bank, it cooperated in the conclusion of the Convention establishing MIGA. By its participation in the two institutions it has expressed its endorsement of and support for more efficient flows of capital and investment capacity to developing and socialist countries, which are deficient in funds. In for a penny in for a pound. Our involvement may serve not only to increase our own capacity to receive capital, but also to contribute significantly to intensifying the provision of foreign assistance to developing countries.

^{31/a} Hungary acceded to the Convention in 1988.

(iii) Hungary's participation in the infrastructure underlying the regulatory mechanism of the world economy, notably in MIGA-type "logistic support" for foreign investments, and the Agency's highly promising operations serves to improve the country's international credit standing and to promote concrete investment transactions.

(iv) With its projected system of relations, MIGA links up and mobilizes various national and international investment efforts and protection schemes. Thus Hungary became, almost at once (*ipso facto* by accession), a party to a mechanism representing several times the potential of its own investment procedures and protection regimes.

(v) In the light of the foregoing, MIGA is capable not only of promoting myriads of investments worth 10 million dollars each (see para. 14/c above), but also considerably increasing, even severalfold, such capacity for protection and promotion, which may be expected to play a significant part in investment flows to Hungary. So long as our investment arrangements fail to provide sufficient security for foreign investors (e.g., Finnish investors see difficulty in that granting of mortgage on joint ventures necessary for the provision of proposed credits in unwieldy, albeit mortgage is needed and virtually available to make investment programmes feasible), it will be a great thing to tell our partners not to worry, but to come with the full amount of capital they seek to invest, because here we have various institutions of protection, particularly MIGA, of which we are also a member and which will guarantee, for an insurance charge of 1 or 2 percent, the investment against non-commercial risks. And, as it follows from para. 14/e above, all this costs Hungary about 0.5 million dollars, only 10 percent of which is payable in cash, involving a liability to be met in national currency up to as much as 25 percent of that amount.

(vi) It should also be noted that, in addition to the above financial obligations subject to such favourable terms, Hungary acquires a much more important right to participate in joint decisionmaking, to play a serious and responsible role in the formulation of MIGA's economic strategy.

§ 5. Regional systems of investment protection

15. Still on Europe, it may be stated that the agreements on investment protection as understood above did not assume a regional character partly because that role is played by the Washington Convention and MIGA in respect to Europe as well, partly because the system of protection in this continent can be regarded as complete with bilateral agreements on and internal mechanisms for protection. Nevertheless, to get the full picture of the system of investment protection, reference should be made to certain specific features of the European Economic Community and the Council of Mutual Economic Assistance.

EEC has to do with investment protection roughly in three planes.

(a) By the terms of Art. 222 of the Treaty of Rome, "this Treaty shall in no way prejudice the rules in Member States governing the system of property ownership", thus referring the protection of property, including investment, to the internal jurisdiction of members. On the other hand, considering that the property regime of the EEC member states is one of private property based on a market

economy, the EEC came into being on that basis, which is presupposed and protected as such by Art. 222 of the Treaty of Rome.

(b) Free capital flow and its gradual promotion are an operational principle of the Treaty of Rome (Articles 3.52 *et seq.*), so the law of EEC offers investment protection from the positive angle, namely it postulates intra-regional capital flow and promotes efforts to widen its scope. This endeavour is enhanced by a considerable legislative activity at the EEC level. Consider the EEC Convention on Settlement and the efforts at the integration of company law, which seek to promote the free movement of enterprises.³² This objective is close to full realization under the well-known programme for establishing the internal market of EEC on a full scale as envisaged for 1992.

(c) The view expressed in western literature on the subject is rather unanimous on that, in a context of philosophy and societal policy, the EEC presupposes and rests on a social system in which economic freedom as a basic principle of human rights is protected by law. With this end in view, a short reference is made to the Universal Declaration of Human Rights (adopted by the United Nations in 1948), which provides that "Everyone has the right to own property alone as well as in association with others" and that "No one shall be arbitrarily deprived of his property" (Art. 17.). True, the subsequent instruments of the United Nations on economic, cultural and social right mark a retrogression from this thesis and, under, the influence of developing countries, proclaim the sovereign right to dispose of national resources, abandoning the above postulate concerning property (see para. 13 above). However, after the Human Rights Declaration of 1948, the EEC's philosophy was really based on the Council of Europe's First Protocol of 1952 to the European Convention of 1950 for the Protection of Human Rights and Fundamental Freedoms. The protocol spells out the right of everyone to own property and that no one must be deprived of his property except in the public interest and in accordance with the general principles of international law.³³ In the last analysis, this is not irreconcilable with either the United Nations instruments adopted under the influence of developing countries (see para. 13) or arrangements under domestic laws or bilateral agreements (see Sections 6 and 7 below). More than that.

16. In what has gone before we have briefly discussed developments concerning regional investment arrangements in CMEA-countries, various international economic organizations and their normative instruments (*supra* para. 6) governing regional investment protection at the CMEA-level.

These instruments do not provide explicitly for regional investment and property protection, for protection against political risks involved particularly in nationalization, all the less so since the existing arrangements are concerned only with the integration of investment capacities. But seen from this angle, developments may be summed up as follows.

(a) Both the Comprehensive Programme mentioned earlier and the Model

³² See Mádl: *The Law of the European Economic Community*, Budapest, 1978, pp. 59 *et seq.* ("The Enterprise in the Integration through the Integration of Company Law").

³³ The international legal instruments in question are known (see, e.g., *Az emberi jogok nemzetközi törvénye* (the International Law of human Rights), a joint publication of the United Nations and the Hungarian Society for the United Nations, New York—Budapest, 1987.

Regulations, both the Uniform Rules and statutes, by-laws and founding documents of concrete international economic and managing organizations afford *positive* protection for the invested assets of participants from outside the host country, facilitating and guaranteeing their operation. Such is the case even if views in CMEA-countries differ on the property-law status and subjects of pooled assets.³⁴

(b) The normative provisions of CMEA-instruments concerning the proprietary status of joint investment in case of termination or liquidation can be regarded as affording property protection of a more technical nature. Art. 31 of the Uniform Rules, for instance, provides that in case of liquidation participating members may present contractual claims proportional to the value of contributed assets, although reacquisition *in natura* of such assets is also possible in exceptional cases. Nevertheless, the general formula is that in case of liquidation assets are distributed in accordance with the founding document or statutes. This high degree of autonomy allowed by statutes (*Satzungsautonomie*) makes it a responsibility of participants in investment projects to act as good owners (co-owners) not only in respect to the efficient operation of invested assets, but also to creating well in advance the security of repatriating their respective shares of property in case of liquidation, namely writing it into the statutes of joint undertakings (founding documents and by-laws).

For the time being, this can be said to be answer of regional regulation regarding the CMEA-mechanism, and it is obviously not enough, especially when that regulation (rather than the national legislations of member countries on joint ventures) would be meant to provide an improved legal framework at the CMEA-level for more significant associations of enterprises. Such a process of association would require a refinement of the existing CMEA-legislation, which should clarify the property-law status of joint economic organizations. In other words, it is necessary to create security for the transfer of membership positions as well as for the repatriation of income and, in case of termination, the appropriate shares of property. This presupposes a legal regulation capable of proper functioning, because the concrete elements of investment protection (e.g., liquidation, repatriation) call for thorough regulations (consider the latest Hungarian rules for the liquidation mechanism). This problem should eventually be addressed by CMEA-regulation as well, which should cover, first and foremost, three aspects or their combinations: 1) refer to the liquidation procedure of the host country; 2) leave it to the founding document or the statutes to govern liquidation; 3) regulate the question at the CMEA-level.

§ 6. Bilateral agreements on investment protection

17. In the inevitably bipolar world of bilateral systems of relations, the otherwise disarranged congeries of diverse interests (which is the greatest impediment to the conclusion of effective multilateral and regional agreements) boils down to a mutually structured pattern of reasoning. Under a clearer formula which allows for a more unequivocal expression of the positions of the investor and the host country than multilateral agreements do, disagreements can generally be resolved

³⁴ Mádl and Vékás: *The Law of Conflicts and Foreign Trade*, Budapest, 1987, pp. 204 *et seq.*

more simply and at the price of less compromise. The general view that bilateral agreements have better prospects of implementation and more practical reality than multilateral agreements and, in particular, abortive draft agreements is perhaps buttressed by this fact as well.

It is thus understandable that these contracts have become an indispensable element of the classical mechanism for investment protection and, in certain cases, even a *sine qua non* for the insurance of foreign undertakings (see paragraphs 34 and 35, below).

Of course, the implementation of bilateral agreements as the realization of essentially and theoretically inherent possibilities, i.e., opposite interests brought to a common denominator, also presupposes a relatively favourable constellation of global historical, political and economic processes, or else agreements might even become a means of obtaining unjustified unilateral advantages.

18. The first bilateral agreements concluded mainly by advanced countries, primarily the United States, England, the FRG and France, with developing nations after World War Two were negotiated against a negative background as indicated above. Under those bilateral interstate agreements on investment protection it was the unprotected, weaker parties that assumed obligations concerning questions like the extent of compensation in case of nationalization, including questions of detail like the exchange rate of convertible currency and even aspects, in no way matters of detail, like submission by states to specific arbitral procedures. While countries freed or seeking to be freed from colonial or neocolonial dependence may, in principle, get rid of the burden of such agreements by denouncing the bilateral agreements in question, those agreements did operate as a serious factor in the subsequent settlement of relations between the developing nations and the advanced investing countries concerned.

19. A special place among bilateral agreements is occupied by certain bilateral agreements between East and West, namely those regarding the settlement of claims, which some European socialist countries signed with the victorious western powers after World War Two. The purpose of these agreements was to settle financial claims which had arisen during World War Two. In negotiating them the western countries sought compensation for nationalized enterprises, too. Although the socialist countries did not go into the question of whether nationalizations had been lawful or not, they recognized the fact that during and after the World War nationals of the other side had suffered financial loss for various reasons, and they undertook to pay a lump sum by way of compensation. It was for the western contracting party to decide which claims of which subjects to satisfy to what extent from that amount. Such agreements were needed for the socialist countries, too (Hungary signed one with England in 1956 and one with the United States in 1973), because they also served the development of financial relations between the countries involved.

20. The agreements in investment protection concluded in recent years by some socialist countries (Yugoslavia, Romania, China and Hungary)³⁵ with the advanced market economy countries are a relatively new phenomenon. These states institutionalized their international commitment to guarantee, in case of state action adversely affecting investments, compensation for investors through insur-

³⁵ For a full discussion see § 7.

ance schemes and other mechanisms. Since no socialist country contemplates nationalizing invested assets, there is no risk in concluding such agreements. Still, the decisive impulse to mutually agreed guarantees was given by the change in external historical, political and economic conditions mentioned in para. 17. On the one hand, there appears in high politics a willingness for cooperation alongside and instead of the confrontation of world systems and, on the other, the recognition of interdependence as an objective law of development has made it possible to ensure that agreements on investment protection serve the interests of both contracting parties. At the same time, the new trend of intensive growth in the world economy and the shortage of capital and technology have made it irrational to follow an economic policy course of isolation and autarky. Moreover, in the international arena, there appeared a competition between importers of capital in respect to both socialist and developing countries. In this struggle, which is waged ultimately for procurement and expansion of material resources needed for economic development, a no negligible instrument is represented by the provision of complex international legal guarantees, through bilateral agreements, for the protection of foreign working capital.

§ 7. Hungary's bilateral agreements on investment protection

21. The importance attached to mutual assumption of guarantees for the protection of foreign working capital has long been emphasized by theory in Hungary as well.³⁶ Related efforts, supported also by the new international wave of agreements on investment protection, finally resulted in normative regulations taking the form of agreements signed in recent years. At present Hungary has such agreements, promulgated and in operation, with France,³⁷ Great Britain,³⁸ the Federal Republic of Germany³⁹ and Sweden⁴⁰ as well as agreements signed at governmental level with Belgium and Luxemburg, the Netherlands and Italy. Similar agreements have been initialled with Austria and Denmark.⁴¹ Considering that they emerged from the mainstream of an international process, the agreements on the promotion and mutual protection of investments go or to apply the strictest rules

³⁶ Mádl: "Beruházások és gazdasági társulások külföldiek részvételével Magyarországon." (Investments and Economic Associations with Foreign Participation in Hungary), *Állam- és Jogtudomány*, 1982/2, Vol. XXV, pp. 270—320; Mádl and Vékás: *Nemzetközi magánjog és a nemzetközi gazdasági kapcsolatok joga* (Private International Law and the Law of International Economic Relations), Budapest, 1985, p. 253.

³⁷ Decree No. 59/1987. (XI. 29.) of the Council of Ministers, *Magyar Közlöny*, 1987/55.

³⁸ Decree No. 5/1988. (II. 12.) of the Council of Ministers, *Magyar Közlöny*, 1988/2.

³⁹ Law-Decree No. 5 of 1988 the Presidential Council of the Hungarian People's Republic, *Magyar Közlöny*, 1988/13.

⁴⁰ Decree No. 25/1987. (VII. 28.) of the Council of Ministers, *Magyar Közlöny*, 1987/31.

⁴¹ Dienes—Oehm: "A külföldi tőke magyarországi beruházásainak elősegítése a nemzetközi jog eszközeivel." (Promotion of Foreign Capital Investments in Hungary by Means of International Law), *Külgazdaság*, 1988/2, Vol. XXXII, pp. 17—27.

in guarantees, namely elements of the so-called Hull standard.⁴² Since the "hard core" of these international legal instruments shows fundamental similarities, we can subject the general features to a comprehensive analysis.

22. Each bilateral agreement on investment protection tries to give a more accurate definition of investment covering a wide spectrum of the questions involved. Thus, for instance, the term investment in the British—Hungarian agreement embraces the value of all assets related to economic activities and acquired after December 21, 1972. Accordingly the enumeration, which is orientational rather than exhaustive, includes ownership of movables and immovables, mortgage, lien, pledge, shares, bonds, debenture and any other form of enterprise interest as well as claims to money or other property or to contractual services expressed in terms of money. Finally, the term investment embraces intellectual property, good will, and business concessions granted under the law of contract (para. 1 of Art. 1).

As is indicated by this definition, the scope of application of these bilateral agreements as to objects extends to the totality of the complex phenomenon of the investment process, including aspects of the law of contract (association) and the law of real property relating to undertakings. The agreements also state that their provisions are applicable to investment made after December 31, 1972. The time-limit suggests that these agreements attach particular importance to the protection of all joint ventures, which may be set up with foreign participation in Hungary exactly from January 1, 1973.⁴³ This does not mean, of course, that the agreed guarantees do not protect investments made exclusively by foreigners either in the interspace or in the future.

23. The scope of application as to persons, or the range of investors is likewise a serious task to define. The complexity of the problem stems from the differing structure of institutions established by the legal systems of contracting states. Thus, while in the Swedish—Hungarian Agreement it was sufficient to refer to nationals and juristic persons (para. 2 of Art. 1), in the British—Hungarian Agreement it was practicable to use the terms "companies, firms and personal partnerships" in respect to the United Kingdom (para. 3 of Art. 1). Similarly, under the FRG—Hungarian Agreement, the scope of applicability to juristic persons includes trade and other companies in general on the one hand and, on the other, the nationality principle of natural persons blends with the principle of domicile, reference being made to Germans and Hungarians domiciled within the territorial scope of the Agreement (para. 3 of Art. 1). However, the differences arising out of the interaction between various company laws and conflict-of-laws norms do not affect the intention, common to these agreements, to extend the shield of protection possibly to all categories of potential entrepreneurs. It is of particular importance to emphasize this in respect to Hungary, considering that other socialist countries confined their own range of investors to economic organizations and for-

⁴² For fair and equitable treatment and for prompt, adequate and effective compensation, see Martonyi: "A külföldi beruházások jogi kérdései." (Legal Questions of Foreign Investments), *Külgazdaság*, 1987/7, Vol. XXXI, pp. 113—122.

⁴³ Decree No. 28/1972 of the Minister of Finance in Economic Associations Operating with Foreign Participation, *Hatályos Jogszabályok Gyűjteménye 1945—1982*, Vol. 5, pp. 501—502.

eign trade companies.⁴⁴ All these elements are indicative of the broadening rights of Hungarian entrepreneurs, which enable them to participate in international economic processes.

24. The first stage of facilitating investments is naturally associated with help in setting up undertakings. Therefore each of the bilateral agreements contains an article declaring an intention to encourage business operations. The relevant text in the FRG – Hungarian Agreement reads as follows: “Each Contracting Party will so far as possible promote investments by investors of the other Contracting Party in its own territory and will authorize such investments in accordance with its laws and regulations. The Parties will accord just and equitable treatment to all investments” (Art. 2.).⁴⁵ The efficacy and realization of such encouragement depends on the *interpretation of authorization*, a key term in the Article. Recent decades have seen in Hungary a constant simplification of procedure, an easing of the required set of conditions, for authorization governed by normative rules. This trend came to a head with the recodification of the company law in the fall of 1988, by the Act. No. XXIV on “The investments of foreigners in Hungary”, when the right to make investment was generally developed into a normative system (i.e., all foreign and domestic juristic and physical persons’ right to invest, with government license required for foreign majority holding only), that is to say that the so-called system of concessions was abolished, the normal normative system prevails. The use of the phrases “facilitate” and “just and equitable treatment” (see Hull standard) in the context of authorization (where still required, as mentioned, for foreign majority holding) is determinant. The adoption of the international phraseology in the undertaking of positive obligations virtually eliminates discretionary elements lingering in the term authorization.

25. As regards now the normal operation of investments and the assurance of owners’ rights, the contracting States seek to offer guarantees by assuming wide-ranging obligations. Special attention is deserved by the fact that general theses which had been disputed even by socialist countries were also written into the agreements.

(a) The commitment to non-discrimination, or the obligation that “Neither Contracting Party shall accord less favourable treatment to investments by investors of the other Contracting Party in its own territory than to investments made by investors of third States”,⁴⁶ is included in all bilateral agreements on investment protection which Hungary has promulgated to date. In other words, this provision may be considered to be equal to the most favoured nation clause, the only way of avoiding inadmissible discrimination, i.e. investors of the contracting States are mutually entitled to all the benefits enjoyed by investors if a third State in the contracting States concerned.

(b) The willingness to apply the *régime national* is a common feature of agreements, except for that between Sweden and Hungary; national treatment gives effect to the neutrality of state regulation not only in relations *inter se* of foreign

⁴⁴ Dienes – Oehm: *op. cit.*, p. 22.

⁴⁵ Emphasis added by the authors.

⁴⁶ Agreement on the Promotion and Mutual Protection of Investments signed by the Government of the Hungarian People’s Republic and the Government of the Kingdom of Sweden, para. 1 of Art. 4.

investors, but also in the wider interrelationship of foreign and domestic entrepreneurs, ensuring a greater transparency of economic regulators and promoting competition as determined by economic rationality.

At the same time, owing primarily to the differences in the social and legal systems of States, the principle of national treatment cannot be implemented with full consistency in all matters of detail concerning investments.⁴⁷ Thus, for instance, the category of state enterprise is still associated with numerous characteristic concepts of the local so-called socialist law, which determine the management of these organizations, their special property-law status and entrepreneurial activity. Obviously enough, many elements of the relevant normative material is essentially alien to investments made with the participation of foreign working capital, and rigid adherence to the unity of national treatment in this field would be like fitting the unequal into a common Procrustean bed.

(c) Another limitation on the application of the most favoured nation clause and national treatment is inevitably placed by the emergence of various integrations, a distinctive feature of the world economy in our time. Accordingly, the benefits otherwise accorded by agreements on investment protection to undertakings do not include those accorded by one of the Contracting Parties to investors of third states in connection with their participation in a free trade area, customs union, common market or any other regional economic organization, for an inverse arrangement could disrupt the economic unity of integrations, which undertake to bear the related burdens and try to achieve maximum economic cooperation among their members.

(d) These corrective rules do not, of course, prejudice the basic objective of Hungary's bilateral agreements to create favourable conditions for the entrepreneurial activity of foreign investors. An added guarantee for attaining this goal is the assumption by the State of obligations to extend just and equitable treatment to investments. One might suggest that justness and equity are vague notions as their meaning and realization are liable to change in the processes of history and society. It is indisputable, however, that these categories tend, by their very nature, toward universality as they are equally impossible to interpret within the framework of individual national legal systems alone. Thus, by adopting justness and equity as guiding principles, states have subjected their behaviour, at least in respect of investments, to international criteria of a larger legal community of nations as well. And, however contradictory and ambiguous those criteria may be, as it has become clear from the application of the Washington Convention, they have often proved to be an effective brake on states' investment policy approaches, which tend to be variable and at times authoritative.

26. Free transfer is of a less comprehensive scale compared with the above philosophical categories, but is a vitally important requirement, because, as a rule, there is a direct relationship between removal of financial restrictions and growing propensity for investment.⁴⁸ In order to increase the latter, all agreements on investment protection concluded by Hungary provide for free transfer of incomes,

⁴⁷ Dienes and Oehm: *op. cit.*, p. 24.

⁴⁸ Pogány: *Bilateral Investment Treaties: Some Recent Examples*, in: *Current Issues in International Business Law*. Gower Publishing Co. Ltd., 1988, pp. 457–472.

including capital gain, profit, interests, dividends, royalties and other fees, in convertible currency and without delay. Free transfer is likewise guaranteed of loan repayments, receipts from transfer of investment, full or partial termination of projects, and earnings of foreign nationals (or a part thereof as may be determined by law).

27. However, the agreements on investment protection under discussion not only specify benefits to be accorded to investors of the contracting States on a reciprocal basis, but also set limits to state action in accordance with relevant international practice, spelling out strict conditions for nationalization. Accordingly, each bilateral agreement provides that nationalization, expropriation or measures entailing similar consequences (restrictions on property ownership) must not be effected except in the public interest and under appropriate legal procedures, non-discriminatively and on compensation, which is to include the market value of investment previous to restrictions on property and interests due until the date of payment. The amount of compensation calculated in this way is transferrable without delay.

As can be seen, giving the Hull standard a normative form requires sovereign powers to observe the general principles largely of classical private (civil) law (prohibition to cause damage, obligation to pay compensation). But what guarantee is there for compliance with the "fine-sounding" provisions of the agreements on investment protection?

So far as Hungary is concerned, the following arguments can be marshalled in the way of guarantees for an effective application of these agreements.

(a) Each of the bilateral agreements has established a system of fora available in case of breach of agreed obligations (see next paragraph).

(b) A guarantee is provided by a basically amicable domestic environment (see para. 30) which is fit for a harmonious accommodation of the institutional system for compliance with international obligations concerning investment protection.

(c) Similarly reassuring is the main course of Hungarian economic policy seeking to base the country's development on independent and efficiently operating undertakings that obey market mechanisms. Foreign investments and the operation of such projects are fully in keeping with this objective.

28. The system of fora established by the agreements affords possibilities partly for settling disputes between contracting parties, partly for deciding claims arising between one contracting party and the investor of the other State.

(a) The agreements provide for amicable settlement, so far as possible, of conflicts between sovereigns concerning the interpretation and application of agreements. Should negotiations fail to procedure results, the dispute should be referred to an *ad hoc* arbitral tribunal on the request of one of the contracting states. If within the set time-limit states are unable to agree on the person of the members or the president of the tribunal, the parties may invite the Secretary-General of the United Nations, under the agreement with the FRG and France, or the President of the International Court of Justice, under the Swedish—Hungarian and British—Hungarian agreements, to make the necessary appointments. In the agreements with the FRG and France it is specifically stated that the arbitral tribunal must base its awards on the agreement on investment protection between the

parties (or such other agreements as may be of relevance) and on the general rules of international law.⁴⁹

(b) Behind a dispute between the foreign investor and the host state there may be a conflict much deeper than the conflicting interests of sovereigns, but an equitable settlement should be found even for such a conflict. It was this need that forced the conclusion of the multilateral Washington Convention, but it is also a "usual, recurrent element of bilateral agreements on investment protection to allow foreign investors to sue the host State in any matter relating to investment and even to submit such matters to an arbitral tribunal in case of disagreement".⁵⁰ Recourse to arbitral procedure offers a more efficient mechanism for conflict settlement than the earlier fora based on traditional diplomatic channels or on the internal laws of the host state. At the same time, actual protection of investors presupposes that such arbitration really allows for judgements on the lawfulness of state actions, i.e., enforces a mandatory course even on sovereigns. To use the language of physics, there should be created a field of force that will keep in its grip even the strongest particles, i.e., states, or else we have a case of hopeless litigation between unequals.

It is particularly important (i) to define the jurisdiction of proceeding fora and, in connection with it, (ii) the concept of investment dispute and (iii) to ensure the investors' right to sue and (iv) the neutrality of proceedings.

(i) The Washington Convention on the Settlement of Investment Disputes between States and Nationals of Other States entered into force with respect to Hungary on March 6, 1987, and it thus became practicable for the jurisdiction of the Convention's fora to be recognized also in Hungary's bilateral agreements on investment protection, since, as we have seen earlier, the Convention recommends conciliation and arbitration specifically for such investment disputes. Accordingly, the Hungarian—British Agreement of 1987 (Art. 8) and the Hungarian—Swedish Agreement (Art. 11) recognize the jurisdiction exclusively of the International Centre for Settlement of Investment Disputes, while the agreements signed by Hungary with France and the FRG in 1986 (Articles 9 and 11, respectively) refer also to other arbitral procedures in case neither State is a party to the Washington Convention, but this is irrelevant in the light of Hungary's accession to the Convention.

Let us now examine the relationship between the jurisdictional clauses of the Convention and the bilateral agreements in question. Like other agreements of this kind, the Swedish—Hungarian Agreement on investment protection provides that "Each Contracting Party *hereby agrees*⁵¹ to refer to the International Centre for Settlement of Investment Disputes—for settlement in conciliatory or arbitral proceedings as provided for in the Convention of March 18, 1965 on the Settlement of Investment Disputes between States and Nationals of Other States—any disputes arising *in connection with investments*,⁵² between one Contracting Party and the investor of the other Contracting Party, made by the latter in the territory of the former under Art. 5 of the present Agreement" (Art. 11). As this long pro-

⁴⁹ FRG—Hungarian Agreement, para. 5 of Art. 10.

⁵⁰ Dienes—Oehm: *op. cit.*, p. 26.

⁵¹ Emphasis added by the authors.

⁵² Emphasis added by the authors.

vision makes clear, and as noted earlier, the states signing bilateral agreements undertake in advance to submit themselves to the jurisdiction of the Centre, thus terminating the conditional character of Art. 25 of the Washington Convention, and the investors affected by bilateral agreements, may initiate, even unilaterally, a litigation or an arbitral proceeding against the host country.

(ii) Special mention is deserved by the concept of "dispute arising in connection with investments", namely the scope of application of the agreements as to objects. Does the advance submission of states to arbitration apply to conflicts arising out of "indirect nationalization", conflicts that may be provoked by, e.g., unrealistic tax increases or denial of access to raw materials? Although Hungary's economic policy by no means seeks to introduce similar measures, an examination of related matters is required for a full coverage of theoretical aspects.

Art. 11 of the Swedish-Hungarian Agreement, for instance, refers back to Art. 5, which provides that both parties must refrain from taking measures likely to deprive, directly or indirectly, investors of the other state of their investments. A comparison of the two provisions makes clear that investment disputes may be generated by any measures affecting a particular undertaking and imposing direct or indirect restrictions on property. This interpretation is not inconsistent with the Washington Convention and can also be confirmed by Hungary's other bilateral agreements in investment protection. Thus, for instance, Art. 9 of the French-Hungarian Agreement expressly states that the jurisdiction of the proceeding forum extends to all disputes connected with investments.

(iii) The question of who is to be regarded as alien, already discussed in connection with the Washington Convention, arises again in dealing with investors' right to sue, since this status is part of the direct legal relationship that enables the investor to institute international arbitral proceedings against an objectionable action of the recipient state. The agreements with Sweden and Great Britain contain an explicit foreign control clause which ensures the right to sue also for an enterprise set up in accordance with the rules of the recipient state, but foreign-owned for the most part. This is that, under the Swedish-Hungarian Agreement, "...any juridical person which was founded in accordance with the law of one of the Contracting Parties and in which the majority of shares had been held by investors of the other Contracting Party before the emergence of a dispute shall be treated as the investor of the other Contracting Party within the meaning of para. 2, subparagraph (b), of Art. 25 of the Washington Convention" (para. 3 of Art. 11). In the case of disputes covered by the other bilateral agreements, the foreign nationality of investors can be recognized subsequently under the aforementioned clause of the Washington Convention functioning as a national law.

(iv) At this point we do not wish to dwell on the requirements for proceedings before a neutral arbitral tribunal. The Washington Convention, the jurisdiction of whose fora has been recognized by the bilateral agreements on investment protection, goes far to secure the conditions for objective judgements, as is manifest in the rules for the designation of judges (Art. 14), in the special immunities accorded to the Centre and its staff (Articles 20 to 24) and in the principle of confidence enhancing impartiality and requiring the Centre not to publish arbitral awards without the consent to the parties (Art. 48.)

29. As important international legal instruments, Hungary's bilateral agreements on investment protection will necessarily (and are bound to) act as a stimu-

lus for domestic legislation, since the cohesion of the legal system presupposes a further easing of administrative restrictions on foreign investments, restrictions that continue to exist after the conclusion of these agreements. Moreover, it is perhaps not without foundation to expect that the guarantees provided by these bilateral agreements on a reciprocal basis will be generally applicable to investors of other countries as well. This is all the more warranted since the domestic law of Hungary, just like national legal systems in general (see *infra* para. 30), has already extended a significant shield of protection over foreign investments.

III. Guarantees under Domestic Law

Without seeking to be exhaustive and to cover every detail we may state in the light of practice that national laws provide significant means for the protection of investments (foreign property) on three planes: first, by constitutional coverage of forms of property and by grant of general legal protection for them; second, by devising special institutions of protection for investment by joint ventures; and third, by investment insurance.

§ 8. General means of protection under national laws

30. Without penetrating too deeply into the world of property theory on the complex problems under discussion we must state on the general theoretical plane that one of the basic questions concerning joint ventures under domestic law is the general assimilation of foreign investments into the law of property.

(a) In the advanced western countries there are no difficulties in this respect and foreign private working capital presents no problems. Private capital in those countries is free to operate within the framework of private property as a general and fundamental legal institution, in an environment not alien to it, but familiar and protected by law, cut out for its own nature and constituting a condition of existence for the socio-economic system of the countries concerned. The fact that this property regime is surrounded with an extensive scheme of protection for social—societal interests (employing numerous known forms of state ownership and means of regulation) does not in effect alter the mode of existence of working capital. Moreover, the freedom of capital flow under property law is not, in its nature, affected by aspects like the country of origin from which private capital flows to these countries and the exercise also by these countries of a certain (occasionally significant) measure of economic policy control,⁵³ which, however, is the concomitant of administrative policy mechanisms rather than considerations of property theory. Foreign investment as a category of property is under the protection of *nihil obstat* or rather the *régime national*.

⁵³ Consider, first, the foreign-specific elements of the company law in western countries; second, the control theory (Mádl and Vékás: *Nemzetközi magánjog és a nemzetközi gazdasági kapcsolatok joga* (Private International Law and the Law of International Economic Relations), Budapest, 1985, pp. 201–202); third, the idea of placing restrictions, even on countries like the USA., on “mass” influx of foreign capital.

(b) In the socialist countries the situation is different from the angle of the property regime. Foreign investments (joint ventures set up with the participation of foreign private capital, or foreign firms in general) represent forms of international economic cooperation resulting in the presence of foreign private property and, by their nature as property of this class, seem to be inconsistent with the socialist property regime. The concept of foreign investment, after initial hesitation and doctrinaire reservations, came to work its way into the political and legal thinking of the socialist countries concerned as a result of the following considerations.

(i) The main problem is constituted by the ratio of foreign property in the entire national economy. As long as foreign property is below the limit where the socialist character of the property regime could be questioned at all (and *roluse* is that, once a mixed property system is envisaged, e.g., in Hungary?), the presence of foreign investment cannot, in principle, give rise to objections by property theory, to a negative systemic immune reaction. About where the borderline is drawn there was no deeper theorizing in the public thinking and legal literature of socialist countries probably for the reason that, *inter alia*, every socialist country was in general still far from that hypothetical limit, since, as is known, the development of this form of international economic relations, the continuing involvement of foreign capital, is the order of the day in every socialist country concerned. Each of these countries is expecting the participation of more capital, as is well illustrated by the example of China. It is a known fact that the largest volume of capital import in the order of many billions of dollars (see para. 5 above) was realized by the People's Republic of China within a short period of time. Still, on the basis of statistical figures, Deputy Prime Minister Tian Jiyun had reason to state that "although the private economy, the Chinese-foreign mixed economy, and the economy operating exclusively with foreign property have registered rapid rates of growth during the past few years, the combined value of their industrial performance accounts for as little as 0.6% of the national total".⁵⁴ Keeping in view these figures and the corresponding data for the rest of socialist countries (see para. 5 above), it can be taken for certain that the level of quality in the property regime is far from the quantitative limit of danger referred to earlier.

(ii) Another consideration of a theoretical nature concerns the fact that the laws of socialist countries governing the regime of property contain numerous provisions to the effect that private property forms part and, as such, is a protected element of the entire property regime, while the dominant role is naturally reserved for social and personal property. Private property in socialist countries generally appears outside the range of personal property, although, as is known, property disputes and theoretical concepts in recent years have tended to relax the rigidity of borderlines to reinforce the "passage-way" between personal and private property and to link up personal and social property. We refer the reader to literature on the core and substance of this, but, with regard to the classical formula, we point out that the property framework for the means of production functioning in a domain other than that of social property is provided by private property, irrespective of whether such means of production or such property are operated by natural or juridical persons, national or foreign. In view of this, the answer to the presence of foreign capitalist property in recipient countries consists in that private

⁵⁴ Quotation and figures from *HVG*, 1987/6, p. 8.

property as a category of property is not excluded from the property regime as a whole anyway. Such is the case in, e.g., Hungary and Poland, where private property is restricted by public interests, but is not excluded from the property regime and, as is known, is recognized and protected by constitutional as well as civil law in Hungary. In terms of legal dogmatics, private property is known to be subject to two limitations: it must not prejudice public interests and must not include assets which, under the fundamental norms of law (e.g., the provisions of the Constitution and the Civil Code) can only be owned by the state. Thus there is no technical and legal impediment, in Hungarian law either, to the assimilation of foreign investments into the law of property. To all these let us add the recent property law developments in Hungary and Poland where a mixed ownership system is meant to operate and already practical; and this not only for foreign investors related undertakings but for the domestic economy in general. The new Hungarian Company Law Act of 1988, e.g., admits and encourages private investment very invitingly. The upper limit, if it is a purely private investment, has been fixed at 500 employees, whereas mixed companies have no limit in size at all.

In other countries (Bulgaria, China or Romania), legislation on joint ventures and, in China, also on enterprises operated exclusively by foreign interests spelled out legal possibilities, protection and guarantees for foreign private property. In a separate article the 1982 Constitution of the People's Republic of China stresses the importance of foreign investments and extends the protection of the law to them with a view to increasing them. The Yugoslav answer to this set of problems — up file now — stems from the special Yugoslav concept⁵⁵ of joint venture and boils down to stating that the system of control over and appropriation of income by foreign investors is governed by the law of obligations rather than the law of association, i.e., appears in a form other than proprietary participation, and hence is free from most of the property-law implications. The new Yugoslav Investment Code of 1988 goes beyond this traditional Yugoslav concept and introduces an enterprise and foreign investment structure based on mixed and foreign equity (i.e., private ownership) rights.

With the appearance of joint ventures, the relevant laws of the Soviet Union emphasize that joint ventures in relations between socialist countries are set up with a character of common socialist property or remain in national ownership. Joint enterprises in the Soviet Union operate as part of the Soviet economic system and in accordance with Soviet laws. This latter principle applies to joint ventures formed with capitalist countries as well.⁵⁵

(iii) Then there is the similarly reasonable view that the property-law element, or the formally existing contradictions and diverse aspects thereof, should not be overemphasized in the sphere of international economic cooperation either, for the core and substance is a joint investment project, a joint enterprise, which, ultimately as a unit of civil law, becomes part of the property regime of the recipient socialist country, an enterprise thereof, virtually representing a new quality emerging from a decision and joint economic action of the founders, conditioned as they are by two as for Hungary, Poland and Yugoslavia less and less different property regimes. For that matter, abstractions of property law, static frameworks appearing to assume different aspects from different angles, are of little interest to modern

⁵⁵ For more detail and indication of sources, see Mádl (fn. 2), para. 39/3.

law company and commercial practice. Under the modern approach of law company everyone's concern is with actual power and management as well as with appropriate guarantees for benefits from efficient performance. Indeed, what counts is the rights, the power and the benefits which the participants in a joint venture can derive from the joint undertaking for themselves. A similar position can be secured under numerous contracts for large cooperation projects as well as in Yugoslav joint venture investments governed by the law of obligations (as it was the case till the recent Yugoslav Investment Code of 1988). This was accepted even by the more doctrinaire minds, because they believed that this formal Pharisaeism guaranteed them absolution from the proprietary "sin" present in direct foreign equity participation, and that the "devil", if pushed behind "*in rem*" (contractual rather than company law) walls, can be looked upon as a mere temptation, and flirtation with him as a mere forgivable sin. This is obviously not the real answer when it is about working capital. It must be admitted that the devil is unlike his former self, is perhaps no longer the devil, and that there has been much change on the other side too, that proprietary cohabitation is a useful way of joint investment as well, for, after all, it helps and wants human cohabitation and cooperation (for the causes and extent of need, see Sections 1 to 3) and may become a fair and useful associate of ours by virtue of the relevant regulations in recipient countries.

(iv) Lastly, we should not forget that joint ventures and other companies with foreign investment are ultimately Hungarian — or the other recipient country's — domestic juristic persons established in these countries under their law; their assets are there and their operation serves their national economy as well.

31. It is an important factor that in socialist countries, including Hungary, enterprises operating with foreign participation are also naturally entitled to use the general means of protection available for property and possession under civil law. They enjoy national treatment, which is likewise extended to individual cases of expropriation for reasons of public interest as an institution of both administrative and civil law. Should any such measure be taken, the same criteria should apply to joint ventures. This is well synchronized with the relevant principles of bilateral agreements on investment protection (as it appears from Section 7 above).

It would take us far, but is necessary here, to mention that the principle of the *régime national* is being strengthened also in respect to the conditions for, or the so-called economic and legal environment of, the operation of joint ventures, although the picture is rather varied. Preferences (e.g., in taxation, exemption from plan instructions where such ones exist, foreign trade rights) as well as still existing inertial restrictions (on acquisition of property, mortgage credit, etc.) differ by country. The future probably lies in a slow elimination of *ius peregrini* dispositions in these respects as well, and this process will certainly depend on internal development (affecting also the status of domestic economic units), but it has remote bearings in investment protection and is mentioned only as the other side of the coin, as a point of reference to what is to be protected at all.

§ 9. Special investment protection under the Investment Codes

32. The ways in which the appearance of foreign private property was assimilated into the socialist property regimes have already been dealt with in general. Assimilation was not primarily a matter of protection, but one of appearance, reception, the "yes or no". What we have to discuss here, naturally in close relationship with this aspect, is the fact that the investment codes (laws on joint ventures) of various countries lay special emphasis on the protection of the property rights of foreigners and on that of joint investments. This is a guarantee provided by law for concrete investments in the post-investment period.

The legal protection of foreign investors has been raised to the constitutional level in China and Yugoslavia, where the investment codes specifically provide legal protection for foreign invested capital. The Constitution of Yugoslavia, for instance, states that "In the Socialist Federal Republic of Yugoslavia the rights of foreign investors of property invested within the framework of associations of associated labour shall not be subject to restriction by either laws or other regulations after the conclusion of the investment contract from which these rights of foreign partners emanate".⁵⁶ Among the institutions of legal protection in domestic laws attention is deserved by the new Soviet legislation on joint ventures, which expressly prohibits administrative intervention by the state: "A joint venture is entitled under Soviet legislation to own, use and dispose of its property in accordance with the objectives of its activities and the purpose of the property. The property of a joint venture shall not be requisitioned or confiscated by administrative procedure. The property rights of a joint venture shall be protected under Soviet legislation protecting stateowned Soviet organizations. Execution can be applied to the property of a joint venture only by a decision of bodies empowered under USSR legislation to hear disputes involving joint ventures".⁵⁷

33. In addition to the general guarantees provided by domestic laws, there have appeared more concrete guarantees in national legislations. Thus, for instance, the Bulgarian, Cuban and Hungarian laws grant access to, indeed recommend the use of, bank guarantees. Upon the request of a foreign partner, the national bank of the country concerned may guarantee the claim for compensation of the foreign partner for pecuniary damages from restrictive or injurious acts of government authorities.⁵⁸ The new Hungarian Investment Code of 1988—while admitting the mentioned bank guarantee practice—goes a step farther. It introduces direct statutory liability of the state for damages resulting from government actions: due compensation must be paid to the investor; the state must discharge this liability by the government agency from which the action in question was emanating; the currency of the compensation must be that of the investment contributed by the injured investor (Art. 1 of the Act No. XXIV of 1988).

Another aspect of bank-like investment protection is that the bank may undertake, according to the customary business conditions, a guarantee for the compa-

⁵⁶ Constitution of 1974, Part IV, Art. 27; Act of 1984 on Foreign Investments, Articles 5 and 6.

⁵⁷ Decree no. 49 of the USSR Council of Ministers on the Establishment of Joint Ventures (January 13, 1987), Chapter II.

⁵⁸ Bulgarian Decree of 1980 on joint ventures, Art. 17; Cuban Act of 1982 on joint ventures, Art. 24; Decree No. 28/1972 of the Hungarian Minister of Finance, Art. 11.

ny's obligations arising out of a membership relationship towards the foreign partner.⁵⁹ Clearly related to the bank, but "merely" a legal guarantee nevertheless, is that in withdrawal, the foreign partner may transfer abroad, in the currency specified by the contract, his share of property equal to the amount paid to the bank or that, in case of liquidation, the net share of foreign property can be transferred abroad free of tax.⁶⁰

§ 10. Insurance of foreign investments

No matter how perfectly every element of the aforementioned protective mechanisms may have been elaborated, it is the means of commercial (civil) law protection against risks to investment, the "ordinary" insurance of investment with insurance companies, that has proved to be the most effective in practice. This is why it has emerged and is at work everywhere, in Hungary too, and this is why MIGA (discussed in para. 14) was born and has a promising future on the international plane.

34. Now a general phenomenon, this device has its origin in the advanced western countries. To better illustrate its substance and its role in external economic strategies, it is worth while to briefly touch on the insurance system established in this field by the United States, which accounts for a particularly large volume of capital exports. The post-World War Two period witnessed the emergence of various large-scale programmes designed to intensify the activity of capital abroad. The most important of all was naturally the Marshall Aid to the reconstruction of Western Europe and to the start of its economic development, but the more general expansion of working capital was then supported by the state economic strategy of the United States in institutionalized form as well. The economic policy goal of expansion through state capital was furthered by the American Export-Import Bank (Ex-Im Bank), while the expansive strategy of private capital was promoted by the Overseas Private Investment Company (OPIC), a large insurance company established out of public funds. The latter, partly contrary to its name, is not a private insurance agency, but a public insurance company for foreign investment of private capital. OPIC undertook to insure foreign investments under favourable terms and conditions, thereby assisting the implementation of America's international economic strategy in the world market. Under such contracts of insurance OPIC undertook to pay compensation for damage caused by non-commercial (political) events like war, civil war, other political developments of a similar nature, expropriation and nationalization as well as state measures which, at the place of investment, disallow repatriation of income or residual assets in case of liquidation.⁶¹ These are well-known insurance categories, which "came into their own" under OPIC practice.

⁵⁹ Decree no 28/1972 of the Hungarian Minister of Finance, para. 3 of Art. 11.

⁶⁰ *Ibid*: Art 11 (4) and Art. 13.

⁶¹ See Loevenfeld: *International Private Investment*, New York, 1977, pp. 424 *et seq.* OPIC paid billions of dollars to, e.g., the General Motors, ITT, the Chase Manhattan, the Chile Cooper and other American corporations for damage resulting from "political risks" in Vietnam, Bangladesh, Zaire, Argentina, Chile and elsewhere (Vogel: *New Policies Cover Foreign Operations*, New York Times, 1977 — Business and Finance).

Following the appearance of these state insurance mechanisms, private insurance agencies in America have also intensified their activities in this field. Similar institutions and schemes started operation before long in the rest of advanced western countries as well.⁶² A characteristic feature of these insurance mechanisms is their operation in mutual legal interrelationship with bilateral agreements on investment protection, as the former provide that preferential insurance contracts are available as a means of protection in cases where the foreign investment in question coincides with the international and domestic economic policy goals of the capital-exporting and the capital-importing country concerned; where investment is made in a country with which the capital-exporting country has concluded a bilateral investment agreement, with the aforementioned principle of subrogation recognized by both parties.⁶³ Subrogation obviously serves a dual purpose: first, to avoid double compensation to the injured party and, second, to increase so far as possible the role of recipient countries in securing actual guarantees, i.e., fulfilling their commitment to pay compensation. Under the domestic mechanism for the insurance of investment the actual arrangement is ultimately for the economy of the capital-exporting country to bear eventual loss suffered by the expansive external economy and serving as a kind of logistic support for, or background to, an effective external economic strategy, but, through the linkage mentioned, part of the amount of invoice is put, by virtue of the provisions of bilateral agreements on subrogation, on the table of recipient countries. Seen from this angle, the parties are assigned a similar role under the MIGA mechanism as well, but that is the viable arrangement, as we have tried to outline (in para. 14). As concerns the essential point of insurance for foreign investors, they have, with an insurance coverage of their own, either by their State or by a private agency in the background, a really wide margin of security for operation also in Hungary, and this in addition to its accession to MIGA. Combined with so many other guarantees, this solution offers reliable protection and is dependably consistent with bilateral agreements as well.⁶⁴

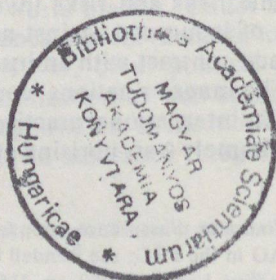
35. The system of protection through insurance is known to have been greatly differentiated in recent years in the practice of socialist countries, including Hungary in particular. Among the insurance contracts generally regulated by the Civil Code, there has emerged a scheme for export credit insurance, which is fairly extensively used in practice. As is known, its terms and conditions cover political risks in addition to economic risks and risks involved in changing rates of exchange. Under the practice of insurance against political risks, Hungarian enterprises may make an insurance contract with an insurance company covering risks to invested capital as well. The inner or national content of political risk is generally the same as that accepted in international practice (under the MIGA Agreement discussed in para. 14 above, namely war, uprising of the civil population, nationali-

⁶² Such is, e.g., the *Compagnie française d'assurance pour le commerce extérieur (COFACE)* or *HERMES Kreditversicherung AG* in the FRG; see Rendell (ed.): *International Financial Law: Lending, Capital Transfers and Institutions*, London, 1980, pp. 215–224, 297–305; Mádl: *Political Risks within the Sphere of Foreign Trade Transactions*: 26. *Ann. Univ.*, Budapest, 1984, pp. 138–147.

⁶³ See Lovenfeld: *op. cit.*, pp. 424 *et seq.*

⁶⁴ In the meantime (1988), however, Hungary acceded to MIGA, an act that served to buttress the legal mechanism designed to guarantee the security of working capital.

zation, etc.), while in concrete cases the political conditions are complemented with specific elements. Thus, for instance, it is a natural and concrete contractual situation that insurance charges vary by country and risk factor, that the periods of coverage and the insured party's share of damages differ, etc.⁶⁵ So it is necessary to chose the proper insurance policy just as the proper investment project, the two elements plus investment protection as a general framework combining to form an integral whole.



⁶⁵ For insurance practice in Hungary, see Mádl (fn. 62), pp. 124—130.



The present volume, the second in the series of Hungarian State and Law, presents, on the basis of legal regulation as well as operational experience, a few distinctive features of the changes that took place in the last couple of years.

In order to ensure a better understanding of the developmental tendencies characterizing the most recent period, the introductory study offers to outline the course of Hungarian economy from direct plan instruction to indirect market regulation. This is followed by a detailed discussion of the different forms of association and enterprise, with special emphasis on problems related to joint ventures with foreign share. The last study deals with the description and analysis of regulations to protect foreign investment.

The authors are outstanding and well-known theoretical and practical experts.