Éva Voszka

# *Encouragement of Competition – with Negotiation*

**Researcher of Financial Research Ltd. *Éva Voszka*,
defended her doctoral dissertation under the title,
"ENCOURAGEMENT OF COMPETITION – WITH NEGOTIATION"
(Demonopolization and State Redistribution during the Transition in Hungary)
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Opponents were *Mihály Laki, Katalin Szabó* and *Erzsébet Szalai*.**

The dissertation examines the process and characteristics of establishment of the basic institutions of Hungarian market economy, focusing on the state's role in encouraging as well as restricting competition during the period of transition. The description analyzes two areas of this complex subject, the market structure from among the topics of encouraging competition, and state redistribution from the means of restricting competition.

## Formation of Market Structure and State Subsidies are Similar Dilemmas

In addition to the identical structure of decision dilemmas, selection of the market structure and state redistribution is justified by the basic context of centrally planned economy, according to which central redistribution of state property, the centralized corporate organization system and income are inter-dependent matters. One would assume, in theory, that changing the various characteristics result in reverse effects, or in other words, the expansion of private property will strengthen the establishment of a competitive market structure and incite withdrawal of redistribution, while dismantling monopolies will enhance the privatization of state-owned companies as well as the reduction of subsidies. Hence, the dissertation examines the following hypothesis: Has positive feedback existed between demonopolization, privatization, and decrease of redistribution in Hungary during the transition period?

There has not been a generally approved strategy for the transformation of centrally planned economies that could be used as a baseline for evaluating the various steps of the changes. Therefore, the dissertation follows the method of positive exposition instead of a normative approach by analysis. It also continues the Hungarian tradition of empirical economic research associated with the concept of new institutional economics.

## Paradox of the State's Role

The dissertation is permeated with the idea that the state essentially plays a controversial role in the transformation of centrally planned economies. The contemporary wording of this statement on *the paradox of the State's role* is that while higher than usual state activity is inevitable, even in theory, during the transformation of market economies (in the interest of dismantling old structures and establishing a new institutional framework), this unusual situation rather confirms than invalidates the well-known disadvantages of intervention. This is actually a generalization of the statement referring to privatization, according to which government failure is an incentive for transformation while, at the same time, it is an obstacle to its efficient realization.[1]

■ The dissertation defines state redistribution in a unique way and defines its relationship with the concept of soft budget constraints. According to this definition, *state redistribution within the economy* is one base mechanism for softening corporate budget constraints. According to the most recent and extended definition, it is a mechanism that is potentially present in every financing system, but separate from paternalism and bureaucratic coordination. Its specific purpose is to prevent financial failures, and it is interpreted as a dynamic and authentic problem of commitment[2] – which specificity is determined by the identity of the participants and the relation of the state and profit-oriented business associations (companies). The dissertation considers the methods of regulating the opportunities and revenues of companies being – not necessarily on the basis of hierarchic relations – state redistributions within the economy. The methods in question are those that serve – besides providing artificial sustenance to state-owned or private companies – the improvement of growth and profit opportunities. These are achieved through market creation and normative tools of fiscal, quasi-fiscal and credit subsidies that are open, hidden, individual, collective, and/or negotiable; but at the same time indifferent in the objectives, the manner, and time of occurrence of the financial consequences.[3] However, this approach enables revelation of the changing state redistribution in a broad sense, and the switch-over/replacement impacts, while distinctively connecting the theoretical literature on soft budget constraints to the practice-oriented examination of state subsidies – mainly in relation to inciting foreign investments and preferring small and medium enterprises.

■ Based on the aforementioned definition, the dissertation differentiates between *enterprise-saving and profit-increasing subsidies* – as the traditional versus new types of redistribution methods – since their operation and outcomes could be significantly different. The former type involves government funds based on hierarchic dependence that are provided as artificial sustenance to companies with financial losses and/or indebtedness. The other type – which is disregarded by the mainstream of research on soft budget constraints – is irrespective of vertical relations and it is the preferred type for improving growth and profit potentials of successful private companies.

■ Exact definition and systematic examination of *market creation by the state,* a method classified as an instrument of redistribution, is a novelty. This definition also important in a centrally planned economy, but scarcely mentioned in professional literature. It originates from the principle that a government can redistribute income that is already made as well as opportunities for acquiring future revenues, in other words, profits. Creation of markets to increase or redistribute sales opportunities is a method that softens – similarly to income distribution – corporate budget constraints. This method affects the opportunities of a company to acquire and keep a market share – among others – through international agreements, public orders, export incentives, and protection of the internal market. The impact of this method finally appears in public and corporate incomes, but only indirectly and with a delay.

## Partial Demonopolization without Clear Principles

■ Raising *market competition and the competitiveness of companies* are not necessarily inter-dependent; *conflicts* could arise between them. This contradiction is an important subject in the debates on competition regulation that accompanies the establishment of the structural base for competition. The dissertation demonstrates that one of the typical, *basic dilemmas of state redistribution has an identical structure*: market creation and subsidies restrict competition, but might increase competitiveness, at least according to the assumption of decision-makers and the promises of petitioners.

*Transformation multiplies and intensifies* dilemmas of redistribution compared to the usual intensity in market economies. One of the direct reasons of economic recession following regime change was market creation and withdrawal of state subsidies. The necessity of fundamental structural change requires competition as well as subsidies to slow down destruction – moderate the series of impacts, or extend the period of adaptation – and strengthen new structures including the protection of small private enterprises and inciting foreign investments. Consequently, redistribution is required to overcome the crisis – created explicitly by its decrease – at the same time when resources have been depleted, and the regime change – involving the withdrawal of state intervention – questions its basic principles and legitimacy.

The dissertation supports the finding of professional literature, according to which the Competition Act and the Hungarian Competition Institute ("GVH") did not play a significant role in the public decisions that directly affected the market structure, such as the revision of the inherited structure or merger audits associated with privatization. The conclusion lately is that *a formal expansion to the scope of the GVH's authority would not have had a significantly different result by itself.* Mass application of merger control would have only delayed the decision-making process and further weakened the foundations and authenticity of the decisions of the GVH, while barely affecting the market structure under the existing interest and power relations and inconsistent – especially before the first amendment was made to the Competition Act – judgment methods.

The demonstration of the relations of privatization and demonopolization measures – that covers a broad sphere of corporate cases – confirms that privatization had priority over market structure during the entire period of transformation in Hungary, similarly to the practices of other ex-socialist countries. This was the main reason why the most important decisions, that affect the structural conditions of competition, were made by central privatization institutions. Since this principle was neither declared nor institutionalized, it could be only enforced after its reconstruction, and the relationship between competition and privatization remained unregulated. The analysis shows that separation of business units prior to or simultaneously with the sale of a company *did not have either a transparent process, or a uniform system of requirements for decision-making.* Formation of a market structure has only been one element of the contradicting objectives of the State Property Agency and its legal successors that were enforced in individual decisions influenced by unstable privatization programs, party policies, the companies in questions, and the customers. Thus, demonopolization remained a *side-product* of privatization decisions. Even subsequently, it is impossible to find a group of economic factors that could explain by itself the extent of organizational decentralization, and would outline the areas of its implementation or absence.

The fundamental – but not exclusive – direction of the organizational decisions of succeeding governments was decentralization, starting at the beginning of the 1980's and lasting for one and a half decade, *in which the regime change did not cause a serious break.* As a sign of direction-dependence, the government that entered into office in 1990, found already set arguments, interests, and institutions for demonopolization that were strengthened by new political features: distrust in large social companies and their management and adaptation of the supply for privatization to the insignificant means of domestic investors in order to create a middle class of proprietors. (Contrary to the general belief, rather the targeted groups of potential customers than the resulting revenue had priority in the decision of the state on whether to separate business units or sell the company as a whole). There is continuity in these decisions as well: *political rationality* continued to play an important role in state decisions affecting the organization of companies. Due to the bargaining powers of companies for sale and some of their buyers, these decisions had a limited success just like their predecessors had in the centrally planned economy.

## Cyclical and Unstable Redistribution

The statistical extent of state redistribution within the economy sharply decreased in Hungary as well as in other ex-socialist countries at the turn of the 1980's and 1990's, then varied between two and six percents of the GDP depending on various measurements. (According to international benchmarks, during the second half of the 1990's Hungary was among the transforming countries with high subsidies).

Taking into account the estimated value of the quantifiable part of hidden subsidies, the dissertation states that redistribution *did not continue to decrease* concurrently with the strengthening of market institutions, however, belying early anxieties, *it was not rebuilt as a comprehensive mechanism of integration either.*

▫ One of the basic features of state redistribution within the economy was its *cyclical character* during transformation; it fluctuated in Hungary during every government cycle in the 1990's, irrespective of the ideology of the parties being in power. On the top and bottom turning-points of cycles, the process is brought into motion directly by parliamentary elections, indirectly by the economic impact of previous measures, internal division of the government, and pressure by companies. The extent of redistribution has mostly remained *under political control.* Competition for power, and consequently, the vulnerability of parties is the driving force as well as the obstacle of the boost: upcoming elections incite not only the welfare, but also – in a narrow interpretation – the economic segment of wealth shared in order to acquire votes, while turnover of government – regularly taking place despite of the welfare allowances – improves the probability of (temporary) corrections.

▫ The other major characteristic of redistribution during the period of transformation is the *instability of target groups and instruments,* which does distinguish between governments with diverse political background. After the 1990's, the instruments of centrally planned economy (another sign of direction-dependence) were applied to consolidate the beneficiaries of the first period, the state-owned companies and banks. This action finally resulted in cash-saving waves of consolidation. In the middle of the decade, the school of "subsidy instead of market creation" was reversed: industry protection strengthened with the customs surcharge for assisting half-ready structures became – as an unintended side-effect – the essence of the stabilization program. Tax allowance, – one of the basic elements of hidden methods – preferred large, primarily foreign investors. The third phase favored domestically owned companies in theory – in addition to the quasi-fiscal support of state-owned companies – by creating markets via state orders rather than industry protection and non-refundable funds distributed in the framework of development plans. Although the top limit of funds granted to small enterprises increased and new methods emerged, neither small enterprises, nor those in domestic ownership obtained a significantly higher share of the subsidies. In 2002, the new government promised preferences to every category of entrepreneurs except for state-owned companies, subsidies of which it attempted to limit. The continuously multiplying programs became the main instruments for redistribution.

▫ Subsidies for saving companies were mostly limited to a certain part of state-owned companies in the 1990's. Succeeding Hungarian governments proved authentically that they were not going to save *every* company, but they could not state that they were not going to save *any* of them. On one hand, this *ambiguous authenticity* contributed to disintegrating old mechanisms, while made the rules of the developing market economy dubious on the other.

Concurrently with the withdrawal of life-saving preferences, *profit-increasing subsidies,* that also soften the budget constraints, *became conspicuous.* The two types often succeeded each other within companies; while beneficiaries were the same, the owners were different. Thus, the analysis confirms the finding of professional literature, according to which privatization is not a primary requirement of hardening budget constraints. Moreover, it also shows that *the objectives and means of redistribution are modified as a result of change in owner* . While the impact on the behavior of distributing and beneficiary organizations, the interrelation of government and business, and distortion of competition – i.e. criteria of selection – are unchanged, economic impact depends on the methods and procedures applied.

Starting from the requirement of the European Union for allowing the provision of state subsidies for reorganization, the dissertation considers the strengthening of the groups of companies concerned and the non-repeated, withdrawing character of state support, all in all, the *sustainability* of the process as the *criteria of success* of the various methods of redistribution. Based on the judgment criterion of individual preferences, it can be stated that the success of such types of preferences proved to be provisional due to the abundance of profit-increasing subsidies during the period under review. In order to evaluate redistribution that affect a broader spectrum and planned for a longer period from its origin, the dissertation *extends the definition of market-substituting and market-building subsidies* to the development programs of small and medium enterprises in a unique manner. These enterprises accept high production and transaction costs, and they are more likely to accept market failure. At the same time, market building has a positive effect on the permanent improvement of efficiency, or in other words, – and in accordance with the original criterion of success – the prospects of redistribution considered only to be provisional.

The analysis states that the market-substituting form dominated in Hungary during the 1990's. From these, normative and temporary tax allowance associated with market performance has the highest probability to meet the criteria of sustainability and improvement of competitiveness. While the other extremity involves opportunities for development and trade, and establishment of market participants strengthened by orders and individual capital injection from the state.

## Switch-Over and Rebuilding of Distributive Coalitions

The analysis based on the extended definition of state redistribution demonstrates in detail the phenomenon of switch-over from one instrument (such as budget subsidies, tax allowances and market creation) to another. Professional literature mostly refers to this phenomenon as a substitute for credit- and fiscal type methods. The new finding of the dissertation is that *switch-over is possible not only between the various means of redistribution, but also between redistribution as a whole and general regulations*. (For example, while establishing institutions for hardening budget constraints and increasing companies' fiscal discipline at the turn of the 1980's and 1990's also established the conditions for the relaxation of this discipline, the stabilization program of 1995 – although this was not its fundamental objective – provisionally decreased the pressure on increasing preferences by providing a beneficial, normative market protection for a broad spectrum of companies). Therefore, the conclusion is that *the most efficient obstacle to extending redistribution is the modification of general regulation in such a way that is favorable for business partners*, and in a broader sense, the establishment of an *institutional environment* encouraging competition and competitiveness as well as guaranteeing predictability and safety.

The dissertation states as a conclusion that *there was not a positive feedback* in the process of transformation between reinforcement of the structural bases of competition, the changes in ownership and the withdrawal of redistribution. Decrease of state-owned property was not systematically related to demonopolization, and redistribution was not reduced in conjunction with the progress of these two changes. Thus, the theory, according to which privatization increases competition by improving market structure, moreover, in conjunction with the expansion of private ownership state redistribution will gradually dwindle, has proven to be an illusion. Politics influenced the establishment of the structural basis of competition and the fluctuation of redistribution not only by developing the general framework, legislation, and oversight of compliance with the rules; ad hoc intervention by the government and short-term interests of the political parties also had their direct influence. *Depolitization of the companies' operation remained limited,* even in this narrow sense.

■ Examination of competition and subsidization policies supports the finding in institutional economics that large scale institutional changes can hardly follow a conscious and harmonized strategy. Expert Hungarian literature also shows the controversy between the entire economic policy and its various parts, emphasizing primarily the disadvantages and involuntary measures substituting them for a deliberate and consistent strategy. Contrary to these works, the dissertation defines a hypothesis – taking into account potential misdirected commitments for maintaining inefficient institutions – according to which it is *exactly* the pragmatic approach and the continuous *correction* – often appearing as a simple improvisation – that *produced a better result of transformation* than what we would assume based on the analysis of the decision-making system. In other words, the *adaptive efficiency* of the totality of government decisions *was high in the last one and a half decade – at least in the short term*. Their effect in the long run will depend on the quality of the structure and the system of institutions formed by them.

■ If there was no positive feedback between privatization, demonopolization, and redistribution in the *process* of transformation, this does not mean that the continued existence and rebuilding of the structure of large enterprises and that of state redistribution are not connected to *future* mechanisms of operation. According to the assumption of the dissertation, that requires further examination, large enterprises – a prominent part of which is directly managed by foreign investors – remained over-represented among beneficiaries despite of the changes in the preferred groups of redistribution. The dissertation defines *the paradox of ownership structure* on this basis: according to other empirical research, the ownership structure that is the most favorable in respect to competitiveness and the revitalization of the structure of production and efficiency is indeed, the driving force behind the preservation of competition-restricting state redistribution.

■ By using *Mancur Olson*'s terminology, we can interpret the *change in the role of redistribution* during the transformation of centrally planned economies as the *disintegration and reconstruction of distributive coalitions*. Political regime change, entanglement of economic relations, and the beginning of large-scale change of institutions shocked old structures and positions. These factors contributed to the dismantling of the significant portion of redistribution, a characteristic of socialism. However, the method of privatization – primarily the insufficiency of demonopolization and the important role granted to cash payment in the fame of influx of foreign capital that finally dominated the replacement of state ownership – created new and influential lobby groups. The sphere of large enterprises is relatively small even after transformation; however, their role in the economy remained significant which is equivalent to good lobby positions according to the logic of collective action. Thus, the relations between the state and companies have become tight again, although the participants changed. Repeated turnover of governments made difficult to strengthen the various distributive coalitions for a long term, – since different groups were associated with the different parties in power – but some of the participants stabilized their position and for the time being, the system itself appears to be permanent.

■ As a result of the rebuilding of distributive coalitions, the proprietary, regulatory, and market creating decisions by the state could be subject to a strong influence by large enterprises, and we can already see the signs of bias by the state (*state capture*). The state can encounter a "catch-twenty-two" situation, similar to that of the centrally planned economy. Vulnerability of the government and large enterprises was mutual at that time as they were inter-related in a closed system. Today, the field of motion *is asymmetric in favor of companies* due to openness and strength of power.

Pressure by companies and state confinement could be prevented by the power of international communities. Joining the European Union promotes market competition and restricts redistribution by stringent balance and procedural requirements. Nevertheless, the European Union also presses for and finances large scale support programs. Obtaining funds from the community is one of the most important – or at least most often mentioned – results of accession by the new member states. Accession could also be interpreted as *market creation and acquirement of funds for redistribution*, consequently, every government as the "lobbyist" of domestic companies must make an effort to attain as much external fund as possible. However, this endeavor and public opinion maintain the claims and expectations of companies, and consequently distort behavioral patterns and might even increase domestic public spending. The impact of EU and related domestic funds on the extent of redistribution depends on – in addition to the total amount of funds spent – the portion spent that softens budget constraints, and the portion of additional funds spent by the Hungarian state on subsidizing companies based on its sovereign decisions.

## NOTES

1 For the statement on privatization, see George Yarrow and Piotr Jasinski eds., *"Privatization. Critical Perspective on the World Economy."* (Routledge, London, New York, 1996): p. 18.

2 János Kornai, Eric Maskin, Gerard Roland, *"Understanding the Soft Budget Constraint."* Journal of Economic Literature (2003): www.sss.ias.edu/papers.

3 The definition incorporates, but the dissertation does not analyze the totality of the redistribution of wealth and rights of disposal, only its specific part that directly relates to organizational changes in companies. These basic sections of transformation deserve separate analysis due to their importance and complexity.