

**From Second Economy to Informal Economy:  
The Hungarian Case**

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In this paper<sup>1</sup> I do not intend to give an exact and overall description of the transformation of the Hungarian economy,<sup>2</sup> let alone an explanation of the causes of the collapse of the socialist experiment in Eastern Europe. Rather, I have set up a verbal model (i.e., I have defined the essential actors and the most crucial processes) and assuming the actors behave in the way I suggest, I offer the reader a series of propositions based on certain theoretical assumptions and logic. At some points I have inserted case studies and empirical analyses which seem to support my propositions.

### **I. Transformation and the second economy—the second economy and the transformation (Model and Propositions)**

The macrostructure of the model is very simple. There are two segments of the economy: the first and the second economy in the rational redistributive economy (Szelényi 1978), and the formal and informal economy in the market economy (Polanyi 1957). On this level of analysis, two ideal types are to be compared, i.e, socialism (communism) and capitalism. The focus is on system-specific differences in the social organization of the economy as such, and on the regulatory performance of the state.

The predominant part of the analysis will take place on the microlevel. At this level the units of analysis are the transactions (see Table 1) and transacting actors such as households and firms. The focus is on the behavior of the actors. State authorities on this level are, on the one hand, personified by their cadres; on the other hand, as organizations they are also actors in the game articulating their own interests.

The time-span of the model is short-term. It begins just before the collapse of the socialist regime in Hungary and ends in the near future.<sup>3</sup> The model covers the short

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<sup>1</sup>I owe many thanks for their comments to István Gábor, Péter Galasi, Mátyás J. Kovács, Mihály Laki and Anna Seleny.

<sup>2</sup>Instead of transition I prefer to use the term transformation, as Stark proposed, since it emphasizes more the short term at the expense of the long term (Stark 1992).

<sup>3</sup>No one knows the date of birth of the regime. Socialism died in Hungary as it was born, unexpectedly and quickly. As a participant observer of the current transformation, I do not know the event that can be declared to

period from the Great Effort launched in 1988 by the last socialist (communist) government, the political landslide in 1989, and the two years of "Tranquil Power"<sup>4</sup> up to the immediate future.

The basic assumptions with regard to the behavior of the actors are close to those of the transaction cost approach (Williamson 1973) and of structural analysis (Wellman-Berkowitz 1988), i.e., bounded rationality, opportunism and network-based strategies. The two questions posed by this model are the following: How did the transformation influence the second economy? How did the second economy influence the transformation?

With regard to the effects of the transformation on the second economy, I submit six propositions.

Proposition 1) In the course of transformation, the term "first economy" became meaningless, therefore we cannot talk about a second economy anymore, i.e., we must change our vocabulary if we are to describe the macrolevel changes in the course of the transformation.

Proposition 2) Compared to the volume of the late second economy, the size of the informal economy has increased and will most probably increase further in the near future.<sup>5</sup>

While in general there is an increasing trend, the rate of increase has been different in the various transactions of the second-to-informal economy. Moreover, some have shrunk while others have remained unchanged as the net result of conflicting effects and new activities have also developed in the informal economy.

Proposition 3) Although the informal economy has retained several similarities with the second economy, it has two relevant new features. These are the internationaliza-

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be the end of socialism and the birth of capitalism. Therefore I cannot name a single date from which the term second economy was outdated.

<sup>4</sup>The term was used in the very successful campaign in 1989 by the leading party of the coalition (Hungarian Democratic Forum).

<sup>5</sup>The increase refers to the growing number of transactions but not necessarily the growing number of actors involved in these transactions or the growing share in the GDP.

tion of the transactions and the spread of full-time activities at the expense of part-time ones.

Proposition 4) The informal economy has radically different social impacts from the second economy, as new types of transactions emerge and as similar elements operate under new political and institutional conditions.

The major differences are in the impact on the distribution of income and on geographical inequality. Whereas the second economy tended only insignificantly to increase income inequality and to even out regional disparities, the informal economy seems to widen both of them.

Due to the growing differences among households and the changing institutional structure of second-to-informal economy, there is a shift in households' economic behavior. While the second economy represented a "colorful" variety of household strategies (using Katsenelinboigen's terms), the informal economy leads to polarized household strategies, i.e., it points towards a "black and white economy."

I have formulated two propositions relating to the impact of the second economy on transformation.

Proposition 5) The actors of the informal economy have been "socialized" in and by the second economy, and invested into it. Both material and symbolic investment was widespread from low-tech technology, leasing, and sharecropping contracts to skills, know-how, networks, prestige.

These antecedents greatly facilitate the introduction of market institutions, by making the former second economy actors capable, equipped to, and interested in participating in market activities. But at the same time this inheritance tends to shape the newborn institutions according to its own image.

Proposition 6) The existence of the second economy was one of the reasons why the transformation took place without violence in Hungary.

## II. The concept of the second economy and informal economy

The term “second economy” usually refers to all activities that fell outside the direct control of the socialist state. By virtue of its simplicity and relevance (using the socialist state as a point of reference), this dichotomized definition is particularly suitable for analyzing the system-specific features of the second economy at the macrolevel.

However, since it is also my aim to offer a microlevel analysis of the interaction between the second economy and the transformation, we need a classification that can more tangibly reveal the variety of transactions comprising the second economy than can the aforesaid definition.<sup>6</sup>

An amplification of economist Istvan Gábor's (1979) definition and classification seems to serve this purpose best. He defines the second economy as the group of economic activities and transactions that take place outside of the socialist sector. The three dimensions of his classification include legality, integratedness and source of income. The first two dimensions should be viewed as a continuum. Their poles are legal vs. illegal (according to the laws and customs of the given system) and integrated vs. autonomous (the point of reference is the socialist state).

The source of income—the third dimension—can be labor,<sup>7</sup> position in the first economy, and the networks both in the first and in the second economy,<sup>8</sup> and wealth, capital, money and production assets.<sup>9</sup>

In Table 1, I have put together the three dimensions and have added some examples for a better understanding.

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<sup>6</sup>But this classification should not contradict that definition, otherwise the macro- and the microlevel analysis would cover different social phenomena.

<sup>7</sup>The most typical examples are subsistence, wage labor, and petty commodity production.

<sup>8</sup>Such as corruption and barter.

<sup>9</sup>The typical examples are usury, speculation, renting and leasing.

Table 1

## The types of transactions in the second economy

	<i>integrated</i>		<i>autonomous</i>	
	<i>legal</i>	<i>illegal</i>	<i>legal</i>	<i>illegal</i>
labor	1. petty agric. production, ("háztáji") entrepreneurship (Stark 1986)	2. tips, black market labor <sup>10</sup>	3. subsistence self-service	4. black market labor
position, network	5. MRT(Czako-Sik 1988), intrafirm barter	6. corruption, bribe, petty theft	7. REL(Sik 1988)	8. brokerage
wealth, capital	9. private entrepreneur	10. invisible-investment, tax evasion	11. private entrepreneur	12. usury, speculation, <sup>11</sup> renting, smuggling, black currency deals

To define **informal economy** I chose Portes-Böröcz's (1988) definition: "The informal sector is defined as all productive and distributive income earning activities which take place outside the scope of public regulation on the macrosocietal level."

This definition can be considered a generalized version of Gabor's definition, as it retains its dualistic nature and its focus on the power-centre.

In one respect this definition widens both the definitions of the second and of the informal economy. It is the notion of income, which I prefer to use in a substantive sense, since there are several types of nonpecuniary forms of income-saving, income-substitution activities and transactions that should be covered by the term second or informal economy.<sup>12</sup>

<sup>10</sup>Working on the side during working hours with "borrowed tools."

<sup>11</sup>In principle everything can be the subject of speculation in a shortage economy. However, the most common examples are currency, real estate and imported goods.

<sup>12</sup>Often these transactions are piled together into a separate segment called social (Henry 1978) or domestic economy (Gershuny 1983).

### III. The Scope of Second Economy in the Pre-Transformation Period

Since the time-span of the model covers only the near past before the transformation, the proper starting point for analyzing the scope of the second economy is the 1980s.

The first source for estimating the scope of second economy in the 1980s is a "guesstimate" of the volume of invisible income in the early- and mid-1980s (Galasi-Sik 1988). The term "invisible income" covers types 2, 4, 6, (partly) 10 and 12 of the classification in Table 1 (i.e., this term more or less covers the scope of illegal activities<sup>13</sup>). According to three independent expert "guesstimates," invisible income as a proportion of GDP in 1981 and 1985 (in current prices) was 14.3 to 15.4 percent and 14.6 to 16.5 percent, respectively. Using time budget information and a skilled worker's monthly average wage in the first economy, we calculated the volume of domestic production (in Table 1 the sum of categories 1 and 3)<sup>14</sup> which amounted to about 30.9 percent and 33.3 percent of the GDP in 1981 and 1985, respectively. Adding the volume of invisible income and domestic production to GDP, their share in total GDP was about one-third and slightly increasing (Table 2).<sup>15</sup>

Table 2

Distribution of National Income Supplemented by Invisible Incomes and Work Performed at Home

	1981		1985	
	Billion Fts	%	Billion Fts	%
Official GDP	635	68.6	842	67.3
Invisible Incomes	95	10.3	130	10.4
Work done at home	196	21.1	279	22.3
Total	926	100.0	1251	100.0

(Source: Galasi-Sik 1988, p. 164)

<sup>13</sup>Categories 5, (partly) 8 and 10 are missing since there was no way one could estimate the volume of MRT, brokerage and invisible investment.

<sup>14</sup>Except the volume of entrepreneurship.

<sup>15</sup>Substantial parts of types 1, 9 and 11 are covered by the official GDP statistics. Therefore (and also because of the missing elements - see footnote 13) the estimate in Table 2 can be considered a conservative one.

Another attempt to estimate the volume of the second economy in the 1980s applied the cash demand method (Laczkó 1991). Tailoring the definition to her method, she defined illegal activities as monetarized private production. In Table 1, categories 1, 2, 4, 9 and 11 are covered by her definition. As Figure 1 indicates, the proportion of illegal activities in GDP slightly increases during the first half of the 1980s, and skyrockets just before the transformation period begins.

To sum up, in the pre-transformation era there was a large and growing second economy in Hungary that began to increase at a great rate in the dawn of the transformation.

#### IV. Of the Transformation

What are the main trends of the transformation process? To define the “essentials” of the transformation, the problem is twofold.<sup>16</sup>

First of all, there have been

—numerous changes,

—in an overlapping and intertwining manner,

—in which “de facto” processes and “de jure” conditions have been, in varying degrees, mixed up.

Secondly, to understand current processes one should pay attention to the non-changes (invariabilities) also, especially in the course of microlevel analysis. That is, there are processes that originate in the pre-transformation period and are stable in the sense that their social or economic role and weight remained unchanged during the transformation.

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<sup>16</sup>There is also a third problem, i.e., there are external changes with great influence on the transformation process. From the point of view of the model, such is the collapse of COMECON and the growing insolvency of the Soviet market, the largest in Eastern Europe, and its uncertain future.



The following non-exhaustive list of structural<sup>17</sup> changes is long, though I selected only those that, in my view, are the most important for understanding the behavior of the actors in a segmented economy. The structural changes (in no particular order of importance) are the following:

- Private ownership becomes the dominant property rights form both in ideology and in law, and several associations, parties and semi-governmental agencies are formed to express and enforce the interests of employers and the self-employed;
- Growing uncertainty in the rules of operation and privileges of the state-run economy (the government no longer rescues bankrupt enterprises, bank loans are limited or subject to different conditions, monetary restrictions are more stringent, personal networks “turn around,” etc);
- Privatization, both the initial spontaneous phase and the subsequent centralized phase. The process is meant to break down state ownership. During the spontaneous phase of privatization those possessing economic power cut apparently valuable slices of the state-owned cake for themselves and their clients. The state established a special bureaucracy to control this process.
- Reprivatization, relevant mainly because of land reprivatization. Within limits, this essentially means redistributing the land owned by agricultural cooperatives to its former owners.
- Abolition of travel restrictions, which means that each Hungarian citizen can travel wherever he or she wants and can stay as long as he or she wishes. No visas are required in Europe and it is easier to travel overseas than it used to be. However, the currency that may be purchased legitimately from the state is insufficient to finance tourism and there is hardly any other legal source of hard currency.

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<sup>17</sup>By structural I mean those changes that straightforwardly abolish the “socialist” elements of the economy.

- Quasi convertibility of the Hungarian forint, meaning the end to a state monopoly of foreign trade and free (though one-way) foreign exchange accounts for individuals.
- “Acceptance” of unemployment as a state policy, i.e., the recognition that neither the restructuring of production nor privatization can take place without unemployment. In other words, unemployment was allowed to surface, i.e., intrafirm un- (or under-) employment has been converted into open unemployment.

As to the problem of evaluating the “de facto” and the “de jure,” e.g., while there is already a law of reprivatization, no one really knows how much land will be redistributed and how this process will take shape. On the contrary, there is the legal basis of a new banking or monetary policy, but a crude power game is already occurring involving the “Green and Red Barons,”<sup>18</sup> the new ruling elite and international sharks.<sup>19</sup>

The most important stable components of the transformation process are (again, in no particular order of importance) the following:

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<sup>18</sup>The nicknames of important socialist managers of cooperatives and firms.

<sup>19</sup>A fine example of the international sharks’ appearance on the Eastern European scene is Mr. Kubiak: “The 47-year-old Mr. Kubiak was born near the town of Brest-Litowsk...he was exiled from Poland in 1968 after participating in student unrest at Warsaw University....Mr. Kubiak, whose return was banned until the mid-80s, went to Sweden as a refugee and completed his education. Immediately after graduating, he entered business for himself, selling Western machine tools to Poland in the boom of the 1970s... he also developed sidelines in exporting Polish timber and arranging loans for state-run Polish companies. Although the timber business was controlled by the state, Mr. Kubiak said, he persuaded some officials to mislabel the best wood and sell it him as if it were of low quality....Poland’s transition to a market economy has only expanded his opportunities. In one deal he took advantage of tax holidays Poland offered to foreign joint ventures. Just before the deadline for setting up these ventures expired last year, he registered 100 shell companies, which he is now offering for sale at a handsome profit....Last year, Mr. Kubiak donated office space in Warsaw’s Marriott Hotel to the Liberal Party. During this period, a leader of the party, Privatization Minister Janusz Levandowski, named him special negotiator in a sale of a state-run television tube factory. Mr. Kubiak said he netted US\$250,000....As the Liberals’ political star waned, Mr. Kubiak cultivated other alliances. He contributed money to a foundation that paid the salaries and office expenses of the Civic Committee, a political group then headed by Mr. Olszewski. After the fall election, Mr. Olszewski emerged as Prime Minister... (“Free-Market Capitalism, Applied to the Stage,” *New York Times*, April 12, 1992).

Of course not only former Eastern Europeans find the chaos of the Eastern European economy tempting but also multinationals and small sharks of genuine Western origin with no previous experience in or network with Eastern Europe feel the itchof earning extra profit in this newly found goldmine. However, since they do not have the language, the local knowledge and the network, they have to hire experts in bribing, lobbying and market research, which makes them less competitive.

- Recession<sup>20</sup>
- Persistence of inflation, which “socializes” both producers and consumers
- A fall in real income, pauperizing low-income people and eroding the positions of middle-income groups<sup>21</sup>
- Tightening of the already fairly strict tax regulations (e.g., the reduction in number of exemptions, compulsory wealth declaration, campaign to identify invisible incomes, etc.).

## V. The impact of transformation on the second economy

### A. The transformation of the vocabulary

The list of structural changes in the course of transformation makes it obvious that the socialist experiment is over. However we describe the state, it is definitely not a socialist (communist) one anymore.

With the demise of the central planning office, single party system, priority investment projects and COMECON relations, the economy can no longer be deemed the first economy of the socialist system. Although the former general manager is still in power and is still dependent on the benevolence of the ministerial bureaucracy, and no matter how predominant the state and all its agencies still are, today's economy can no longer be described as a redistributive system. Perhaps the best label we can use to characterize the contemporary Hungarian economy is a “state-controlled market economy.”

But if socialism is gone, so is the system-specific distinction between first and second economy. And since we are left without any better option, we must shift to the general term, i.e., use the formal/informal dichotomy.

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<sup>20</sup>Some examples from a report of a leading market research institution (the figures are the percentage compared to the previous year=100%): —the GDP in 1989 and in 1990 was 99.8 and 96.0; in 1991 the forecast was 92-92%; —the rate of inflation was 117% and 129% and the forecast was 136-137%, —the gross industrial production 99%, 91.5% and 85% (Eorsi 1991).

<sup>21</sup>In a representative survey in Oct 1991, 12% of the population claimed that they do not have money enough for food and 9% reported problems in paying the rent or mortgages (Sik 1992).

The paradox is that, had there been no change at all on the microlevel, the macro-vocabulary would have changed anyway. For example, even if a private entrepreneur or shopkeeper does everything in the customary way, his activity has become part of the formal economy overnight.

To sum up, Proposition 1 simply follows from the existence of structural changes during the transformation.

### **B. Of the changing size of the second-informal economy**

The starting point for testing the validity of Proposition 2 is Table 1. The ultimate question is: in what direction has the volume of these types of transactions moved during the transformation?

Due to structural changes of the transformation process, some types of the second economy are not parts of the informal economy. In a capitalist economy, private entrepreneurs, retailers, private farmers and the self-employed are all participants in the formal economy. In other words, some activities of the former second economy (Types 1, [partly] 2, 8, 9, [partly] 10, 11 and [partly] 12) now emerge as part of the formal economy.<sup>22</sup> Hence, the informal economy that has grown out of the second economy, according to Proposition 1, by definition excludes certain activities.

But if the informal economy is structurally different from the former second economy, then the first question of Proposition 2 should be raised with great caution. In other words, instead of having one group at two points of time we have two, partly overlapping, groups to be compared before and after the transformation. But due to structural change there are also activities and transactions in the informal economy that did not exist in the second economy.

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<sup>22</sup>The entrepreneurship (legal, integrated activity based on labor) disappeared entirely, since it was, on the one hand, a means of coping with tight wage regulations and with the lack of work incentives and, on the other hand, a state-sanctioned means for key staff in socialist firms to organize their internal labor market (Seleny 1991, Stark 1986).

That is, the post-transformation informal economy differs from the pre-transformation second economy in two ways: due to structural changes there are activities which could not exist in the second economy and activities which used to be the elements of the second economy but cannot be the part of the informal economy (Figure 2).

In the light of the above we have to redraw Table 1, leaving out those types which are not part of the informal economy ( $X_{sec}$ ), and adding to those transactions that are new ( $Y_{inf}$ ). The result can be seen in Table 3.

Table 3

## The types of transactions in the informal economy

	<i>legal</i>	<i>integrated</i>	<i>illegal</i>	<i>autonomous legal</i>	<i>illegal</i>
labor			2. black market labor, tips	3. subsistence self-service labor	4. black market labor immigrant
position, network	5. MRT(Czako-Sik 1988) intrafirm barter		6. corruption, bribe petty theft	7. REL(Sik 1988)	8. racketeering
wealth, capital			10. tax evasion <sup>23</sup>		12. usury, black currency dealing, smuggling drugs, illegal trade in aliens

To test the validity of Proposition 2, I must prove that

$$X_{inf} + Y_{inf} - X_{sec} > X_{tr}^{24}$$

Lacking any sort of reliable time-series data, in the following pages I present some think pieces that are based more on the behavioral and time-span assumption of the model in

<sup>23</sup>Brokerage (of type 8), entrepreneurship (types 9 and 11) and renting and speculation (of type 12) are not informal activities, but to the extent (and it is likely to remain great) that some transactions closely associated with these activities remain within the territory of the informal economy—but in different cells such as black labor, corruption or tax evasion.

<sup>24</sup>Had I not taken into consideration the structural changes the conclusion that  $Y_{tr}$  is greater than  $X_{tr}$  would be almost trivial since it is almost trivial that  $X_{sec} + X_{inf} + Y_{inf}$  is greater than  $X_{tr}$ , except if the decrease of  $X_{sec} + X_{inf}$  is greater to or equal with the volume of  $Y_{inf}$ , which is very unlikely the case.

Part 1 than on the sporadic empirical facts I was able to gather. The logic of the think-piece-based analysis is the following:

—if the verbal model (Part 1) is correct,

—and if the characteristics I artificially chose to describe the transformation process are relevant,

—then in the following nine think pieces the actors should behave as I propose,

—and therefore the volume of transactions should move toward the direction that follows from the behavior of the actors.

Proposition 2 is likely to be correct if, summarizing the moves of the various types of transactions influenced by the processes described in the think pieces, we find that there is an overall increase both in Xinf and in Yinf piles.

**Think piece 1:** Privatization and reprivatization are common, insofar as in both cases state ownership is replaced by private ownership. This change of property rights (and the necessary consequences in ideology and in the legal and political system) is the most important element of transformation in the long run. Since it is not my aim to analyze the effects of changing property rights in general, I selected only one element of this structural change that seems to be of crucial importance in determining the size of the informal economy in the short run. With reference to Kornai's approach (Kornai 1980), privatization can be interpreted as a change of owners through which the cost-insensitive and resource-constrained socialist sector of large enterprises will turn into a cost-sensitive and demand-constrained market sector of capitalism.

What is the impact on the second economy of the move from cost insensitivity to cost sensitivity in the short run?

Two additional arguments are needed to answer this question. First, the privatized sector is faced with unfavorable market conditions (shrinking domestic market, difficulty in entering international markets because of low technological standards and marketing skills, high fixed production costs such as taxes, raw materials, transport). Moreover, since

it is very likely that the unfavorable conditions will not change in the short run and since this skepticism is widely accepted, entrepreneurs tailor their behavior to these forecasts.

Second, privatization and reprivatization are undertaken by "poor capitalists"<sup>25</sup> and in an environment where the supply of credit is scarce and expensive.<sup>26</sup>

If the preceding two arguments are true, we may assume that the profit (which should be high even in the short run because the new owner has insufficient reserves) cannot be increased by the rapid build-up of mass production, by the penetration of new markets, or by implementing new technologies, since neither capital nor experience and time are available.

Consequently, there are only two ways to increase profits immediately: to raise prices and/or to cut costs. As to the former, rising prices are a common experience in Eastern Europe. Both producer and consumer have already been well socialized to expect inflation. But there are two obstacles to exercise this profit-raising strategy. First of all, the efficient demand of the impoverished population is decreasing; secondly there are official measures to counteract inflationary processes.

Cutting costs can be done again in two ways: reducing the quality of the product (or the service) or reducing the only non-fixed costs, i.e., labor costs. Reducing quality has been a widely known and applied cost-saving technique in the second economy (Galasi-Kertesi 1985, 1987), so very likely it is also often used nowadays, the more so since there is almost no obstacle to it. The only problem with this cost-saving method is that it does not increase profit very much in the short run.

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<sup>25</sup>Despite the fact that half of foreign investment in all Eastern European countries in the past two years was focused on Hungary, the per unit amount of foreign investment is very low.

<sup>26</sup>To characterize the financial conditions of domestic entrepreneurs I refer to a study done by TARKI in early 1991. The data (a representative sample of 1000 limited companies and 1000 self-employed) shows that 55% and 87% of them have less than 3 employees, 38% and 40% have their office (or production) space at home, 11% and 35% of them do not use phones and of those who do, 40% and 46% have no office phone.

Reducing labor costs is a fine new solution. There are three mutually non-exclusive methods that are particularly expedient and require no additional inputs<sup>27</sup> to reduce labor costs, i.e.,

—lay-offs (and the termination of contracts with homeworkers, with contractual self-employed, and with sharecroppers) and more intensive and/or less well-paid use of the remaining workforce;<sup>28</sup>

-substitution of paid labor for domestic labor (self-exploitation instead of market transaction) and

-tax evasion<sup>29</sup> by hiring black market labor.

Considering the aforesaid consequences, the question is how these results of privatization and reprivatization affect the volume of the informal economy. In the short run, in an environment of unfavourable market conditions and scarce capital and loan supply, privatization and reprivatization inevitably result in unemployment, increasingly intensive or underpaid work, the shrinking of contractual, and the increasing of black market labor and increased self-exploitation and tax evasion.

**Think piece 2:** As the level of unemployment rises sharply (Figure 3) partly because of privatization (Think piece 1), partly because of general recession, and partly because of growing uncertainty in the remnant of the state sector, the intrafirm informal economy (petty theft, work on the side, "troubleshooting," barter, etc.) will shrink because

- it is easier for the management to organize and control fewer workers,
- the threat of unemployment itself is a disciplining force,

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<sup>27</sup>More expensive and less immediate solutions such as moving to a less expensive local labor market, reorganization, labor-saving investment, etc., are obviously out of question.

<sup>28</sup>In a survey done by the ILO and the Department of Human Resources at the Budapest University of Economics in 1991 (N=407, representative to the entire FELDOLGOZOIPAR) privatization turned out to be the strongest factor in explaining the likelihood of layoffs. While on average there were 4.4 layoffs in 1990, among those firms that were state-owned in 1988 but became private by 1991 the average number of layoffs was 11.6.

<sup>29</sup>The evasion of social insurance benefits is perhaps even more important since its level is higher than that of the tax.



—and there is no longer the kind of shared interest between workers and foremen that was also endorsed by plan- and production-oriented top management (Sabel-Stark 1982, Stark 1986). On the contrary, since there is ownership and management change in the course of privatization of large firms, both the former patron-client networks and the firm-oriented “We-consciousness” expire, demolishing the socio-psychological obstacles of lay-offs.

**Think piece 3:** The growing importance of family business (as a result of privatization, reprivatization and unemployment<sup>30</sup>) expands the scope of subsistence<sup>31</sup> and of self-service, and in turn of REL, which is the integral extension of household production.

In rural areas, partly due to reprivatization (which is a promise to those who want to become farmers and a threat to those who will lose their jobs if the cooperatives dissolve), as a result of extremely rapidly rising unemployment<sup>32</sup> (Figure 4), a combination of subsistence and petty commodity farming in addition to REL and black market labor may often be the only possibility for survival.<sup>33</sup>

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<sup>30</sup>The extremely high number of taxi drivers in Hungary is partly a result of the fact that recently young, urban (or living in the close vicinity of major cities) and relatively well-to-do (who could invest a car) people with some entrepreneurial ability flooded into this market to escape unemployment (Sik 1991).

<sup>31</sup>There is nothing cheaper than self-exploiting subsistence, especially in a situation where there is no chance of getting a job, not even casual work. Zero opportunity cost can be the result of the total lack of alternative job opportunities.

<sup>32</sup>While the level of unemployment is about 3% in Budapest it is as high as 15-20% in some parts of Hungary. Unemployment among the rural population is rising more rapidly partly because a firm first lays off commuters. Even if a firm no longer subsidizes travel expenses, it soon leads to unemployment since the travel costs are very high compared to the low wages. Moreover, rural firms were the first to be closed down as they were often less efficient than their counterparts (more outworn machinery, higher transaction costs, less developed infrastructure, etc.). Finally, some of the largest socialist industrial developments (mines, steel and chemical plants) occurred in some rural areas, and these monstrous plants now are on the edge of total bankruptcy causing unemployment to entire local markets.

The changing experience of the rural and the urban population is mirrored in Table 23 in Kolosi-Robert (1991). While in 1982, in 1986 and in 1989 the proportion of those who feared unemployment was low (about 9%, 7% and 16%, respectively) and similar both in cities and in the villages, in 1991 in major cities 43%, in towns 47%, and in the villages 52% of the population feared unemployment.

<sup>33</sup>According to a recent survey of the Hungarian Statistical Office in 1991 the number of part-time farmers younger than 50 increased and the overwhelming proportion of them produces only for self-consumption and does not want to become full-time farmers (HVG 1992).

Subsistence and self-service (in housebuilding and maintenance, in services and caring) combined with REL are likely to increase, the more so because this is an obvious way to supplement diminishing real income due to inflation.<sup>34</sup>

**Think piece 4:** Due to the decreasing effective demand and the liberalization of imports there is no more shortage of production or consumer goods. The other side of the coin, however, is that there are growing problems in selling products and services. Consequently, while bribes for buying shortage goods are becoming rarer, bribes and corruption for selling goods are gaining importance.<sup>35</sup> The fight to reach or to maintain monopoly positions may go as far as the appearance of racketeering and mafia-like organizations (especially in markets offering windfall profits).

While there is a change in the direction of bribes, the spread of customary tip-giving remains unchanged but perhaps the net level of it diminishes due to the decreasing efficient demand of the ordinary consumer.

**Think piece 5:** On the one hand, partly because privatization and reprivatization offer a unique and temporary occasion, partly because of growing uncertainty in economic policy, and partly because of the opening up of the economy toward world markets, there are excellent opportunities to seize the moment and increase wealth, market position, and power. On the other hand, since the state retained key positions in financial and economic policy-making, and since the overall conditions of production and distribution lack stability, both corruption and MRT are likely to increase.

**Think piece 6:** Since Hungary's borders have been perhaps the easiest to cross in the whole of Eastern Europe and its geographical location is central, specialized forms of smuggling may quickly develop and proliferate.

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<sup>34</sup>In a representative poll in October 1991, 61% of rural respondents characterized themselves as having problems making a living, in contrast with the 47% of the Budapest respondents (Sik 1992).

<sup>35</sup>Galasi-Kertesi (1990) prove that even in the second economy more than half of major corruption cases (their data contains the content analysis of articles dealing with major corruption and bribe cases in a police journal between 1966 and 1988, N=116) used to be aimed at selling goods for state agencies (37%) and getting permission from state authorities (22%).

The recent history of illegal trading and of illegal markets, the so-called “Polish or COMECON markets,” also illustrates that this is an uninterrupted development from “subsistence” peddling, through small-scale marketing, to internationally organized illegal trading. And of course the advantages of economies of scale can be achieved only if trading relies on stores, sales networks, market research, racketeering and bribes.

Given its geographical location, liberal policies, bribe-oriented authorities, underdeveloped monitoring infrastructure, and the political and economic changes in the neighbouring countries, Hungary is at the main crossroads of international stolen car smuggling (cars stolen in the West [mostly in Austria and in Germany] to be sold in the East [mostly in Poland and in Russia]), of the illegal exchange of immigrants (smuggling of would-be migrants from the Far, Middle, near and very near<sup>36</sup> East to the West), and, more recently, gunrunning (from West to South the very near East) and drug trafficking (from East to West).

At the same time, unemployment and general pauperization resurrect illegal “subsistence” trading of a “Third World” form in which an increasing number of people peddle or go to the marketplace to sell their last pieces of junk or small items, depending on the “capital” they have.

Think piece 7: Just before and during the first months of the transformation, the liberalization of travel possibilities, with limited foreign exchange supply and the quasi-convertibility of the Hungarian forint, together with the craving of the broad middle classes for conspicuous consumption, have pushed up both the “tourism-smuggling” industry and black currency market.

Gradually, however, as the effective demand of the population fell, tourism and the possession of foreign currency became “natural,” and as companies enjoyed increased freedom of exports and imports, “tourism-smuggling” diminished while the international

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<sup>36</sup>That is, Romania, Ukraine, etc.

underworld of currency dealers and smugglers organized itself in Hungary. The very liberal Hungarian border control and immigrant policy made it easy for the international mafia to monopolize the black currency market.

But due to the pauperization of the middle classes, the liberalization of currency conversion and foreign exchange accounts, as well as the adjustment of the forint exchange rate to international movements of currencies, the profitability of black currency market activity has decreased. Nowadays to keep savings in a Hungarian forint account is a better deal than buying and selling on the black market (Figure 5), since the black market prices are constant if not falling (Figure 6).<sup>37</sup> In the face of declining profits, however, dealers can only survive by organizing the market, i.e., with a mafia-type organization and more violent fights for market monopolies, and by transferring the profits of currency dealings into other related activities that can be operated through existing international links and skills such as smuggling and fraud.

**Think piece 8:** While the great commotion described in the preceding paragraphs put Hungary at a crossroads, it is not the case for international migration. While the Iron Curtain is gone, the Western countries have built a new Steel Ring around their borders. Therefore, in international migration, Hungary acts as a forced terminal. Those migrants who do not get permission to enter into Western countries remain in Hungary and set up businesses<sup>38</sup> or join the unemployed in the fight for casual jobs.<sup>39</sup>

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<sup>37</sup>The paradox of the contemporary situation is that while the Hungarian forint is convertible in Austrian and German banks it is not acceptable in any former fellow-communist countries except the Czech and Slovak Republic, since former transferable ruble-based bilateral agreements expired together with the COMECON. It is not surprising that there is a growing black market now in lei, zloty, dinar, leva and ruble. The black market of the Romanian lei is especially important since the overwhelming proportion of immigrant guest workers comes from Romania and, on the one hand, smuggle lei into Hungary, on the other hand, buy lei for the forints they earned in clandestine employment in Hungary.

<sup>38</sup>In the past few months a small but growing Chinese community has appeared in Hungary, which is partly due to the fact that Hungary was the only country they could enter without a visa. In March 1992 Hungary introduced (temporarily) a compulsory visa system for Chinese.

<sup>39</sup>According to recent official estimates in 1991, about 40,000 temporary labor permissions have been issued by the authorities and another 100,000 illegal guestworkers did casual work in Hungary. Most of them work in private construction and agriculture. The average length of their staying is 1 to 3 months.

**Think piece 9:** Although tax rates have not changed recently, there is a trend towards taxing income sources that have so far enjoyed exempt treatment. Starting next year, increases in wealth will be monitored and a campaign has been launched to discover invisible or hidden income.

However, the response to such restrictions is likely to be increased tax evasion. And if we recall what we said earlier (about difficulties businesses face with growth in black market labor), the scale of tax evasion, which will of course be "lubricated" by corruption, will increase even faster.

In Table 4, I summarize the conclusions of the nine think pieces. Except in types 2 and 6 in which cases one can argue both pro and con), the general trend is obvious. The model suggests an overall increase of all types of informal economy.

**Table 4**  
The direction of the change by the types of transactions in the informal economy

	integrated		autonomous	
	legal	illegal	legal	illegal
labor		2. TP1- TP4o TP2-	3. TP1+ TP3+	4. TP1+ TP3+ TP8+
position, network	5. TP5+	6. TP2-,TP6+ TP4+,TP7+ TP5+,TP9+	7. TP3+	8. TP4+ TP6+ TP7+
wealth, capital		10. TP1+ TP9+		12. TP6+ TP7+

In light of the above it is very likely that the informal economy is greater than the second economy used to be because

—except for the case of illegal integrated activities (type 2), all other types of Xinf have increased (types 3, 4, 5, 6, 7, 10 and 12),

—there are several and rapidly increasing new informal activities, i.e., Yinf exists and increases (types 4, 8 and 12),

And what cannot be seen in Table 4 is that large amounts of Xsec type transactions appear in Xinf cells, i.e., "haztaji" from type 1 shifts to type 3, tax evasion connected to renting, speculation and private entrepreneurship of types 9, 11 and 12 increase the scope of type 10.

The first statement of Proposition 2 therefore seems to be valid, i.e., the remnants of the former second economy, plus the new elements of the informal economy, minus the formalized part of the second economy, are likely to be greater than the second economy used to be before the transformation. Referring to Figure 1 it seems plausible that the rapidly increasing trend of 1990 has been continued.

As to the second statement of Proposition 2, since there are activities which reflect several and strong causes of increase, it is unlikely that their rate of increase would be the same as that of those with fewer and less strong driving forces (e.g., illegal autonomous transactions vs. MRT). (Let alone those two types which are influenced in a controversial way [bribe and intrafirm black labor].) All in all, though I have no reliable data, I do believe that the pace of increase is different among various types of informal activities.

### C. Of the new characteristics of the informal economy

Almost all of the new informal activities (Yinf) witness the internationalization of the Hungarian informal economy (see think pieces 6, 7 and 8 and types 4 and 12 in Table 4). This seems to support the first statement of Proposition 3 that there is a rapidly growing internationalization and increasingly significant transactions of some parts of the informal economy. And if we also consider that an increasingly popular form of tax evasion is to buy black currency and to keep it in one's foreign exchange accounts or private founda-

tions, and that there are rumors that the international cocaine mafia is showing interest in Eastern Europe (where it is supposedly easier to launder dirty money than in Switzerland), the above argument seems even more valid.

The second statement of Proposition 3 about the shift from the part-time second economy to the full-time informal economy is supported by the following arguments:

—rising unemployment increases the number of those who are forced to make their living doing casual work (what used to be their part-time auxiliary job). In other words, losing a full-time job in the formal economy but managing to maintain a former part-time job creates full-time involvement in the informal economy,

—the illegal and autonomous informal economy (especially the internationalized part of it) promises high income but requires full-time participation.

#### **D. Why has the informal economy different social impacts from those of second economy?**

There is but one (and then only an indirect) empirical proof that income inequality has increased in the course of the shift of the second economy into an informal economy. Between 1989 and 1991, the total income in the highest decile compared to the lowest decile has increased, while during the 1980s it was almost constant (Kolosi-Robert 1991).<sup>40</sup>

Another indirect empirical argument is that the invisible incomes used to be more unequally distributed than the income from the first economy (Elteto-Vita 1987). In 1989 this was also the case (Table 5).

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<sup>40</sup>In 1982 the highest income earners had 4.2 times higher income compared to the lowest decile, in 1987 4.9, in 1989 5.03, and in 1991 it was 6.01, respectively.

**Table 5. The inequality of income in different segments of the informal economy**

	N	Gini-coefficient
Total income	1011	0.305
Income in the formal economy	777	0.300
Welfare payments	563	0.355
Shadow income of self-subsistence work	952	0.523
Income in the integrated informal economy	437	0.546
Income in the autonomous informal economy	243	0.594

The table also shows that the incomes from autonomous and illegal informal activities are more unequal than the ones from integrated and legal transactions. From this it follows that if the share of autonomous and illegal transactions increases in the total informal incomes, then the inequality of these incomes should also increase.<sup>41</sup> And since according to Tables 1 and 4, illegal and autonomous activities are increasing at the expense of legal and integrated activities, income inequality in the informal economy should also have increased in the course of transformation.

Certain arguments based on the think pieces support the proposition that the informal economy increases income and territorial inequality, while the second economy tended to equalize them. The reasons for increasing income inequality are as follows:

a. The increasing importance of full-time activities results in wider income inequality in two ways. First, in the face of losing jobs, reduced real income, inflation and the oversupply on the black labor market, subsistence activities have to be continued even at a lower income because they are the single source of survival for many (see think piece 3). This is particularly the case with the loss of the secure, though poor, double strategy indi-

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<sup>41</sup>I assume also that there is the same association between legal and illegal activities, i.e., the more illegal the transactions, the more unequal their income distribution is.



viduals enjoyed under socialism (i.e., small but safe and effortless income in the first economy and the "undercontrolled" and foolproof second economy).

Second, the full-time informal activity undertaken in the hope of large income has to yield well because it has to cover the increased risk, the substantially higher transaction costs,<sup>42</sup> and sometimes prestige consumption.<sup>43</sup>

b. Internationalization increases income inequality insofar as foreign capital recruits a small, loyal and profit-oriented elite group which is highly overpaid compared to the local income level. Thus, a group with extremely high income emerges.

c. It is obvious that high corruption incomes increase income disparities, as they are invariably accessible to a small group. And corruption is growing not only because of its self-inducing tendency (Galasi-Kertesi 1987) or the net result of the effects already described in the think pieces, but for two other reasons as well. The increasing income disparities resulting from the emergence of small full-time and international activities drive up corruption premiums on the one hand, and a similar effect is produced by the replacements of the state apparatus, since the new cadres should be carefully tested and tempted and that supposes extra search and corruption costs.

d. If it is true that the scale of tax evasion positively correlates with the size of income, growing tax evasion (think piece 9) also adds to income disparities.

e. Finally, inflation also increases income inequality, assuming that inflationary extra profits, the ability to immediately pass on inflation and the inability to fend off inflation have a positive correlation with the income level. And we have every reason to believe that this is the case, because earning high income and emerging a winner from the encounter with inflation stem from the same economic and social roots.

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<sup>42</sup>The growing costs of organizing full-time informal activities stem from the higher costs of corruption and of racketeering.

<sup>43</sup>Conspicuous consumption is not just for its own sake but is an important symbolic investment which in the long run has payoffs in the form of increased prestige, popularity, fame and resourcefulness.

As to the causes of the increasing disparities between urban and rural areas,<sup>44</sup> I would argue that the shift from second to informal economy benefits cities (and Budapest in particular) in the short run. Given the infrastructural advantages, foreign and local investments and related informal activities will flow to cities which offer a more convenient ground for illegal activities (weaker transparency, the concentration of public administration to be bribed and of illegal migrants, providing a preferred site for monopolies because of the larger market and lower transaction costs).<sup>45</sup>

In addition to the aforesaid, the trends described in think piece 3 also severely affect rural areas.

All in all, both statements of Proposition 4, i.e., the growing income and territorial discrepancies in the course of the shift from second to informal economy, seem to be acceptable.

Turning our attention to the second statement of Proposition 4, the polarization of the households' economic behavior is a combined result of the

—shift from auxiliary income, part-time second, to low or high income full-time informal economy,

—emergence of a high-income international informal segment,

—growing inequality between rural and urban areas. Thus, there will be a lasting and growing polarization of household economic behavior.

This bifurcation of the informal economy will facilitate the spreading of "black and white economies," i.e., criminal and self-subsistence activities, while hindering "in-between" solutions. In other words, within the newborn informal economy, the process of structural changes creates two separate sub-economies with different social impacts—a social economy based on households, self-exploitation and part-time-activity-based petty

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<sup>44</sup>There are other dimensions worthy of further research, e.g. increasing inequality between developed and underdeveloped areas, the increasing social differences between those areas where full-time and international informality are more widespread (Western border cities) and where these activities are missing.

<sup>45</sup>This was already the case in the last decade of socialism as can be seen in Nemes-Ruttikay (1989).

commodity production; and an underground economy operating on a large scale, based on full-time activities, growing more and more international and combining high risk with windfall income.

Such a polarization (corresponding to the second part of Proposition 4), which in the short run leads to cumulative income and regional disparities, could easily lead to a sort of "third- worldization" in the informal economy in the long run. As a result, the income and territorial inequality among households will ultimately solidify into overlapping and intertwining social inequalities which will be manifested not only in different consumption patterns and standards of living, but also in different intergenerational household strategies, in residential segregation and in cumulative and lasting social differentiation.

#### **VI. The impact of the second economy on the transformation**

The "creation" of the second economy (in the beginning a pacifying policy "from above") or the fact that the second economy was allowed to exist (as a sort of grassroots movement which at one point overcame its obstacles) was perhaps the most important economic policy element of the kádárist experiment, strongly linked with supporting mass consumption, toying with the market and maintaining the status quo on the basis of peaceful coexistence (giving more carrot than stick for as long as possible). The second economy was greatly instrumental in keeping the first economy operable, maintaining relatively high standards of living and turning Hungary into the jolliest barracks in the camp.

Of course there was a price to pay. Informality not only lubricated but also distorted the first economy where everybody from managers to unskilled workers first considered using tricks, lobbying, bargaining and loopholes rather than improving efficiency or quality, where all sorts of personal networks and informal organizations run the economy, where the first and the second economies, living peacefully together, took advantage of vulnerable consumers and of soft budgets (see Galasi-Kertesi 1985, 1990).

The second economy was neatly controlled and autonomous, simultaneously (Gábor 1979, 1991). As a result of the rapidly changing short oppressive and longer laissez-faire periods, the second economy remained labor-intensive, investments were postponed and innovative skills were consumed in order to survive and not to develop business. The participants of the second economy were interested in short-term profit maximization and saw (rightly) the cheapest and least risky way of doing so in self-exploitation and if they could manage in the development of miniature monopolies through personal contacts.

The existence of the above conditions for decades led to a nation-wide subculture and to a dense personal network in the economy which socialized the participants and organized their relations. Consequently, there was practically no escape from participating in the second economy in one form or another, but typically in both forms, i.e., as income earner and as consumer.

Obviously, such a wide and long-lasting kind of subculture and network could not disappear in the course of transformation. Why should they have disappeared once they had been so effective for a long time? Every social formation has a degree of inertia, so that even if the subculture and network had become redundant, it would have taken some time before they would have completely disappeared.

In fact, since the given subculture and networks emerged and crystallized as a means to overcome troubles, these skills and networks became proper coping means at a time of transformation and upheaval (see Part 4).

Consequently, the informal economy has an increasing importance for the households in making ends meet, not only because of the inertia of the former second economy or because of the new informal elements, but because people are rational and they rely upon their deeply socialized behavioural patterns, skills and networks for earning their bread-and-butter. And they do it not because of "traditionalism," but because they invested

in these assets (see human capital and transaction cost literature) and these are assets which proved effective in coping with economic troubles.

#### A. Second economy distorts the newborn formal economy

What sort of economy will emerge in the course of transformation? The answer seems to be simple: it will be a market economy. But there is a variety of market economies. The marketplace in Dahomey, in ancient Greece or the medieval market (Polányi 1957) does not even resemble the market of the neoclassical or Marxist theory. Without going into details, let me illustrate with another think piece that the “quality” of a market is largely determined by the behavior of market participants. Let us assume it axiomatic that each market participant makes rational decisions and tries to maximize profits or wages. The behavior of the participants is, however, also influenced by sociological factors including the behavioural patterns,<sup>46</sup> the composition of human skills and the already existing networks. In other words, their behavior on the market depends partly on how they previously learned to behave in market transactions and partly on the investments they previously made.

The above example is relevant for our case because there used to be a market in Hungary, and on this market most Hungarians practised market behavior as producer, service-provider, and of course, as buyer. However, it was a market that was threatened, tolerated and often (if the wheels were properly “greased”) encouraged simultaneously by the state.<sup>47</sup> The uncertain combination of threat and toleration, and the multiple ways of

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<sup>46</sup>Or as Etzioni put it: “... individuals are penetrated by the institutions and cultures in which they spend their formative years....Many...citizens of post-communist societies...have acquired specific personality traits and work habits that cannot be modified in short order. These include working slowly, without undue exertion, not taking initiatives or responsibilities, stressing quantity over quality, featherbedding, using work time for other purposes...promotion based largely on irrelevant considerations such party loyalties and connections, barter of work time and material for other favors, and low-technology approaches.” (Etzioni 1991, p 4).

<sup>47</sup>To find a balance among oppression, toleration and encouragement in policy-making in regard with the private sector, Gabor (1991a pp. 6-7) characterizes three dilemma which was unsolvable for the economic policymakers: “... (1) stimulating private activities while trying to keep earnable incomes in parity with comparable wage rates in the public sector; (2) stimulating private accumulation while seeking to restrict

taking advantage of the built-in corrupting mechanisms of the system prevented the formulation of a "normal" market strategy, be it artisanship or entrepreneurship,<sup>48</sup> long-term planning or investments that would have offered long returns or full-scale "citoyenship."<sup>49</sup>

Moreover, since there was no difficulty in selling products and services as the state "guaranteed" shortages and efficient (though not large) demand, therefore marketing or public relation were not necessary. Thanks to the low price and poor quality of products in the state sector, it was easy to excel in the second economy where it was not imperative to improve quality, but where it was possible to raise prices. As Galasi and Kertesi (1987) suggested, both the state and the second economy found their own respective strategies to earn easy money because it was easier, cheaper and safer to monopolize than to develop products. The market of the second economy was also inclined to monopolize whatever possible, hence, it developed local and product monopolies or cartels in the absence of antitrust laws, and competition boards (Sik 1991).

Obviously, the various actors of the second economy were socialized by their experiences and invested into their human and network capital in different ways.<sup>50</sup> Except for the fact that all of them used to be actors in the second economy, there were very few similarities in their socialization and in the structure of investment between a prostitute and

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income differentials deriving from capital investment: (3) restraining entrepreneurial autonomy and entrepreneurial profit through first economy firms as integrative monopolistic firms while trying to preserve the market-sensitive and self-financing character of small plants and farms thus integrated."

<sup>48</sup>According Gabor (1991a) the impacts on private entrepreneurs are the followings: "In the first place...the erosion of business morality... to strive for quick enrichment instead of pursuing a longer-term business policy. Secondly,...to build bribe connections in order to moderate uncertainties due to unpredictable fluctuations in government policies. Thirdly, it contributed to making full-time participation and business investment in the second economy marginal...."

<sup>49</sup>Gabor (1991b p.125) refers to Szelenyi (1988) saying that the behaviour of rural private entrepreneurs as citizens and as farmers in socialism is "so distorted that they could hardly be compatible with conditions of a market economy being sought.. (since)the entrepreneur called into being by socialist embourgeoisement is.. more 'bourgeois' and less 'citoyen' than the small producer in Western societies."

<sup>50</sup>Of course not only the various types of activities but other social differences such as nationality, age, place of residence and social background also influenced the way one developed capital and experienced socialization in the second economy. See Stewart (1991), Verdery (1991), in regard with nationality.

her pimp, a subcontractor of a cooperative and skilled worker in an entrepreneurship, a subsistence farmer and a corrupt manager.

But the few similarities in their socialization and investment deriving from their status of being active in the second economy are very important if we are to understand the behavior of the actors of the former second economy under new circumstances. To be active in the second activity meant that one had something to hide. To avoid cognitive dissonance this could be done only by questioning the legitimacy of state-imposed policies such as tax, wage regulation, etc. To carry out activities within the second economy one should develop mutual trust among the fellow-transactors and to achieve this one should develop and maintain dense personal networks.

The transformation can do a great deal, but it cannot erase ingrained habits and cannot influence people to sacrifice their previous investment in human and network capital on the altar of change. The former practices will continue to survive for a considerable time so the spirit and the practice of the second economy haunts the new Hungarian market economy and shapes the institutional conditions and the behavior of those who want to enter the formal economy.

This is particularly true since there is no reason to change former habits or abandon already existing networks at a time when there is nothing better with which to replace them (see Part 4 and think piece 1 and 4). Thus it is worth relying on them because they are tried and tested. In today's polarizing informal economy, which is tied to the staggering and rather unsteady cart of the formal economy, both losers and winners may feel that they have hardly anything to rely upon except that which they learned in the accursed past.

#### **B. The role of the second economy in preventing violence in the course of transformation**

One of the favourable effects of the second economy was the birth of the petite bourgeoisie (or the birth of the semi-proletariat see Szelényi 1988), a wide workers elite and a

large group professionals. Although life grew harder for everybody by the end of the 1980s, the standards of living did not drop so low that this could have sparked off a revolution. In Marxist terms, thanks to the second economy, people had more to lose than their chains, and as we know from the history of labor movements, revolutions tend to be started by those who have nothing to lose but their chains.

Or, using the terms of structural analysis and of transaction cost economics, Hungarians invested in and developed a sizeable and asset-specific capital comprising skills, network, knowledge, prestige and know-how; and rational actors do not let their investments be ruined.

Investment into know-how, position and network (both vertical (Csanádi 1991) and horizontal (Czakó-Sik 1988)) was especially crucial for those bureaucrats both in the party and in state authorities who could manage to do it. It seems to be plausible to assume that experience in the second economy and hopes (if not concrete plans) to develop or extend investments into the would-be informal economy could have been one of the reasons why some of the cadres<sup>51</sup> were ready to abandon their power in the first economy which obviously increased the chances of a non-violent transformation (See Nee 1991).

Of course, it was not simply by creating the relatively higher standard of living and the certain (though limited) extra opportunities to maintain or increase it that the second economy "derevolutionized" the transformation process. The coping means which have been developed to achieve a higher standard of living, to cope with shortage and to beat the system, created a special milieu, and little by little a subculture in which

- people tried to solve their problems individually,
- on a "things-will-workout-somehow" basis,
- using personal networks.

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<sup>51</sup>Especially the younger, well-educated state technocrats who spoke foreign languages were familiar with the protocol of the market and whose networks extended beyond the Hungarian economy. Several examples prove that this circle of cadres was quite substantial.



Such an individualistic, wheeling-and-dealing-oriented, personalized sub-culture does not promote the kind of collective action necessary for revolution.

During the two decades of peaceful coexistence, both state and citizens have learned that it is useful to seek compromises, that major decisions (Big Leaps) usually end up in fiascos and that everybody can be only a loser in an upheaval. The lesson of how to become depoliticized was learned in the school of the second economy. In other words, it was the ground on which both actors learned the rules of peaceful coexistence. And a citizen who is used to seeking compromises, relying on a "wait-and-see" approach and defending whatever he has accumulated, will not go out on the streets to kill.

Finally, the personal networks that ensure the operation of the second economy intertwine the whole society. And people tend to use violence against strangers and not against acquaintances. Hence, the network basis of the second economy spilled over and prevented a showdown.<sup>52</sup>

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<sup>52</sup>Except when personal networks are segmented along national, tribal, clan or residential clusters. This configuration of dense networks and informality increases the chances of conflict especially in the course of transformation when, on the one hand there is a sort of power vacuum, on the other hand the economy is in chaos. This explains why, for example, in Georgia and in Armenia the very well-developed second economy fuelled violence instead of hindering it.

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**Figure 1 The proportion of illegal activity in the GDP (1980-1989)**

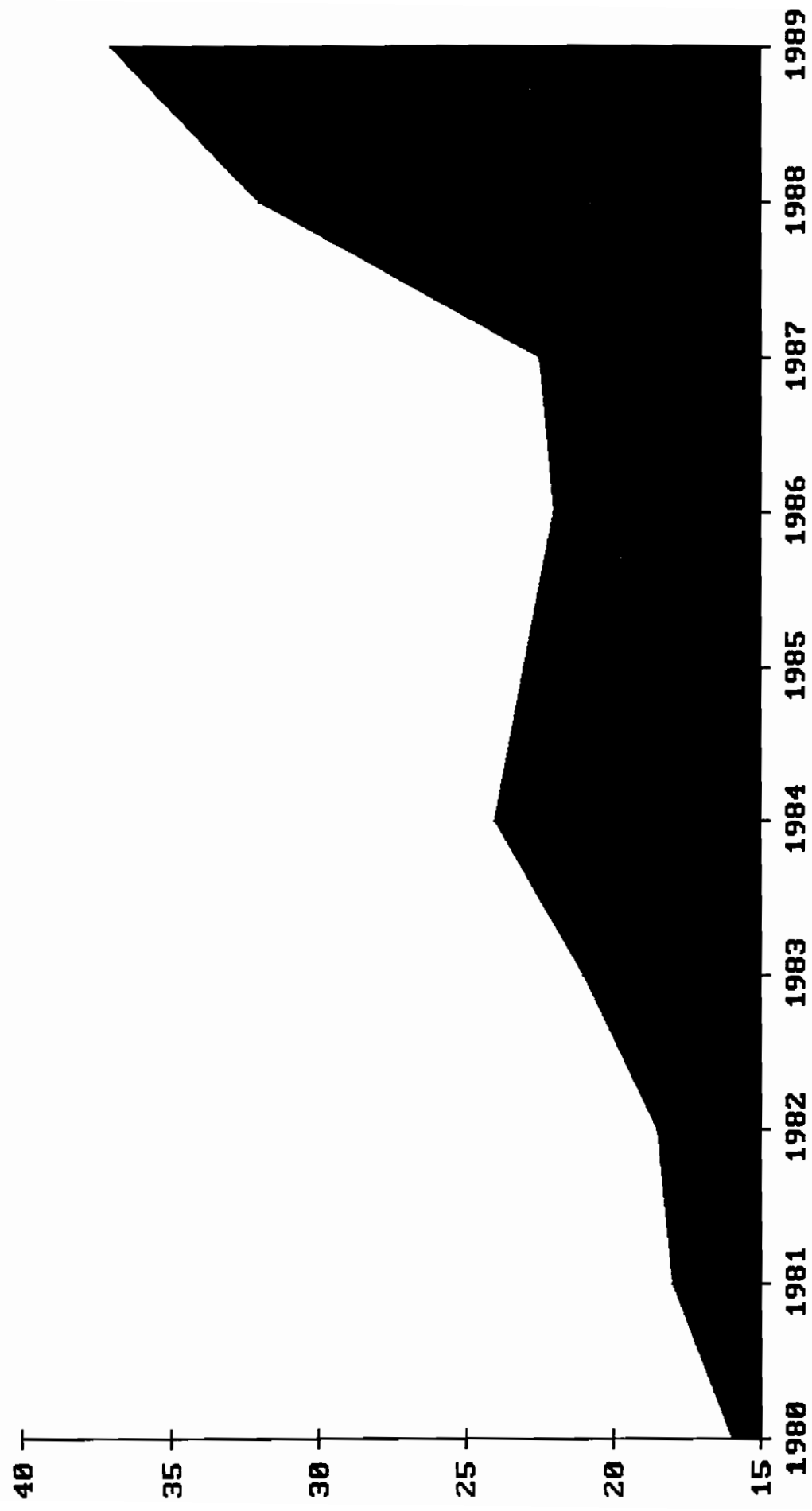
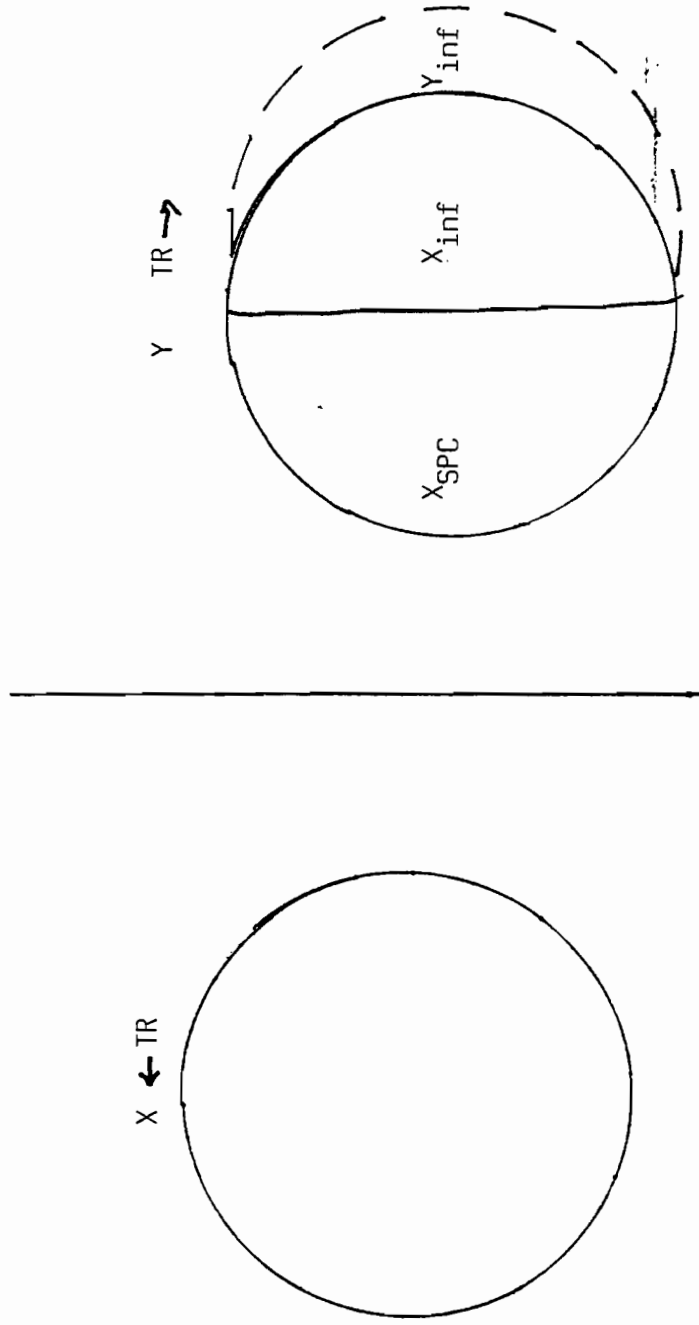
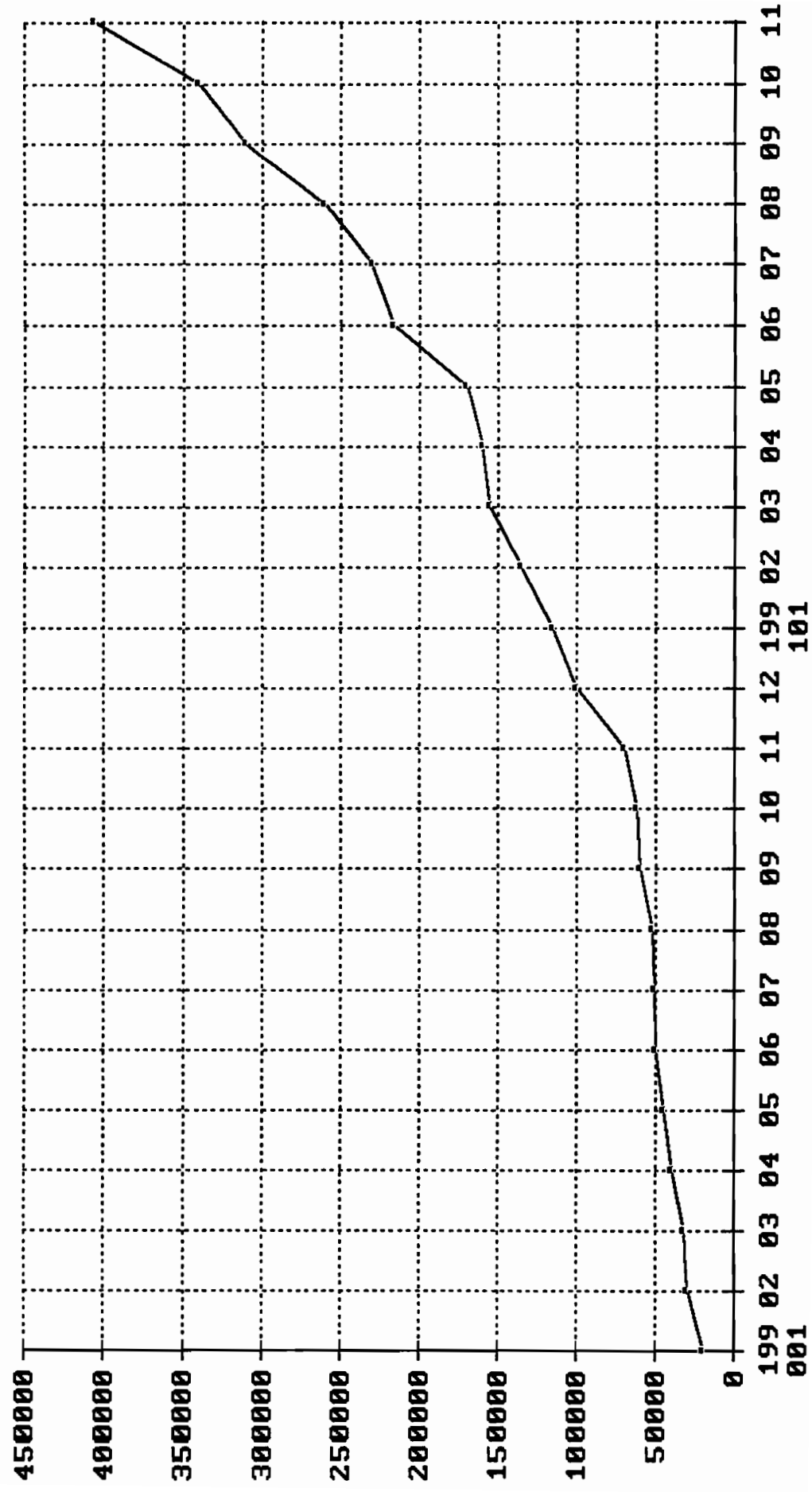


Figure 2 The shift from second to informal economy

Transformation



**Figure 3 The level of unemployment (1990 Jan - 1991 Nov)**



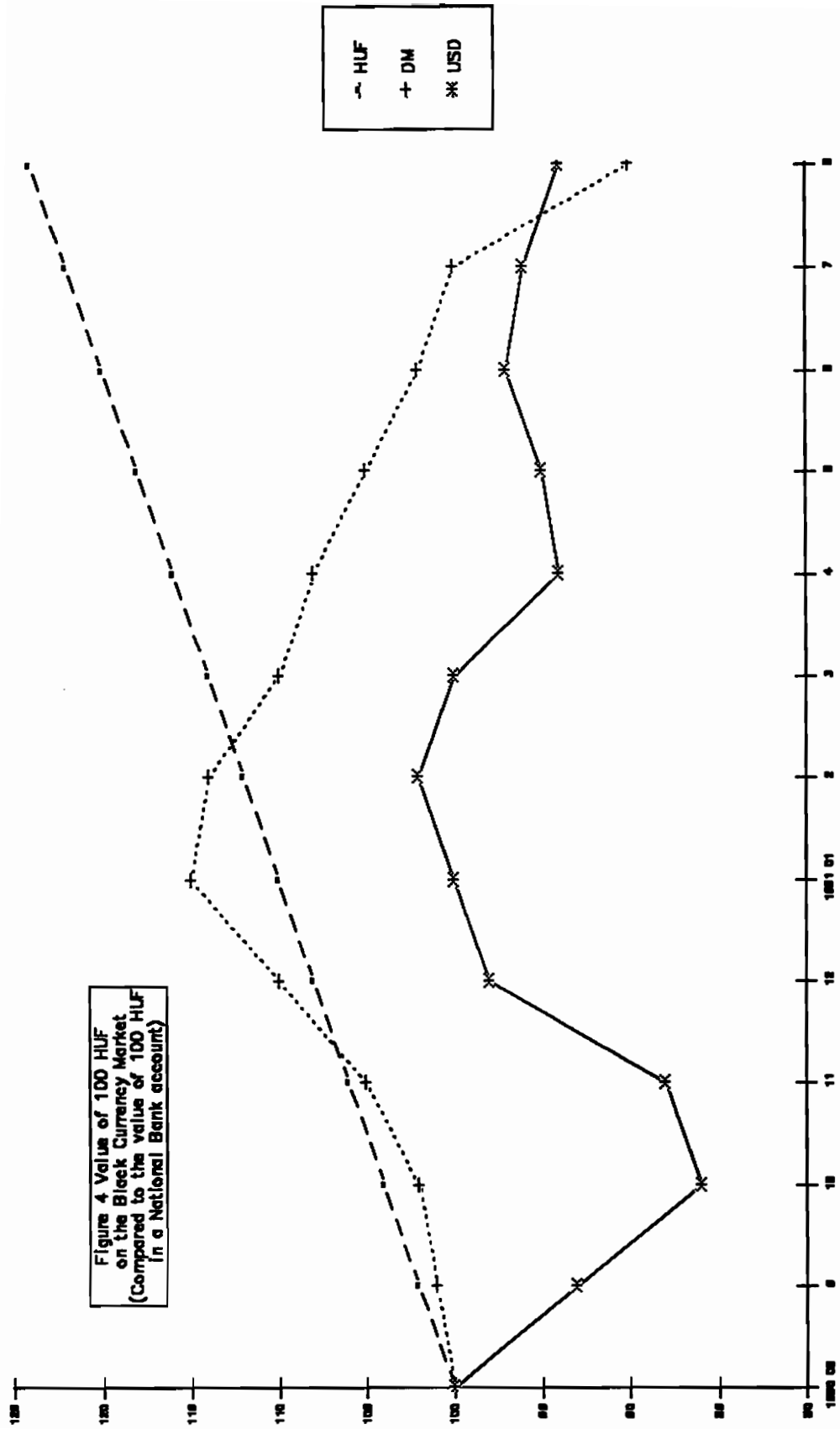
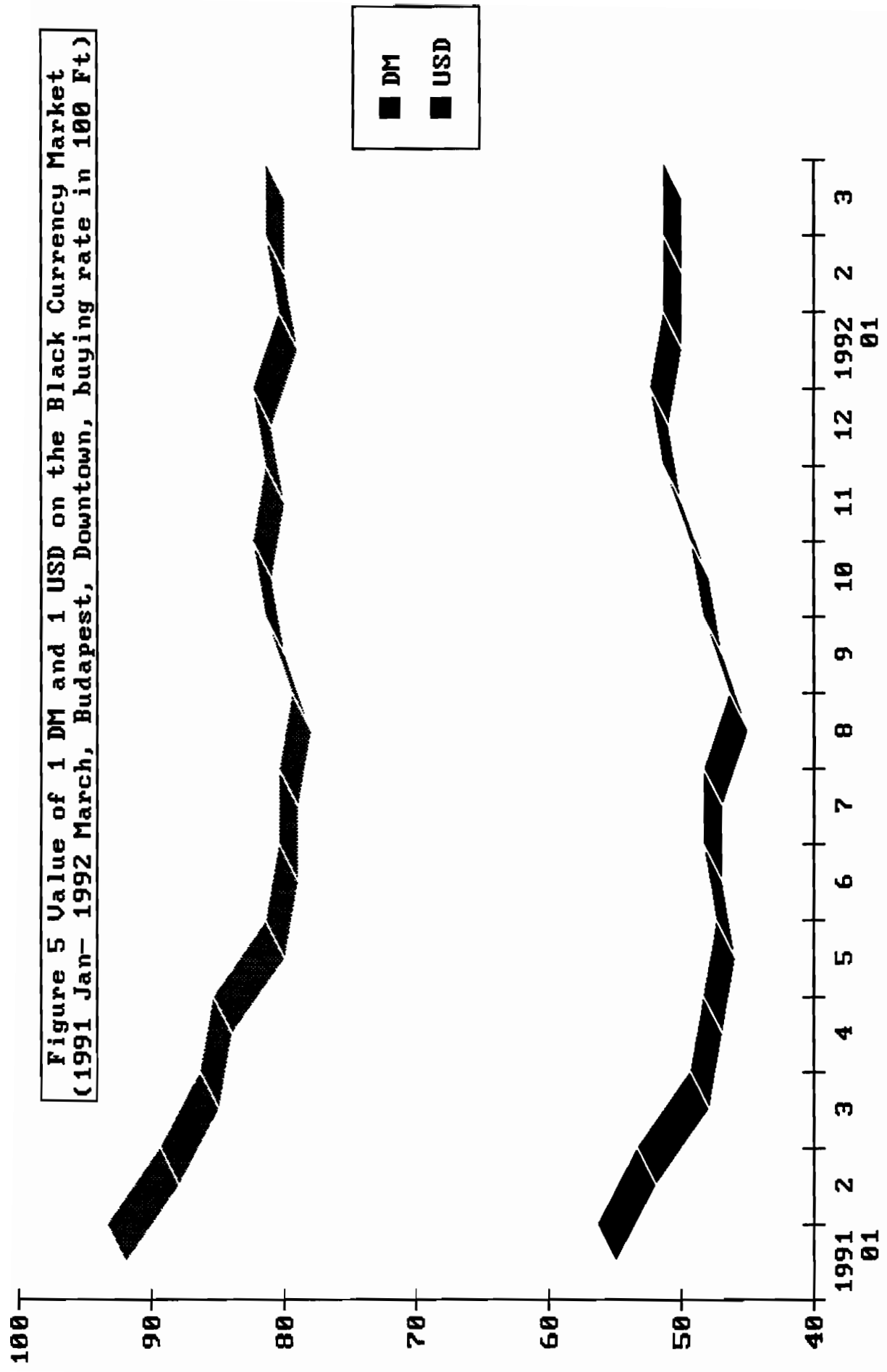




Figure 5 Value of 1 DM and 1 USD on the Black Currency Market  
(1991 Jan- 1992 March, Budapest, Downtown, buying rate in 100 Ft)



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