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Informality and the Second Economy in East-Central Europe

Discussion Paper 7
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I. Introduction

The subject of this paper is "non-state-socialist" economic activities under state socialism and their implications for social change away from state socialism on the basis of recent East-Central European experience. It defines the two main strategies of such partial exit - informality and the second economy (contrasting them to the informal sector under capitalism), addresses the problem of their origins and magnitude, and assesses their significance under, and during macro-structural change away from, state socialism. Finally, it considers various policy implications with special regard to labor issues during the transition.

II. Definitions: The Second Economy and State Socialist Informality

The concept of the informal sector has been developed for state-regulated capitalist economies, i.e., those characterized by the simultaneous presence of the following features: (1) legally-protected private ownership is the dominant form of enterprise in the economy and (2) enterprises are linked to each other primarily through bargaining mechanisms (market-exchanges) so that (3) the main role of the state is record-keeping, regulation and taxation of enterprise behavior, and the regulation of the capital-labor relation. On this basis, the informal sector of a state-regulated capitalist economy is defined as the sum of all economic activities outside the realm of state record-keeping, regulation, and taxation.²

The above definition of informality cannot be applied directly to state socialism as the "generic" model of the state socialist economy does not meet any of the above assumptions. The hegemonic property form is not private property but direct ownership by the "socialist" state. Management of state-owned assets is centralized and bureaucratized so that the relations among enterprises are primarily not market-based. Hence, regulation, record-keeping, and taxation are not clearly separated from proprietorship, management, and profit-taking: all of these important processes - institutionally somewhat separate under regulated capitalism - are merged together and absorbed by the state. This arrangement increases tremendously the power of the state in the economy. Control by the state comes to be the condition that determines the basic structure and functioning of the economy. The main mechanism of superimposing political control over the economy is centralized planning - in its most ambitious and most elaborate form, a detailed set of directives prescribing input, output, stock, and flow requirements in natural terms to the entire national economy - specified at the level of tasks to be performed by individual producers. The abstract formula of centralized state socialist planning involves a combination of top-to-bottom flows of plan-commands with bottom-up flows of information. The implementability of plan-directives thus hinges on the quality and quantity of information concerning the economy available for the planning authority.

The first, and harshest, period of East-Central European state socialism, called Stalinism, represented a major effort to enforce this "generic" model of state socialism. The relatively quick demise of Stalinism in East-Central Europe³ has to do with the extreme
rigidity and high social cost of Stalinist practice. The introduction and maintenance of this crude form of overcentralized planning required extremely high levels of generalized political violence by the state, and the frequently arbitrary rearrangement of cultural, social, settlement, and work practices for a large part of the subject societies.

The post-Stalinist, second version of state socialism can be described as the softening of plan-command arrangements by a wide array of compromises between the party-state apparatus and society concerning their enforcement. Hence, since the early 1960s, exclusive attention to the formal legal structure of the state socialist economy can be highly misleading: it reveals precious little of the "real" processes that make up the second period of state socialism in East-Central Europe. What differentiates the second, less rigid period of state socialism from the "generic" model is the emergence of practices and processes that make central planning more tolerable for society. The two main dimensions of these political-economic compromises and their structural consequences are the subject of this paper.

A. Second Economy

The first and most fundamental distinction to be made involves differentiating the two sectors of the state socialist economy according to the degree to which the enterprises and direct producers who participate in them are subject to substantive control by the "socialist" state. In the first economy (also called the "socialist" sector), substantive control by the state is exercised through centralized planning. The basis of centralized planning is direct state ownership or a hybrid property form called "cooperatives" which, although technically not the property of the state, operate under practically full control of the state. Both direct state property and "cooperatives" are subject to planning, so that the most important aspect of the "success" of their functioning is fulfillment of plan targets set for them by the planning authority. Under hard output requirements in natural terms and a "soft budget constraint" (Kornai 1980), they have a tendency to overextend expenditures. In contrast, the "non-socialist" sector of the economy comprises enterprises that are neither directly owned nor substantively controlled through planning by the state. Plan targets (centrally determined output requirements) are largely irrelevant for them -- unless in a "negative" sense, i.e., that they often operate in the niches left open by plan-targets -- while their budget constraints are usually extremely hard, so that directly-consumed product output ("direct use-value"), social prestige and utility value on a reciprocal basis, or market-based profitability are the main determinants of their success. It is this "non-socialist" sector of the state socialist economy that this paper will call the second economy.

B. Informality

The contrast between formal and informal activities and processes concerns a distinction whether they are subject to public record-keeping, regulation, and scrutiny. (Taxation also depends on public record keeping.) Although much of the literature on state socialist informality speaks only about the second economy, it would be a mistake to absorb the
formal-informal contrast in the first-second distinction. Formal processes per se fail to explain much of the functioning of the first economy, while at least some of the enterprises in the second economy are registered, small-scale private businesses with a clearly visible formal presence. It is better to understand the state socialist economy as one divided by the formal-informal contrast quite independently of the "first-second economy" distinction.

Figure 1 provides a visual summary of the conceptual apparatus of this paper. First, along the horizontal dimension, it divides the economy into two sectors -- the first ("socialist") sector and the second economy, distinguished on the basis of the presence or absence of substantive state control. Then it subdivides (vertically) both of those according to whether the particular activities that take place are subject to public record-keeping, regulation, and scrutiny. Cell a includes formal activities of planned (state-controlled) enterprises and their employees. For a long time, the economic literature on state socialism -- written in East-Central Europe as well as in the West -- had only focussed on activities in this cell.

Cell c includes informal activities within the state-controlled sector. Several studies (e.g., Czakó and Sóf 1987; Lomnitz 1988; Korboński 1981) have described the widespread system of favors and tricks, privileges and exclusions, and information leaks and deception taking place among managers of state-controlled enterprises through intricate systems of personal, professional, kin-based, and friendship-based social networks. The main explanation for the proliferation of such informal networks is their relative efficiency in comparison to the unsatisfactory information demand of centralized planning and its structural rigidity. Such informal activities increase managers' ability to fulfill -- or at least to present the appearance of being able to fulfill -- plan quotas, that is, they provide stability in an economic environment subjected to unpredictable plan targets and other external rigidities.

Cell b of Figure 1 contains all formal activities of the "non-socialist" sector, i.e., economic activities of the second economy. This area has been made possible because, as we will see below, registered private enterprise has never been completely eradicated in East-Central Europe. Finally, cell d comprises all informal activities of the second economy.7 This cell includes two kinds of enterprises: (i) informal, "off-the-books" activities of otherwise registered enterprises in the second economy (mainly for tax evasion purposes) and (ii) all activities of completely unregistered enterprises (i.e., moonlighting, housing sublets, reciprocal exchange of labor, food production for non-market-based distribution, micro-plot farming, etc.).

The dividing line in Figure 1 between the first and the second economies is somewhat more clearly marked than that between formal and informal activities. There are several reasons for this. First, given the predominance of the state in the economy, economic activity outside the state's realm represents a certain sense of resistance. In contrast, the formal-informal distinction offers various economic activities that can be rather easily combined to form more complex income earning strategies. The bureaucratic centralization of the management of state-controlled resources cannot possibly account for all activities of
Figure 1
The State Socialist Economy

\[
\begin{array}{c|c|c|c}
 & \text{FIRST ECONOMY} & \text{SECOND ECONOMY} \\
\hline
\text{FORMAL activities} & a & b \\
\text{INFORMAL activities} & c & d \\
\end{array}
\]
the employees of the state; as studies on corporate "culture" indicate, infringement of procedural rules is a regular practice in a bureaucratized environment. On the other hand, registered second-economy enterprises are constantly forced into informal dealings due to the often unreasonable tax regulations imposed on them by their main sectoral competitor, the state. Finally, both first- and second-economy enterprises are faced with endemic shortages of resources of all kinds; hence, ability to obtain scarce resources through informal means becomes an essential condition of their survival.

C. Legality

Overall, informality and the second economy can be thought of as alternative strategies of partial exit from, and hence partial evasion of, the rigidities of the "generic" pattern of state socialist practice. The second economy is a sector of the economy relatively independent from direct exposure to plan commands by the "socialist" state. Informality, on the other hand, is a strategy of removing economic practices from the scope of public record-keeping, regulation, and scrutiny.

The issue of legality-illegality often emerges in the literature on state socialist informality and the second economy, especially in studies describing Romania or the former USSR, i.e., the less tolerant, less compromise-based (more Stalinistic) economies of the region. To disentangle this problem, it may help to examine a revised version of the above model of the state socialist economy.

As Figure 2 suggests, the realm of legality includes all formal activities in both the first and second economies plus part of first- and second-economy informal practices. Helping-out management of one company by another at times of bottlenecks, shortcuts in the distribution mechanism, etc. are activities that are often expressly legal: the only reason why they are forced into informality is that the rigidity of formal procedures may make them more cumbersome or may not allow for them to take place at all. Hence, cells a, b, c1, and d1 together comprise the field of legality.8

Under state socialism, not all that is not explicitly legal is illegal. There exists in all state socialist economies a large "gray" area which "technically" may not be desirable -- and, hence, may not be declared expressly legal -- by the state. Yet, many such activities are often widely tolerated. The extreme enlargement of this field -- symbolized in cells c2 and d2 -- is the key to understanding the particularistic compromises in Hungary and Poland during the last three decades. Much of what is described in the literature on the second economies of those two countries, including urban services from moonlighting plumbers through highly sophisticated computing services, internal subcontracting, etc., are forms that had not been expressly legalized until the early 1980s in both countries.

Finally, there exists a realm of informal activities in both the first and the second economies that are expressly illegal and the regulations concerning their illegality are actively enforced by the state. This area includes activities such as drug trade or prostitution that
Figure 2
The State Socialist Economy

<table>
<thead>
<tr>
<th>FORMAL activities</th>
<th>SECOND ECONOMY (not planned)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>a</td>
</tr>
<tr>
<td></td>
<td>c1</td>
</tr>
<tr>
<td></td>
<td>c2</td>
</tr>
<tr>
<td></td>
<td>c3</td>
</tr>
</tbody>
</table>

"legal"

"tolerated"

"illegal"
are more or less illicit in all societies. There are, however, other forms of economic behavior such as "profiteering," "speculation," or currency dealings, whose illegality is specific to state socialism or to certain periods of state socialism. The boundaries between the realms of "legality," the area of "tolerated" activities, and illegality have changed in each of the region's societies over time to enlarge the "tolerated" area (as in the case of Poland and Hungary above) or on the reverse (e.g., the anti-alcoholism campaign of the early Gorbachev period augmented the field of "illegality" in all countries of the region). In a comparative perspective, various systems of post-Stalinist political-economic compromises have been defined in terms of the relative size of the realms of "legality," "toleration," and "illegality."

III. Origins

In addressing the origins of informality and of the second economy in East-Central Europe, it is necessary to separate two sets of causal factors. One of those sets -- the structural rigidity, and propensity towards producing endemic shortages, of centralized bureaucratic planning -- has to do with structural features of state socialism addressed above. The second cluster of considerations pertains to the historical baggage that the societies of East-Central Europe had brought with them at the time of their transition to state socialism. Two main aspects are emphasized here: the socio-cultural legacy of various informal strategies of resistance to state power (often foreign state power), and the relative "backwardness" of industrial-capitalist development and the resulting predominance of small-scale enterprise in virtually all of the region's societies.

A. Socio-Cultural Legacy

The socio-historical legacy of informal resistance to state power has to do with the East-Central European tradition of a higher involvement of the state in economic and societal affairs than in Western Europe or the United States. State "interference" in various aspects of society is by no means a recent, let alone, a state socialist phenomenon in the eastern half of the continent: the despotism of the Czarist Russia, the more rural-based, militarized, less-commercialized character of the Eastern (Prussian) part of Germany, the ethnic and socioeconomic inequalities of the lands of the Habsburg Empire, and the South-East European reaches of the Ottoman Empire all represent oppressive systems of overbearing state power. Those patterns had emerged centuries before the establishment of state socialism in East-Central Europe.

Local resistance to central state power goes back to these roots, deeply encoded in the respective national cultural traditions, including peasant resistance to backbreaking corvée labor (i.e., forced labor as legally prescribed service to the feudal landlord to be rendered by the serf family or the village community), state bureaucrats' disobedience to enlightened central reforms, and the traditional, often nationalistic, defiance by East-Central European nobilities of modernizing central monarchies, taxation, civil rights, emancipation, political change, etc. The emergence of various forms of resistance in East-Central Europe
after World War II was partly the resurrection of some of those traditions under similarly heavy oppression by a different kind of state.

B. Economic Backwardness

The relative economic underdevelopment of East-Central Europe in its pre-state-socialist history is one of the most widely-noted features of European economic history. Table 1 provides an overview of some of these characteristics for the region.

In 1913, all countries of the region for which data are available had gross domestic product per capita (GDP/cap) figures substantially lower than the European average. The more complete data set for 1938 indicate an identical distribution: the countries of East-Central Europe register GDP/cap figures between 51 percent and 81 percent of the European average, among them Yugoslavia with the lowest and Czechoslovakia with the highest GDP/cap. As column (3) of Table 1 indicates, this has much to do with the relative degree of industrialization of these economies: percentages of those engaged in agriculture are strong and inversely related to economic development measured in GDP/cap. Three countries of the region (Bulgaria, Romania, and Yugoslavia) had been almost completely agrarian before World War II, and only (the Bohemian and Moravian two-thirds of) Czechoslovakia can be regarded on par with Western Europe in terms of its degree of industrialization.

During the early 1930s, the relative importance of "own-account" workers was clearly much greater in East-Central Europe than in Austria or Germany, the two countries on the region's western border. At that time, the percentage of "employers and independent workers" in the labor force of the countries of East-Central Europe is 1.5 to 2.0 times higher than in Germany and between 2 to 3 times higher than in Austria. The difference remains (of the same magnitude and direction) when unpaid family labor is accounted for in the rubric of economically-active non-employees (i.e., employers, independent workers, and unpaid family workers). Percentages of population in agriculture suggest that, in Bulgaria, Romania, and Yugoslavia, most of economically active non-employees were peasant producers; in Czechoslovakia, they were primarily artisanal and commercial small-scale entrepreneurs, while in Poland and Hungary, they were a mixture of both.

Columns (4) and (5) of Table 1 suggest an important feature of the East-Central European economies before their state socialist takeover: a very high proportion -- between one-third and four-fifths -- of the economically active populations of the countries of the region were outside, in one way or another, of formal employment through either self-employment or employment under informal labor arrangements.

Without exception, the "socialist" transformation of the region's economies entailed forced and accelerated large-scale industrialization projects. Agricultural small enterprises became subjected to concerted state efforts aimed at squeezing incomes, work, and other resources out of them, into the emerging urban industrial establishments and large-scale
enterprise in general. This process clearly manifested itself in the changing composition of the labor force.

Documenting the fundamental transformation of the labor force during much of East-Central Europe’s state socialist history, Table 2 reflects the outcome of a major, several-decades-long, struggle between a party-state pursuing a clear large-scale utopia to which society should be fitted, and a society resisting the overwhelming force of the transformative "socialist" state. The most important component of that struggle consisted in the reorganization of the economy with a greater emphasis on industry, manufacturing, and large-scale investment in general, and insistence on abolishing small-scale independent production in the agriculture as well as in manufacturing and the service sector.

Between the early 1930s and the early 1950s, all East-Central European countries exhibited dropping percentages of employers and independent workers, while both Austria and Germany registered increases in the same measure. The increases in Austrian and Germany have to do with the destruction of those countries’ industrial bases during World War II, so that small-scale entrepreneurship gained ground temporarily. As the destruction of the East-Central European industry during World War II cannot be assumed to have been smaller than in Austria and Germany, it is very likely that the decreases in those countries’ percentages of employers and independent workers have to do principally with the confiscation and collectivization drives by the respective states and are to be interpreted against the backdrop of likely increases in self-employment after World War II.

The establishment of state control over the East-Central European economies was neither instantaneous nor exhaustive, however: in 1950 (i.e., five years after their Soviet occupation and two years into the sweeping state socialist confiscation and collectivization campaigns begun in 1948), the proportion of employers and independent workers was still around 25 percent of the labor force in most countries. Only the most industrialized country of the region, Czechoslovakia, registered a figure (12.8 percent) that was lower than the corresponding value for Austria. In 1950, the proportion of small entrepreneurs in the labor force of all other "socialist" countries was higher than in their closest non-state-socialist neighbor, Austria.

By 1960, the picture had changed substantially. With the German industrial reconstruction well underway, the West German figure dropped to around 10 percent where it remained throughout the ensuing period. Austria’s percentage of employers and independent workers also remained steady, around 20 percent. In sharp contrast, the state socialist East-Central European countries indicate a very wide spread in terms of the "survival rate" of their small entrepreneurial strata. The Bulgarian and Czechoslovakian figures of 1.3 percent and 2.7 percent suggest the near-complete destruction of the small entrepreneurial segment of those countries’ class structure. Hungarian, Polish, and Yugoslavian figures indicate, in contrast, that a sizeable segment of those societies had been able to maintain an independent-entrepreneurial form of livelihood throughout the harshest years of Stalinist political terror.
<table>
<thead>
<tr>
<th>Country</th>
<th>GDP/asp, 1913</th>
<th>GNP/asp, 1938</th>
<th>% of Pop. in Agriculture, 1930</th>
<th>% Independent Earners, early 1930s</th>
<th>% Active Non-employees, early 1930s</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>66.4</td>
<td>420</td>
<td>80</td>
<td>28.4</td>
<td>83.1</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>634</td>
<td>548</td>
<td>28</td>
<td>21.1</td>
<td>36.4</td>
</tr>
<tr>
<td>Hungary</td>
<td>372</td>
<td>451</td>
<td>54</td>
<td>27.5</td>
<td>42.0</td>
</tr>
<tr>
<td>Poland</td>
<td>372</td>
<td>451</td>
<td>65</td>
<td>30.2</td>
<td>64.7</td>
</tr>
<tr>
<td>Romania</td>
<td>434</td>
<td>343</td>
<td>78</td>
<td>31.5</td>
<td>75.6</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>339</td>
<td>339</td>
<td>79</td>
<td>32.9</td>
<td>77.1</td>
</tr>
<tr>
<td>Austria</td>
<td>661</td>
<td>640</td>
<td>32</td>
<td>9.4</td>
<td>21.3</td>
</tr>
<tr>
<td>Germany</td>
<td>737</td>
<td>1,126</td>
<td>29</td>
<td>16.4</td>
<td>32.8</td>
</tr>
<tr>
<td>European Average</td>
<td>534</td>
<td>671</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>


Data represent missing data.
The percentage of independent small-scale producers in the Hungarian labor force dropped to Czechoslovakian and Bulgarian levels -- to around 2 percent -- by the early 1970s. This has to do with the "successful" completion of rural property change by the Kádárist state. The collectivization of the Hungarian agriculture in the early 1960s involved, however, a historically new innovative kind of arrangement: the institution of what came to be known as "around-the-house" micro-plot farming. Its essence is a symbiotic relationship between large-scale agricultural cooperatives and state farms on the one hand, and a large number of micro-plot part-time farms on the other. The symbiosis of the two sets of enterprises extended to practically all aspects of agricultural production, including utilization of resources, marketing, credits, etc. Hence, the dropping numbers of registered small-scale enterprise in Hungary in the 1960s signaled a process different from that in Bulgaria and Czechoslovakia a decade or so before. The Hungarian arrangement was a large-scale compromise between state and society, arrived at after more than a decade of sharp rural conflict over land rights, forced delivery quotas, farm credits, and subsidies, while the earlier more Stalinist transformations of Bulgaria and Czechoslovakia represented a more thorough eradication of small-scale production in general.

The Hungarian compromise turned out to be spectacularly successful. Soon the country became a net exporter of food products and Europe's largest agricultural producer per unit of arable land. In order to be able to receive the benefits of symbiotic cooperation with large farms, micro-producers did not necessarily have to register in any way with the state. Tax provisions gave tacit privileges to this kind of economic activity by allowing enterprises below a certain generous threshold of annual output to go unrecorded. Most of the labor that went into this extremely labor-intensive form of farming was arranged through family- and kin-based organization on a clearly informal basis. Importantly, the overwhelming majority of those involved in this putatively "auxiliary" farming activity did not pursue it as a full-time livelihood: of the 2.5-2.7 million people involved in micro-plot farming at the mid-1970s, only about 20 percent were full-time peasants (Révész 1990: 114). The rest of them combined full-time employment in the first economy with incomes from second-economy farming. This transformation resulted in the emergence of new, complex, and multiple-source income-earning strategies (Róna-Tas 1990) on the part of the population and a class structure with a large number of people occupying multiple class positions (Böröcz 1989).

The compromise reached in the agricultural sector concerning property rights, the relationship of state-controlled and second-economy enterprises, the relaxed enforcement of labor legislation, taxation, and record-keeping requirements for micro-plot farming were embedded in a more general atmosphere of political compromises under economic growth. Practices of informality and second-economy arrangements soon spread over to other areas of the economy, including tourism services, urban personal services, and manufacturing. A full-scale, mostly part-time, second economy was born in Hungary. During the early 1980s, new institutional forms emerged which gave a character of internal subcontracting to mostly already-existing informal arrangements within first-economy companies -- the segment of the
Table 2

Employers and Independent Workers in the Labor Force
Selected Countries, 1930-1980
(Percent)

<table>
<thead>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Bulgaria</td>
<td>28.4</td>
<td>20.6</td>
<td>1.3</td>
<td>.4</td>
<td>.3</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>28.4</td>
<td>12.8</td>
<td>2.7</td>
<td>.9</td>
<td>2.8</td>
</tr>
<tr>
<td>Hungary</td>
<td>21.1</td>
<td>.</td>
<td>12.9</td>
<td>2.4</td>
<td>4.3</td>
</tr>
<tr>
<td>Poland</td>
<td>30.2</td>
<td>23.1</td>
<td>22.9</td>
<td>33.1</td>
<td>17.2</td>
</tr>
<tr>
<td>Romania</td>
<td>31.5</td>
<td>.</td>
<td>26.6</td>
<td>7.6</td>
<td>.</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>32.9</td>
<td>25.1</td>
<td>.</td>
<td>22.6</td>
<td>7.3</td>
</tr>
<tr>
<td>Austria</td>
<td>9.4</td>
<td>17.5</td>
<td>18.9</td>
<td>24.5</td>
<td>7.3</td>
</tr>
<tr>
<td>Germany</td>
<td>16.4</td>
<td>49.1</td>
<td>12.6</td>
<td>9.1</td>
<td>8.4</td>
</tr>
</tbody>
</table>

economy most resilient to the open toleration of political compromises concerning property relations up until then.10

Statistics for Hungary in Table 2 reflect the drop of the percentage of employers and individual workers. As much of the emerging second economy is part-time activity, performed over and beyond employment in the first sector, it does not show up in labor statistics that only focus on primary employment. Following Iván Szélényi’s (1988) "interrupted embourgeoisement" hypothesis, supported by data from the rural second economy in Hungary, there is good reason to speculate that the drop in registered self-employment and independent entrepreneurship in Hungary during the 1970s marked a retreat of individual small-scale producers into the realm of informality provided for them by the Kádárist more "jovial" form of state socialist political practice.

The impact of the Hungarian example has been more-or-less detectable in all countries of East-Central Europe. The Hungarian pattern of informality was transmitted to other economies of the region through three separate channels.

(1) It became a centerpiece of economic policy debates among top political decision-makers of the Soviet bloc: the degree to which each country’s political leaders accepted or denounced the Hungarian practice of "reforms" was a reliable gauge of their country’s economic "openmindedness."

(2) The structural interdependency and mutual interpenetration of the economies of the Council for Mutual Economic Assistance (CMEA) -- the now-defunct organization that provided a framework for trade and other economic relations among socialist countries -- resulted in a whole series of incompatibilities and comparative advantages and disadvantages due to the presence of a large, and widely tolerated, "non-socialist" second economy in Hungary.

(3) The progressively intensifying informal linkages connecting the societies of East-Central Europe to each other -- i.e., extremely massive tourism flows, small-scale informal trade, and labor flows -- worked to increase the scale of informality even in those societies where the regime put up serious resistance against political compromises concerning the ever-present "non-socialist" sector. Along with Hungarians, Poles and various Yugoslav nationalities played the most important role in the construction of such cross-border informal linkages.11

The relative differences in the degree of the tolerance of each regime vis-à-vis economic activity outside of its own realm determine the relative size of the "legal," "tolerated," and "illegal" areas of informality. It is quite clear, however, that the immutable presence of the second economy, and the even wider spread of informality, has been a fundamental defining feature of the post-Stalinist period throughout East-Central Europe. The most explicit Hungarian pattern, based on wide political compromises, is only the most visible version of that phenomenon.
IV. Case Studies on Informality and the Second Economy

Due to its concealed nature, informality is usually impossible to measure directly. Making matters even more difficult, focus on the second economy – again, the least "socialist" sector of the economy – had been, for quite a while, politically discouraged by the party-state regimes. This section will highlight the literature that presents results of such work.

The earliest efforts at describing and measuring the second economy of state socialist societies came, appropriately, either from Western observers or political dissidents within the region. Although preoccupied with the problem of legality (i.e., defining their subject matter as "illegal" by default, thus misplacing the locus of the argument and losing cells c1, c2, d1, and d2 in Figure 2 above) and, hence, limited in their analytical power, the first Western descriptions pointed at the gross discrepancies between official economic policy statements and statistics on the one hand, and actual practice on the other. The result was a growing body of anecdotal and ethnographic material on the state socialist economies outside the plan.

Some of the earliest evidence pertains to the former Soviet Union. Simes (1975) described how such urban services as household repairs and decoration, taxis, fashionable clothing stores, and medical and legal services were arranged by Soviet citizens for lack of appropriate provisions by state-owned enterprises. He estimated, on the basis of survey information quoted by the Soviet press, that of the freshmen entering Moscow University’s Mathematics Department, as many as "85 percent ... used the services of private tutors in order to prepare themselves for admission tests" (1975:48). He also described (1975:45) how the invention of hard-currency-only shops, created for visiting tourists and top officials with special coupons, fostered "hard currency speculation" or "hoarding." Although his description was mainly aimed at the second economy, Simes also emphasized the existence of informality within the "socialist" sector and integration between the informal second-economy and informal activities within the "socialist" economy.

In an analysis based on the idea of assigning different colors to various informal second-economy "market" segments, Katsenelinboigen (1977) confirmed the informalization of widely varied economic commercial activities such as commission and pawn shops, flea markets, in-kind incomes re-sold by kolkhoz peasants, various transfer schemes of city apartments and second homes, access to education, health services, repair services, trade in flowers, barter of excess commodities (especially among company managers), profiteering by shop assistants, dealings by foreign tourists (especially in hard currency and other badly needed precious commodities), the "gray" or "black" trade of alcohol, prostitution, etc. Although numerical estimates are rare and their reliability is always very questionable, these early studies at least called attention to the wide scope of "non-socialist" practices under state socialism.

Using interviews with Soviet emigrés upon departure from the Soviet Union, Grossmann (1989: 151) found that, depending on variation in regional and ethnic
background, between 18 percent and over 90 percent of the respondents drew at least half of their regular income from the second economy. Based on the same data set, Grossmann and Treml (1987) showed that hidden incomes from private food sales by kolkhoz employees constituted a very substantial amount -- between 135 and 584 roubles per annum. Incidentally, Grossmann and Treml (1987:293) noted that these figures are "remarkably close to the corresponding ratios based on official Soviet statistics" of kolkhoz market sales.

One of the first pieces of writing on the subject of informality from a native's perspective, a book by Hungarian dissident sociologist János Kenedi (1981), summarized the experience of an urban Hungarian in constructing his own house during the late 1970s. Rich in ethnographic detail on the impassability of "official" ways and the intricacies of informal organization, this very readable book anticipates virtually all major themes that would be later echoed in the more systematic economic sociological literature on the subject. Rural housing construction, incidentally, had almost completely exited the realm of state control by the early 1980s in Hungary, as subsequent studies -- such as one by Endre Sík (1986) -- demonstrate.

Korboński (1981) offers a similar description for Poland at the turn of the 1980s. Although still encapsulated in the legalistic perspective, he emphasized the fuzziness of the borderline between the private legal and illegal sectors. He described how the Catholic Church participated in providing services outside the realm of the plan, and walks the reader through a tally of informal and second-economy activities in Poland, very similar to those noted above in the USSR. Korboński (1981:10) argued that reliance on informal contacts, and comparative advantages arising therefrom, was so widespread among officials that "[o]nly the Polish military appeared to be untouched by the wave of corruption which reached epidemic proportions in the late 1970s." He also made a causal connection between the birth of Solidarity and not only the impending collapse of the official economy, but also the parallel emergence of a strong second economy, especially in such "strategic" commodities as food.

Brezinski and Petersen (1990) attempted to estimate various aspects of the size of the Romanian second economy, fighting notoriously unreliable statistical reporting practices. They suggest that in the areas of services and construction, the second economy was officially accepted in the Romania of the early 1980s. Between 1970 and 1985, the share of private livestock and agricultural products varied between 30 and 99 percent, according to kinds of livestock and products (1990:72). They also surmised that the second economy made up about 10 percent of the country's meat consumption.

In Yugoslavia, Bičanić (1990) suggested that the unofficial economy had grown very significantly. Quoting a study made on the topic in Yugoslavia (Kukar and Simonić 1984), he conjectured that the second economy grew at an increasing average annual rate: 4-8 percent in 1960, 12-16 percent by 1970, and 23-27 percent by 1980 (1990:86-7).
Indirect inference from official statistics indicates a similar macroeconomic conclusion in Hungary. According to an apparently rather generous estimate quoted by Sik (1986), in 1960 and 1980, "the second economy took up 57 percent and 56 percent [respectively] of the [Hungarian] economy's total work time" (1986:36). Gábor's estimates (1983, quoted by Sik 1986:36) suggested that, around the beginning of the 1980s, about one-fourth of the labor time and one-third of incomes in the Hungarian economy were made up by activities in the second economy. Galasi and Sziráczki (1985) calculated that, around the early 1980s, incomes drawn from the second economy represented nearly 40 percent of all net income and contributed about 20 percent to the total GNP. By the late 1980s, even official statistics had begun to portray explicitly the phenomenon in question: according to the time-budget survey of the Central Office for Statistics, the time spent by Hungarians performing income earning activities outside their "primary" job had increased from 28.9 percent to 35.6 percent between 1977 and 1986.

The first piece of systematic, large-scale research on the second economy in East-Central Europe was part of Hungary’s first nationwide social survey taken in 1980. This project included both explicit and implicit information on the size of income-earning activities outside the state-controlled sector of the Hungarian economy. The data produced in this seminal investigation (Kolosi 1984) suggest that, during the year before the widespread legalization of various non-state-controlled economic activities in Hungary, roughly three-fourths of all families and individuals interviewed had been drawing incomes regularly from sources outside of a primary employment in the state sector, mostly from non-market farming (30 percent) or small-scale agricultural commodity production (24 percent). The rest included (in decreasing order of magnitude): subcontracting, consulting, moonlighting, incidental work done by retirees, tips, registered non-agricultural small-scale private enterprise, and renting out rooms and other real estate (Kolosi 1984:57). About 27 percent of all families drew their second incomes exclusively from "around-the-house" farming for their direct consumption, and another 19 percent derived a second income exclusively from agricultural commodity production (Kolosi 1984:58).

In an important survey analysis, Czakó and Sik (1987) found that nearly all Hungarian agricultural managers regularly used some form of non-market, non-redistributive system of reciprocity as part of their managerial behavior. Comparisons of the Kolosi survey (1984) and the analysis by Czakó and Sik (1987) help clarify that it is a serious misunderstanding to consider the second economy as a simple manifestation of some kind of eternal "market principle" springing up automatically and exclusively as a counterweight to state redistribution. Not only do such non-market-oriented processes (e.g., direct use-value-production, social-network-based redistribution, and widespread managerial reciprocity) exist, but in fact the percentages of those involved in non-market farming production are consistently higher than the equivalent figures of market-producers, and it would be extremely difficult to find a single Hungarian manager who relied only on formal-redistributive and/or normative market procedures in running the enterprise. Neither the second economy nor the realm of informality can be considered simply "the free-market sector" of state socialist economies.
The sporadic literature on the size of the second economy in East-Central Europe is inconclusive at best. All of its methodological and theoretical shortcomings notwithstanding, it suggests very forcefully that analytical attention focussing exclusively on the formal first economy (cell α in Figures 1 and 2) grossly misrepresents actual economic processes. Informality and the second economy had been organic components of the workings of the second period of state socialism and, hence, they should be taken into consideration when addressing the socio-political transformation away from state socialism.

V. The Significance of Informality and the Second Economy

Informality and the second economy are not "extrinsic," "additional," "auxiliary," or "alien" to state socialism. Rather, they constitute an important social, economic, and political counterweight that had made these rigidly-defined politically-overdetermined societies inhabitable for a large part of the population for four decades or so. Informality and the second economy are part and parcel to the functioning of all known examples of post-Stalinist state socialist practice.

The significance of informality and the second economy is Janus-faced: they represent strategies of partial exit from, and implicit resistance to, the dominant political-economic paradigm of state socialism, both in theoretical and practical terms, while at the same time, they contribute to its survival by improving its efficiency and, thus, by making state socialist economic practice tolerable. The best example at hand is the recent Hungarian experience where the demonstrable political legitimacy of the Kádár regime had everything to do with its attitude toward informality and tacit compromises concerning alternative economic activities. To the extent that a large segment of the population was able to participate in this compromise, the regime's short- and medium-run legitimacy was enhanced.

With the recent collapse of the party-state regimes, there has emerged an explicit political consensus that a capitalist economy — more or less along the lines outlined at the beginning of this study — is the most agreeable ideological model for the economic transformation in East-Central Europe. That has resulted in a drastic reduction of the redistributive-planning activities of the state. The abandonment of the state-socialist property structure is widely regarded as desirable. Given the fact that liquid savings by the populations of the region's countries dwarf in comparison to the amount of capital that is to be removed from the realm of the state's control (exacerbated by heavy external debt burdens, a contracting economy, high inflation, and rising unemployment rates), market-based privatization of state assets to domestic cash investors is very much the exception rather than the rule. The result is increasing foreign investment and the simulation of property change through largely informal means. The latter option includes solutions whereby the state remains the "formal" proprietor but effective control over its assets shifts to informal networks weaving together company management, the financial circles, and political power holders. Enterprises that have operated mostly or exclusively in the informal area of the second economy are being transformed into formal-private enterprises if and only if the expected benefits of such a transformation — i.e., more secure access to markets, resources,
etc. — clearly outbalance such virtually certain disadvantages as higher rates of taxation or exposure to government regulation. For instance, most of the recent increases in the number of registered enterprises with private ownership in Hungary have been the result of the breaking-up and "hollowing-out" of large state-owned companies such that, ultimately, the state remains their principal legal proprietor.

In such transformations, the historical role of informality and second-economy linkages developed under the recent period of state socialism become particularly crucial. It is hardly an exaggeration to submit that informal ties better explain the transformation processes than the penetration of world-market pricing, the abolition of soft-currency trade, the entry into the East-Central European economies of foreign — mostly Western — producers and capital, or the conversion of political privileges into property ownership by the former political party-elites. From a point of latent tension and a source of relative stability under the recent period of state socialism, informality has become the main pattern-producing mechanism of the transition away from state socialism. Emerged as a historically-grounded alternative strategy of resistance to the arbitrariness of "socialist" state power, informality metamorphoses into an important mechanism of large-scale social change.

With the abolition of the state’s political control over the economy, the ongoing metamorphosis of the economies of the former state socialist bloc of East-Central Europe involves a large-scale structural transformation so that the primary contrast of "state-control" versus "second-economy" (outlined in Figures 1 and 2 above) is being replaced by a contrast that characterizes state-regulated capitalist economies. The latter distinction implies the differentiation between enterprises that operate under the record-keeping, regulatory, and taxing authority of the state and those that stay outside. Hence, those societies of the region that had had, until recently, a high degree of informalization in their "first" economy and a large second economy can be expected to develop a large informal sector, similar to the less advanced capitalist countries, most prominently, the European Mediterranean countries and the relatively better-off Latin American societies.

VI. Policy Implications

Most second-economy activities in East-Central Europe have been part-time, "second-job" operations. As a result, the class structure of the state socialist societies has exhibited a large number of individuals and families with double or even triple class positions, depending on their involvement in various economic activities, sectors, and qualities (Búrócz 1989). The transition from a "first versus second" economy contrast into that of a "formal versus informal" sectors implies the abolition of most of those multiple class distinctions so that the income earning strategies of a large number of individuals and families become simpler, and the class structure of those societies becomes more clearly defined. Meanwhile, the economic room of maneuver is bound to decrease for most members of post-state-socialist East-Central European societies. By itself, this condition suggests sharper class conflict and mobilization.
The state socialist second-economy is known for higher remuneration for labor time than the first economy. On the other hand, the level of remuneration in all segments of capitalist informal sectors is known to be, in an overwhelming majority of cases described by the literature, significantly lower than in the formal sector. Such a shift from over- to under-remuneration can already be observed, for instance, in undocumented labor migration from the poorer countries of the region to those better-off. As a result, the labor market of such destination countries has begun to resemble the bifurcated labor market of the United States and other relatively wealthier societies, with undocumented foreign labor locked into a lower-paid "dead-end" segment. This explains how it is possible, in the Hungarian case for instance, for unemployment to rise from 100,000 to over 400,000 during 1991, while the economy absorbed an estimated minimum of 100,000 undocumented foreign workers (mainly from Romania and the Ukraine) and another nearly 100,000 war refugees from Yugoslavia.

Much of the second economy and, by definition, the entire realm of informality within the first sector, has been based on a fundamentally parasitical relationship whereby second economy and informal actors utilized state resources for their particular interests. Consequently, much of the second economy was tacitly subsidized by the state sector (Portes and Böröcz 1988). The logic of this relationship implies that the quick demise of the state’s central role a large proportion of society’s resources is not unambiguously in the interest of such actors. As a result, it is plausible to speculate that some of the apparent sluggishness of destatization of the property structure can be explained by the dense webs of informal and second-economy ties that connect virtually all actors of the economy in one way or another to the survival of a lame duck "socialist" first sector. The property change that does take place under such conditions is the net result of the ensuing struggle. This implies that neither the "free-market" paradigm nor any other simplistic monocausal scheme can account for the property transformation process at work so far.

One of the most important economic and social policy issues of post-state-socialist societies is the distribution of the burden of the combination of the systemic transformation at large and the economic crisis. The political negotiating mechanisms set up for handling this problem include, following the pattern of West European corporative welfare states, three main actors: the government, employers, and the trade unions. Invariably, all three of them act as if informality and the second economy had never existed. Their negotiations concerning unemployment benefits, retraining, the indexation of wages, social benefits, and retirement pensions consistently ignore the large realm of informality (e.g., in Hungary’s case, again, between one-third and one-half of the population’s economic livelihood). Consequently, the resulting policy decisions often have little effect. Frustrated over the inefficiency of such measures, the governments are urged either to re-criminalize informal economic activities of certain groups -- most prominently, those receiving unemployment benefits or poverty aid -- or to diminish the purchasing power of the benefits that are provided. Both reactions work to create and exacerbate the proliferation of a cycle of "genuine" informal economies of survival, following the pattern of the Third World, by excluding segments of the population from the protected segment of the labor force.
These "dropouts" from formal employment and/or social provisions are forced to join undocumented foreign labor in the emerging underclass segment of the labor force.

One of the most crucial consequences of a history of informality and the second economy is the legacy of widespread social fragmentation and individualization. The four-and-a-half-decade-long practice of state socialism can be interpreted, in this regard, as a major social experiment to diffuse, misorient, or outright block the articulation of various interests in society through democratic procedures, political or labor movements, and professional or local grassroots associations. In addition, by allowing or even subsidizing the partial exit of society from the state's control, the second-economy-oriented compromise-based version of state socialism provided an individualistic fragmented kind of alternative that does not lend itself to mobilization and, in general, the assertion of collective interests. This has resulted in widespread skepticism throughout East-Central Europe vis-a-vis politics, strikingly low voter turnout in national elections, and suspicion against any form of collective action in general. This condition was further aggravated by the humiliating electoral defeat of all of the region's labor-oriented political parties in the first series of post-state-socialist parliamentary elections so that the rhetorical representation of specific working-class demands has become virtually impossible in the realm of formal politics. A combination of the above factors explains how the post-state-socialist enterprises appear to have been able to institute harsh anti-union controls in the collective contracts.24

Finally, perhaps the most important aspect of the legacy of state socialist informality is its implications for national development, economic growth, and East-Central Europe's changing mode of articulation in the world economy. According to a conventional modernizationist perspective, the prescription to economic growth is cultural change, the abandonment of "traditional," "communitarian" ways and the adoption of "modern," achievement-oriented social norms. The most informalized societies of East-Central Europe conform very closely to that prescriptive image. For instance, a nationwide survey of economic attitudes and value orientations (Kuczi et al. 1991), taken in 1989, reveals that surprisingly high percentages of Hungarians think of themselves, first and foremost, as "entrepreneurs" or would-be "entrepreneurs." Given its recent state-socialist history of rapid industrialization, cultural and social dislocations resulting in large-scale social fragmentation and individualization, and the predominance of an entrepreneurial ideology of self, success, and identity, Hungary offers itself as an outstanding empirical test for such a modernizationist hypothesis.

Evidence from the first two years of post-state-socialist practice cannot be completely definitive. However, evidence available so far suggests that the case of Hungary fails to substantiate the modernizationist expectations. No serious economic "take-off" has taken place since the abolition of the party-state regime. Living standards are falling, and at least one main direction of the transformation of the state-socialist informal sector is toward a Latin-American-type of informality of survival: informality continues to serve as a mechanism through which society "corrects" the "inefficiencies" of the system through increased work input as individuals have to find a way to make ends meet. Meanwhile, the hegemonic post-
state-socialist ideology of "destatization" — demanding first and foremost the quantitative "reduction of the role the state" — prevents the development of political measures towards state assistance to small informal enterprises of the "flexible specialization" type by way of market protection, training, or subsidized credits, all of which are known to have contributed significantly to the few successful cases of informal-based economic development.
Endnotes

1. For this analysis, East-Central Europe includes Poland, Czechoslovakia, Hungary, Yugoslavia, Romania, and Bulgaria. East Germany will be omitted from this description due to lack of appropriate data, the peculiarities of its external linkage structure, and the distinct historical path it took after the collapse of its party-state. Except for a few examples, the complex problem of the former Union of Soviet Socialist Republics (USSR) is also outside of the focus of this paper.

2. This definition belongs in the tradition of Alejandro Portes and his colleagues. He defines the informal sector in “western market economies” as “the sum-total of income-earning activities with the exclusion of those that involve contractual and legally regulated employment” (Portes and Siemens-Koeh 1987: 31; but see also Portes 1981 and 1985). The only modification made for the purposes of this summary is that the sociological locus of “contractuality” and “legal regulation” is tied more explicitly to the role of the state under regulated capitalism so that an explicit comparison with state socialism can be developed below.

3. Except for Romania and Albania, all societies of the region had moved away from the “generic” model after about 10 to 15 years of Stalinism, that is, by the early to middle 1960s.

4. Heavy industry and infrastructure are without exception directly state-owned. “Cooperatives” are found typically in small-scale manufacturing, the services and, in those countries where the “collectivisation” of the agriculture has taken place, farming.

5. The “soft budget constraint” is one of the key descriptive concepts developed by Hungarian economist János Kornai (1980) to help understand the peculiar behavior of firms under state socialism that leads to endemic, economy-wide shortages. The “soft budget constraint” denotes the condition in which companies owned by the “socialist” state are less constrained by competitive access to capital than their capitalist counterparts because the “socialist” state has a tendency to overinvest without regard to profitability requirements.

6. This definition is closest to that of Hungarian sociologist István R. Gábor and his colleagues who conceptualize the second economy from a labor market perspective, in different instances, as “income-creating activity outside the sale of labor to the socialist sector” (1985, cited by Swain 1990), “all income-producing activities which are carried out by households or individuals not as employees in the organizations of the socialist sector” (Gábor and Galasi 1985: 123), or “all income-purposive economic activities which are performed, whether legally or not, by individuals and households. Such activities may be undertaken instead of, or more often along with, employment in the socialist (state and large-scale cooperative) sector” (Gábor 1989: 597).

7. Strictly speaking, much of the descriptive literature on the second economy focusses on activities in this cell.

8. Lof (1990: 5-6) uses a typology that is neither exhaustive nor mutually exclusive: she terms the interaction between cells a and b “the legal second economy inside the first economy,” that between cells b and c2 “the illegal second economy inside the first economy,” cell b “the legal second economy parallel to the first economy,” and cell c3 “the illegal second economy parallel to the first economy.”

10. For more on this, see Szita (1987) and Stark (1989).

11. Böröcz (forthcoming) offers a more elaborate overview and a more explicit analysis of the transformation of Hungarian external linkages and their overall significance for political and economic change.

12. An important consequence of this is that country studies made for international financial organizations tend not to consider informality or the second economy in their assessments. By way of examples, see Prust et al. (1990) or Boote and Somogyi (1991).

13. Such special-access store chains proliferated throughout the 1970s and 1980s in the Soviet Union (Beriozka), Poland (Pewex), Czechoslovakia (Tuzex), and Hungary (Intertourist). Shrewd dealings in hard currency or coupons could create huge profits due to the absence from the domestic market of much of the Western-produced merchandise sold there.

14. The analytical power of Katsenelinboigen's presentation is hampered by his exclusive focus on commercial activities.


17. In the case of Hungary, the doubling time of direct foreign investment is about 9 months, and accelerating.

18. To quote only the most spectacular number, the number of limited liability companies has jumped 84-fold during the three years elapsed between December 1988 and December 1991.

19. This has recently been emphasized very eloquently for Poland by Jadwiga Staniszewska (1991) as "political capitalism."

20. East-Central Europe and the more desperate parts of the Third World ought to be distinguished from each other not only because of the differences in their relative levels of economic development (i.e., East-Central Europe is positioned between the poorer European capitalist countries and the better-off Latin American ones). Due to East-Central Europe's legacy of state socialism, a whole set of social, health care, educational, etc. provisions are already in place.

21. Some evidence already indicates, for instance, that labor contracts at formerly state-owned companies that have been privatized to foreign investors stipulate a ban on involvement in any other kind of economic activity, "moonlighting," "around-the-house" farming for the market, subcontracting, etc. by the employees.

22. That is the equivalent of a growth from about 2 percent to 8 percent of the labor force.

23. In the Hungarian case, the government has recently refused to index unemployment benefits and the 1992 budget refuses to subsidize day nurseries (in order to moderate rising unemployment by forcing women to stay at home with their babies).

24. In some extreme cases of newly sold companies, not only second-economy participation, but also membership in trade unions or other professional associations, has been forbidden.


