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Some system-specific features of capitalism*

Let me begin on a personal note. I spent decades examining the socialist system. In the course of this I developed a methodology for my researches, which I later named the *system paradigm* (Kornai [2008b], Ch. 8; Madarász [2008]).

I am now drawn to apply that approach to examining the capitalist system. I have put off the task for a long time, as I felt those who had specialized in capitalism from the outset and built up greater experience of how it operated would be better placed to analyze it. But in the event, I have been urged to do so precisely by Western friends and colleagues, who argue that a researcher conversant with the socialist system, viewing capitalism with a comparative eye, may have an extra intellectual contribution to make to the fund of knowledge about it.

The mood of the public

Capitalism—many people flinch at the word. Many people in the post-socialist countries mistrust the new system or feel express hostility toward it. Some never expected much of it anyway, and many who were confident initially expected something better and feel disappointed in it.

Table 1 shows the majority of people in Hungary expected initially that a change of system would better their livelihoods (Vásárhelyi [2007] 173–92). Though not a surprising expectation, it must be said straight away it was an illusory one. Nor is it surprising that the disillusionment has been so strong.

Another poll (Vásárhelyi [2005] 51–58. o.) asked members of the public if they agreed with this statement: “Capitalism is not perfect, but under that, of all existing systems, people’s lives are still the best.” In effect what the researchers did was apply to capitalism Churchill’s famous dictum about democracy (“Democracy is the worst form of government, except for all those other forms that have been tried from time to time.”) Agreement did not imply enthusiastic faith or even a favorable rational judgment, just acknowledgment that capitalism was the least bad of the existing systems. But even so cautious and relative a position gained only 31 percent support in 1992. The peak came in 1998, when the proportion reached 36 percent, but it has been declining since, to 25 percent in 2007.

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Table 1

Expectations of the change of system, fulfillment of them, and the order of importance attached to them (1993 and 2003)

	Expectations		Fulfillment		Importance*	
	1993	2003	1993	2003	Value	Ranking
	Proportion of affirmative responses					
Easier livelihood	69	71	6	14	7.3	1
Increased individual freedom	72	76	58	61	4.9	2
Expertise	79	73	24	29	4.6	3
Rational management of public property	79	73	13	17	4.0	4
Reduced state debt	64	63	4	26	3.9	5

* Respondents were also asked the importance they gave to each expectation, on an ascending scale from 1 to 10. The declining series of averages yields an order of importance for the expectations.

Note: The survey took a representative sample of 1000. The table in the source gives data on 11 expectations, of which the 5 chosen are the first 5 by the average rank of importance.

Source: Vászárhelyi [2007] 182.

Many people are wistful about the old regime. This is reflected in lines 2 and 3 of Table 2. A similar public mood emerges in another survey, of which a few findings appear in Table 3. Only one respondent in three would agree firmly that the new system was better than the old.

Why is the antipathy to capitalism so strong?¹ There are many *perception* distortions, i. e. in transmission between experience and how it is perceived. These I would like to cover in other studies. What I want to address here is the *reality*. The analysis is concerned with the causes of the real problems, troubles and embittering experiences. These I place in three groups:

1. The nature of the capitalist system. Covered here are the *general system-specific attributes* that apply in all countries and all periods.
2. Phenomena arising out of the *transition* between the socialist system and the capitalist system. These are factors that apply only temporarily.

Table 2

Statements about the political and economic system (1992–2002)

Do you agree with the following statements?	Proportion of respondents agreeing with each, %						
	1992	1994	1996	1997	1998	1999	2002
Capitalism is not perfect, but under that, of all existing systems, people's lives are still the best.	31	32	33	34	36	33	30
A great many things would have been worth salvaging from socialism.	28	37	52	53	47	51	43
The Kádár system paid more heed to the problems of ordinary people.	42	49	67	68	52	59	61
The market economy has to be applied even though it demands a great many sacrifices of people.	39	29	27	28	30	33	30

Note: The survey took a representative sample of 1000. The source table covers 17 expectations, of which the five chosen rank highest in order of importance.

Source: Vászárhelyi [2005] 53.

¹ The mood of the public here refers to public opinion in the post-socialist countries. Anti-capitalist sentiment, which has appeared as a reaction to globalization in several regions, falls outside the subject-matter of this study.

Table 3

The mood of the public: the distribution of responses to the question “Which system was better, the pre-1990 one or the present one?” %

Response			Altogether
The old system	About the same	The new system	
40.6	27.0	32.4	100.0

Note: The survey was taken in May 2005 by the Medián and Szonda Ipsos polling organizations, under a program of the Public Foundation of the Hungarian Center for Democratic Researches (DKMKKA), using a representative national sample of 2000 Hungarians. Information about the data collection appears on the web page www.tarki.hu:8080/valasztaskutatas/adatfelvetelek.

Source: Communication by Róbert Angelusz and Róbert Tardos.

3. The *specific, individual circumstances* affecting a given country at a given time. Here I can list, for instance, the institutions operating in that country at that time, and the effect of political activity, including the policy of the administration, the personalities influencing the events, and so on.

Examinations of all three types of cause present in themselves research tasks of great magnitude. There are grave difficulties involved in distinguishing the three types of cause analytically. This study is therefore confined to examining the first type of cause, and as the reader will find, even that is covered only in outline. The subject is so broad that comprehensive treatment would far exceed the bounds of a journal article.

The rest of this study extends outward, looking not at what capitalism is like here and now, in Hungary in 2008, but at *capitalism's general character*.

Conceptual clarification—system-specific attributes

Those who think in terms of the system paradigm are trying to identify the system-specific attributes of the system being studied.

A system-specific attribute is an *inclination*, rather like an innate genetic inclination in a person. For instance, our arteries tend with age to harden and the walls of the arteries to collect a deposit. There is dispersion among individuals, but the inclination is very strong. We are not at the mercy of destiny, however: the speed of sclerosis is influenced by eating and drinking habits and other lifestyle factors. But the tendency itself is built into the inherited genetic code.

Even in the Stalinist–Maoist period, bureaucratic centralization was not uniformly strong in all socialist countries. But despite the wide variation, the inclination was coded in. It can be deduced logically and confirmed empirically that a monopoly of power, a one-party system, and a dominant role for state ownership necessarily produce bureaucratic centralization.

The inclination can be resisted, but there is no final victory. To illustrate this, let me turn from the inclinations inherent in all people to the narrower sphere of inclinations inherited from family forebears. Think of someone many of whose parents, grandparents and their siblings have suffered from cardiac and circulatory disease. It is worth finding out whether that susceptibility to disease has been inherited. The result can be considered a stochastic prediction, i. e. a greater than average likelihood that the disease will affect the person with such an inheritance.

If there is such a risk factor, it is no good expecting a *final* victory over it. Those who watch their diet, take exercise, abstain from smoking, and are not under stress too often are combating the inclination to cardiac and circulatory disease effectively. But if the struggle is abandoned, the danger will increase again.

Some system-specific attributes

At this point it becomes clear what is implied by the title of the study: *Some system-specific features of capitalism*. Let me illustrate this by listing some characteristics, although the list is by no means complete. I have confined it to those that appear in *economic* life in a narrower sense, without referring to the relations between the economic and political spheres:²

First group

Dynamism, innovation, enterprise

Flexible adjustment of supply to demand

Economical use of resources

Competition among sellers for buyers

Second group

Unemployment, under-employment

Unequal distribution of income and wealth

Short-term interests stronger than long in enterprise decision-making

Sellers corrupting buyers

Each item, attribute or inclination in the list denotes a real, observable, empirically identified feature of the capitalist system. To put it in scientific terms, these are *positive* attributes; the study offers no *normative* assessment.³ It depends on one's system of values and the effect on one personally how favorable or detrimental some attribute of capitalism or other is seen. Nonetheless, I would like to point out that I have given the intentionally neutral names "First group" and "Second group" to the features most people find favorable and unfavorable respectively.⁴ But it has to be added that the validity of my message here does not depend on what normative approach people take to the features mentioned. The study sets out solely to convince readers that such features as those listed above (whether one likes them or not) certainly appear on the face of capitalism.

The system-specific features do not appear in the list in order of importance; both important and less important are mentioned. The list does not reflect the structure of relations between the features. It does not say, for instance, whether there are underlying features generating the more superficial, derived features. The causal relations between them remain to be analyzed.

What follows is confined to two system-specific features of capitalism, one from the first and one from the second group. This shows that the study is at most a sample—fuller discussion calls for analysis of all important system-specific features.

Dynamism, innovation, enterprise

If this system-specific feature of capitalism had to be associated with one name it would be that of *Schumpeter* [1912/1980]. Its appearance has been followed by a flood of literature on this aspect of capitalism. The aim here is not to present original, hitherto unheard-of ideas, but something much more modest. I would like to integrate this phenomenon into the system paradigm.

Why is it right to call the central role of the entrepreneur in capitalism (and only

² The capitalist economic system, based on predominance of private ownership and market coordination, is an indispensable requirement for durable parliamentary democracy. This, in my system of values, is the foremost favorable feature of the capitalist system. I have expounded this idea elsewhere (*Kornai* [2008], Chapters 5 and 6) and refrain from analyzing it again here, important though it is.

³ This use of "positive" as the opposite of "normative" in the philosophy of science differs from its use in common parlance as a synonym for "favorable" and can lead to conceptual confusion. It is hopeless to try to eradicate "positive" in the sense of favorable from common speech. All I can do is underline that "positive" is to be understood as the opposite of "normative" in this study, my other writings, and scientific theory in general.

⁴ I have described my world view in detail in other writings, explaining that in my system of values capitalism's favorable features outweigh its detrimental ones. I confine myself here to that remark, not wishing either to hide my position from readers or to divert the argument into normative discussions.

capitalism) a characteristic, *system-specific* feature? How is it possible to claim in this case that this is a relation of cause and effect, i.e. the capitalist system makes a protagonist of the entrepreneur?

Enterprise is a psychological attribute, a propensity found in many people in small quantities. Quasi-Schumpeterian entrepreneurs have appeared under systems other than capitalism (in pre-capitalist periods or under the socialist system that operated alongside the capitalist system for several decades). It may have been in a warlord with everything required: money, horse, arms, government support. It may have been in a charismatic politician performing some functions of a Schumpeterian entrepreneur: launching a great new movement and obtaining the funds and supporters required, along with a political market for his ideas and actions.

Yet these two brave, ambitious people still differed from the entrepreneurs of the capitalist system. Let me emphasize here four criteria that capitalism (and only capitalism) meets. The argument will be more easily comprehended by readers in Eastern Europe if capitalism is compared with the socialist system.

1. *Freedom of enterprise.* I will trade if I wish. I will not trade if I do not so wish. I am not ordered or forbidden by a higher authority to be an entrepreneur.

It is worth those whose memories are short recalling that such rights are not self-evident. New factories were established, new technologies were introduced, new shops were opened, etc., under socialism, but all of these events were planned, prescribed, ordered, or perhaps stopped and forbidden from above.

2. *An exceptionally strong incentive.* Entrepreneurs gain huge rewards if they manage to do what they wish. But they suffer grave losses if they do not. Success is a matter of life and death. The outcome of failure is *exit*, destruction of the business.

One essential side of enterprise is experiment. Only one attempt in a hundred succeeds. Let us not look only at what a successful entrepreneur earns. It is also worth calculating what the *expected* value of the reward in probability terms, i. e. multiplying the sum of reward by the probability of success.

Think of the lottery. Though the likelihood of success is one in a million, a great many people are willing to buy a ticket, because the reward is very high. Even in the face of very low probability of success, the very high reward can offset the cost of failure, though the chances of the latter are overwhelming. The public in the socialist period accepted that lottery winners would win vast sums of money. They also accepted that a football star might earn several times what an average citizen did. But providing impetus to the economy was not to be rewarded so generously.

3. *Competition among sellers.* Sellers (and ultimately producers) compete for buyers primarily by offering new products or services. The socialist system is marked by a shortage economy where a sellers' market applies. Buyers are pleased to obtain the product or service at all and there is no need to entice them with innovation. Competition among sellers for the buyers' attention and ultimately their propensity to buy is one of the strongest driving forces behind dynamism, innovation, and technical progress. The opposite of that is when a chronic shortage economy curbs or distorts the dynamism of the economy, cools the spirit of enterprise inside many people, stands in the way of innovation, condemning the economy to stagnation and trailing idly behind the rapid technical advances of developed capitalism.

4. *The presence of free, untied capital.* Its owners seek chances to place it usefully. The capital market making capital available to entrepreneurs is flexible.

Some readers of this study may have read *Economics of Shortage* (Kornai [1980a]) and even remember it. There is no slack (usually unused) capital in a shortage economy. Everything is allocated, indeed over-allocated beforehand. There is no money available for unplanned investment projects, let alone experimentation or uncertain undertakings.⁵ The

⁵ The situation is sized up in the main title of Thomke [2003]—*Experimentation Matters*—a book often cited

rigid machinery of bureaucratic centralism leaves no room for the form of investment of *venture capital*, where great profit is sought at a venture and obtained from the venture if successful, but at a risk.

Let me add a methodological comment. Comparing systems seems to have explanatory force. This is one important constituent of the system paradigm. It is unfortunate that ordinary people do not make such comparisons. They forget many bleak aspects of the old system, though today's old people (parents and grandparents of the young) complained much about them at the time. The younger generation no longer has direct recollections and experience of the pre-change period and may be mistaken about it. But it is a doubly unfortunate error of *methodology* if social scientists fail to compare systems. Long books appear on the present economy without comparisons being made with the socialist system even at the most obvious points. The latter is seen as over and done with, yet authors should be comparing the present with the earlier system precisely because it failed. It failed, for one thing, because it would not let Schumpeterian enterprise develop.

There is a close causal relation between enterprise and the dynamism of capitalism. Listed below are 70 innovations, all new products, new services, or new forms of organization that turned people's lives upside down and reshaped them. The list does not include technologies that revolutionized production. It is confined to those we meet as consumers, in the part of the day spent away from the workplace, or at least that play a part there. Not all the items have equal weight. Mentioned side by side are innovations that made a revolutionary change and those with narrower effects. Nor is the list complete in the area outlined. There are many other innovations worth mentioning. Whole sectors have been left out—pharmaceuticals and diagnostic equipment, or new teaching aids. The aim is to exemplify how our lives are imbued with the influence of innovation. No side of our life has been left unaffected by innovations such as the ones mentioned.

Great twentieth-century innovations that affect everyday life

- Personal computers, laptops, the computer mouse, hyperlinks, laser printers, scanners, portable calculators, the Internet, the World-Wide Web, email, Google and other Internet search engines, Internet shopping and banking.
- Television, satellite TV, cable TV, compact discs, video, DVDs, portable radio and devices for listening to music, remote controls.
- Cell phones, short message service (SMS), fax, automated still and video cameras, Xerox and other duplicators, Federal Express and other worldwide private postal services.
- Electric refrigerators, washing machines, clothes driers, dishwashers, automatic coffee machines, vacuum cleaners, microwave ovens, Saran and other plastics for food wrapping, plastic bin liners for trash, air conditioning, domestic burglar alarms, solar panels for heat generation.
- Canned drinks, vacuum-packed foods, drinks in Tetrapak and other cartons.
- Electric shavers, disposable plastic razors, sprays for domestic and cosmetic use, electric hair-driers, self-adhesive bandages, paper handkerchiefs, paper towels, disposable diapers, hook-and-loop fasteners, halogen lamps.
- Quartz watches, self-adhesive tape, "post-it" self-adhesive notes, Lego toys, electronic toys.
- Supermarkets, shopping malls, bar-code readers, bank cards, credit cards, Amazon and other Internet booksellers.
- Jet planes, "last-minute" airline tickets, electronic air ticketing, commercial package tours, escalators.

Source: Own compilation, drawing on the <http://inventors.about.com/> (Famous Inventions A–Z, ed. Mary Bellis) and <http://www.ideafinder.com/> ("20th Century Innovation Timeline") websites.

Inventions are usually (but not invariably) made by scientists or inventors, but practical implementation and distribution are done by entrepreneurs. They discover or finance the inventor, find the capital required for introduction, employ the labor required,

bring the inventors together with the potential users of the inventions, and arrange mass production, sales, and consumption.

The literature on technical advance could fill libraries. Everybody registers its importance, but tends to forget it is a child of the capitalist system. Change of system means forsaking the socialist system—unable in fifty years to produce one of the civilian innovations that transformed people’s lives, at most to copy them after much delay—and turning to the capitalist system, which produced them all.⁶ Never-ceasing production of innovations is a feature specific to the capitalist system.

Unfortunately many have failed to understand this connection in the post-socialist reagon. People are not told about in school, on television, in the newspapers or in politicians’ speeches.

Innovative entrepreneurs are richly rewarded by competition. But the public fails to make the connection between the dynamism of capitalism and the entrepreneurs as the impetus behind innovation, inspired by the prospect of rapid financial success. A great many people roundly condemn such rapid enrichment. This appears from a survey in Hungary described by Endre Hann and Mihály Laki. Respondents were asked in 1991 to consider the following: “It is not permissible for some successful business people to get rich.” Fifty-two percent of respondents agreed with this condemnation of riches (*Hann and Laki* [1992], 186).

Nor are such sentiments specific to Hungary. The journal *Foreign Policy* reports in an article how French and German school textbooks are anti-entrepreneur and sow anti-capitalist ideas in young people’s heads. Capitalism, they are told, is brutal, wild, and American; technical development destroys jobs; heads of corporations are indolent, cigar-smoking plutocrats (*Theil* [2008]).

I have to say frankly I am more outraged than ever when an angry author writes anti-capitalist articles on a computer, or demonstrations of those incensed by capitalism are summoned by cell phone or Internet and eagerly expect television to show the crowds who come. They make unhesitating use of the innovations, while attacking the system indispensable to the making of them.

Let me recall the explanation at the beginning of the study: a system-specific feature means an innate *inclination* in a system. Capitalism certainly has a strong ability and inclination toward dynamism, innovation and enterprise. This may burst forth, but it may also be cooled or stifled. I return to the matter later.

Unemployment and incomplete utilization of labor

One marked feature of the overall labor situation is the system specificity of its typical steady, normal state of lasting, long-term equilibrium. The classical socialist system typically displays chronic labor *shortage*, capitalism chronic labor *surplus*.

A good few respected research economists recognize, or even emphasize that under-employment, a certain level of unemployment, less than full utilization of labor, a surplus of labor are an inescapable accompaniment to capitalism. *Stiglitz* [2001b] states, “The most important *systemic* failure associated with the market economy is the periodic episodes of underutilization of resources.” It is possible in this sense to talk of *equilibrium unemployment*,⁷ but even such researchers do not regularly sharpen their idea by

⁶ The Soviet Union and other socialist countries had living and researching in them some first-rate scientists making major advances. Some made revolutionary discoveries of use to industry, for instance the Soviet physicist Abram Jaffe, known to the history of science as one of the pioneers of semiconductors, later vital to computer production. He came up with his inventions about 1938, but the economic environment was wrong for applying them. It lacked entrepreneurs to turn scientists’ or engineers’ inventions into innovations, start production of them, and disseminate them.

⁷ Excellent examples of this approach are the works of Joseph Stiglitz and Richard Layard. Stiglitz

contrasting this with the socialist system, where a state with the opposite sign becomes chronic. They do not utilize this contrast to show that the normal state of the labor market is a *system-specific* attribute.

The commoner and more widespread outlook prompts economists examining the labor market comprehensively, for instance textbook authors, to list conscientiously the phenomena of unemployment and under-employment and the direct causes of them, while failing to ask whether these are partial factors or ones deriving from the system's nature. Such authors avoid analyzing deeper causes and turn straight to practical regulations and how to contain the harmful phenomenon.⁸

To what extent does the capitalist system generate unemployment? I cannot include a comprehensive account of the causal relations here, but let me pick out two of the mechanisms deeply imbedded in capitalism that are causes of unemployment in a system-generated way. For both, there are very important, well-known and generally accepted theories available.

The first is *structural unemployment*. The dynamism of the capitalist system and the process of innovation, just dealt with in detail, cause persistent, mass errors of adjustment in labor supply and demand. There is what is graphically described as a mismatch between the vacancies on the job market and the specific supply of labor available. This is a complex phenomenon involving several factors.

New technologies are introduced into production and the existing expertise of the labor available does not match in several ways. Some skilled workers become redundant. Adjustment and acquiring new expertise take time; those concerned may not find work in that period. Furthermore, they are existing workers incapable of adjusting to the new technologies, who therefore drop out of the labor market altogether. The dynamism of the economy continually compels older firms to exit, causing job losses, and there are continual entries as well, new firms seeking employees. But it is not certain that the new demand and the old supply of those who have lost their jobs and seek new ones will match.

There are several effects of increasing the productivity of labor. One common one is to save labor on the more capital-intensive work of assembly. As productivity rises, production increases extensively alongside the intensive development of the economy. The latter process creates jobs. But several kinds of disproportion may develop between the two kinds of change: there may be a delay between the redundancies and the expansion; the two may have different geographical structures or skill requirements, and so on. An illuminating example of these kind of structural mismatch within a single country is the transformation of agriculture. A mass surplus of labor appears in the villages, while the several urbanizing regions may be unable to absorb it fast enough.

Territorial redistribution of demand for labor occurs not only within countries, but between them. As development in some relatively backward countries accelerates (think of the dizzying growth rates in China and India), cheap exports by such regions squeeze out many producers in developed countries. Chinese or Indian farm workers who leave the villages for cities and go into industry gain jobs, but German or Belgian workers lose them, as an effect of globalization.

This brings us to one of the main conclusions from this argument. The more dynamic a capitalist economy is, i.e. the more strongly one system-specific inclination, the favorable one, becomes, the more structural unemployment appears, in other words, the more strongly the other, unfavorable system-specific propensity asserts itself.

For the capitalist economy is always marked by the basic characteristic of dynamism and innovation. But that also means there is no way to predict the precise direction in

summarizes his ideas on this briefly in his address of acceptance on winning the Nobel Prize (*Stiglitz* [2001a], 479–80). *Layard et al.* [2005] uses the expression “equilibrium level of unemployment”, adding, “our concept of equilibrium does not imply market-clearing.” (pp. 8 and 11).

⁸ An example is the excellent textbook *Heyne, Boettke and Prychitko* [2004] (Ch. 19, 441–65), which is widely used in Hungary.

which it will move. Who could have guessed in the 1930s, as the Western world likewise built countries “of iron and steel,” that a world of information and communication would appear half a century later and call for expertise? Who would have predicted the rapid geographical reorganizations of world production that are seen today? While capitalism brings splendid new triumphs of human intellect and rapid worldwide spread of civilization, it has also caused the loss of millions of jobs.

The other group of phenomena that continually reproduces unemployment is known to analysts as the *efficiency wage*. This is the premium that employers may be willing to pay over the market-clearing wage (the wage at which supply and demand for labor would be exactly equal). Employers are drawn to do so not by the goodness of their hearts, but out of self-interest, based on various considerations.

Above all, they see it as a defense against shirking.⁹ It would be very expensive to place a supervisor behind every worker. When monitoring costs are compared with the costs of paying a premium over the market-clearing wage, the latter turns out to be cheaper, especially if the performance is difficult to reduce to measurable indices, i. e. the quality of the result is decisive. The more intellectual content there is in a work task—i. e. the greater the extent to which intellectual performance is required of an employee—the less effectual “piece wages” or simple payment by time become, and the less easy it is to catch slackers in the act. So internal motivations have to be developed, and that is where efficiency wages come in, in various ways. When employers appear on the labor market with an offer of higher pay, they are presented with a greater choice of candidates than they would be if they simply offered the market-clearing wage. And an employee who obtains such a well-paid job is doubly careful not to lose it again.

An efficiency wage is effective if employees strive to work hard not only to retain the extra pay, but for the still more pressing concern not to lose their jobs. The employers as a whole have a collective interest in the presence of a chronic surplus of labor because this provides the means of discipline in every workplace. Even the most enlightened and socially aware of employers will give only halfhearted support to the idea of sharp fall in unemployment. Under no circumstances would they want to see the labor market tip the other way, to mass shortage of labor. As things are, employees are haunted by the prospect of dismissal.¹⁰ This assertion may sound very Marxist, but it is true nonetheless.

There is a well-known *macroeconomic* argument against too radical measures against unemployment, especially “over-employment”. If excessive impulses to raise wages appear, the excess demand for labor causes costs and prices to rise, which may lead to an inflationary spiral. This argument is justified.¹¹ But it does not preclude another mechanism as well, whereby the collective interest of employers lies in maintaining a certain degree of unemployment to ensure labor discipline.

Here it is worth stopping to recall the labor-market situation in socialist economies that had reached a medium level of economic development: the Soviet Union and the East-European communist countries. There appeared a chronic labor shortage in the production sphere. There were many unfilled vacancies and relative to that an insignificant amount of registered unemployment. It was generally known how much this weakened labor discipline. Employees could rightly feel they would not be dismissed if they did not try very

⁹ The pioneer theoretical work on efficiency wages is an article by *Shapiro and Stiglitz* [1984]. There is an extensive literature offering description and causal analysis. One is the textbook by *Milgrom and Roberts* [2005], pp. 338–49.

¹⁰ The mechanism described does not require the collective interest in retaining unemployment to appear in the consciousness of employees. If the labor market became very tight and employment reached 100 percent, it would raise the wages required for the requisite performance to heights unacceptable to employers. As employers each raise wages through their own labor-market bargaining, employment returns to well below 100 percent, even unconsciously.

¹¹ This relation is the backbone of the theory of a “natural rate of unemployment”. The pioneering works are *Phelps* [1967], *Phelps et al.* [1970] and *Friedman* [1968]. The theory is expounded in all macroeconomic textbooks.

hard, or even if they were absolute shirkers. If they happened to be dismissed nonetheless, they had no difficulty finding another job. The situation drew incessant complaints from every factory manager and every foreman. A high proportion of the workforce did respectable work mainly out of underlying honesty and a feeling of identification with their tasks, and in hope of financial rewards for better performance, where these could be given relatively effectively. But there was no threat of unemployment to exert a disciplinary effect. Employment, still more job security, gives a comfortable feeling. It was not guaranteed by the efforts of trade unions, the regulations, or the moral principles of socialism, but by the chronic shortage-economy.

I have refrained from including in the argument theories of unemployment that rest not on system-specific causes, but on other factors and other mechanisms contributing to a surplus of labor. Let me give a single example of these.

A contribution to the development of a surplus of labor and to unemployment is made by problems of information, which are considered in the theories of search (see, for instance *Pissarides* [1989] and [2000]). Those offering jobs and those seeking them have to meet. But this important aspect is absent from this analysis as it is not system-specific—it appears under capitalism and under socialism.

The structural unemployment described earlier and the just-mentioned unemployment for the duration of the search for a new job, due to information shortcomings, are closely connected and overlap in a sense. If the information was perfect on both sides of the market, including exact predictions of future changes, the mismatch caused by structural transformation would be far smaller. Conversely, if the technology, the sectoral structure and the geographical distribution within the structure of the economy concerned consolidated, the search and the matching of supply and demand would become much easier. There was big trouble with both phenomena in the socialist economy, which was marked by sluggish technical development and rigid, overly centralized bureaucratic rigidity. But the main problem here was with the brakes on technical advance. Capitalism's soaring technical progress would itself bring sizeable structural unemployment, regardless of how well the information flowed on both sides of the market. That is why I list this phenomenon among the system-specific features of the capitalist economy, but not the frictions caused by deficiencies of information.¹²

It is time to sum up what has been said. Chronic unemployment and under-employment form a painful system-specific feature of capitalism. They bring suffering, financial loss, and humiliation to the unemployed. They also cause uncertainty for those working, who face the threat of unemployment. Racism and other types of discrimination are often involved when candidates are being selected for jobs, or rejected and left out of work.

It is quite unrealistic to endorse and support capitalism and then demand "full employment." There is no sense in juggling with the word "full," as many politicians and even researchers do. I can only accept a precise interpretation: "full" means 100 percent, not 97 or 93.

Rigorous researchers are not alone in objecting to that. Those directly concerned feel the same way. There is only a 100 percent likelihood of surgery succeeding if the operation *always* succeeds. Medical researchers or professional accounts based on statistical facts may announce that 97 percent means the intervention is "fully safe" and a fine achievement for medical science, but the 3 percent for whom it does not succeed may die or be crippled for life. A 3 percent rate of unemployment may be an imposing achievement for macroeconomic policy, but it causes much suffering to those in the 3 percent group.

¹² Although frictions due to information deficiencies appear under both systems, the loss due to error is greater under capitalism than under socialism. However low the efficiency of a socialist enterprise's employment of labor, it can survive the loss (due to the soft budget constraint). Workers also suffer less from the frictions of the labor market because there is less dispersion of the wages and therefore they can decide to change jobs more easily, if they really want to.

It is possible—and necessary—to pursue macroeconomic policies and found institutions to reduce unemployment and make it more bearable. That is a realistic task to undertake, something worth working for. This exemplifies well what I wrote at the beginning of this study about a system-specific *inclination*. The capitalist system shows an inclination to chronic mass unemployment. But that does not mean standing back fatalistically and letting the tendency appear as it will. It has to be combated, for it can be pushed back, reduced, ameliorated, and made more bearable.

Connections between system-specific attributes

Those familiar with my work may excuse me for recalling at this stage in my argument a comparison I have often used before: the supermarket of history (Kornai [1980b]). Many people would like to combine elements of various systems that they find congenial, but omit ones they dislike. To keep to the subject of this study as we push round our supermarket trolley, let us take from the shelf the dynamism and innovative force of capitalism—but eschew the outrageous *nouvelle richesse* of the successful entrepreneurs, of course. Let us add to the trolley the avoidance of unemployment. In other words, let capitalism be and not be, both at the same time.

Such ideas as these were current before the change of system as well. Their currency was demonstrated in the opinion polls of the period; they can be found in the first rough drafts of some of the political parties that were forming. Yet some people cannot grasp even today that this comfortable combination is unattainable.

Surveys by opinion pollsters and sociologists show many people tend to hold inconsistent opinions. They want one thing, but also another that is opposed to it. But the two concurrent intentions, expectations or goals are mutually exclusive.

Table 4 shows two groups of people responding to the questions of the survey in an inconsistent way. More than half of them found present-day capitalism better than the old socialist system, except that they wanted to exclude from capitalism a fundamental characteristic of it—the dominance of private ownership—and the state to remain as owner. Almost 12 percent of respondents confirmed in the response that the state was a bad master and privatization the right thing, yet they also stated that the old system was better.

Let me go back to some of the system-specific features of capitalism referred to a couple of pages ago: dynamism, innovation, enterprise, flexible response to demand, and seller competition for buyers; and on the other hand, unemployment, underemployment, inequality in the distribution of income and wealth, and the predominance of short-term interests over long in corporate decision-making. The list is not a full one, but sufficient to show the coexistence in it of features seen as good and features seen as bad. But the system generating such system-specific features does not allow them to be combined with the system-specific features of socialism, such as shortage of labor or the lack of extreme inequalities, and at the same time avoiding such immanent, essential attributes of the old system as political repression and bureaucratic centralization of the economy.

Having made that assertion, central to my line of argument, let us remain *within* the capitalist world. As mentioned earlier, it is possible, as mentioned earlier, to weaken or strengthen the intensity of the system-specific inclination through interventions. This effect can be obtained even by altering a single parameter of economic policy (raising or lowering a tax rate, for instance). But a *lasting* effect will be gained by *institutional transformation*—what is known as *reform*. This brings us to one of the main problems related to the theory of reform.

Table 4

Distribution of responses to the question: “Which system was better? The pre-1990 one or the present one?”
%

	Responses:	
	The old one was better	The new one is better
The state should supervise as owner	68.8	55.5
Intermediate position	19.3	21.5
The state makes a bad owner; privatization is correct	11.9	16.8
Total	100	100

Note: The survey was made by the Medián and Szonda Ipsos research institutes, under the program of the Hungarian Central Public Foundation for Democracy Research (DKMKKA). The survey taken in May 2005 was based on a representative national sample of 2000. Information on the data collection appears on www.tarki.hu:8080/valasztaskutatas/adatfelvetelek. The survey allowed for an intermediate position (“about the same”), as *Table 3* also showed. Here, however, the middle column has been omitted, as it does not illuminate the inconsistency of the responses.

Source: Communication by Róbert Angelusz and Róbert Tardos.

In an earlier part of the study, I listed features and inclinations. How the influence of one inclination coincides with the assertion of other inclinations? What are the effects of an institutional reform, if the effect is observed concurrently on several propensities? For ease of explanation, let me cite just two features, A and B, although in fact, of course, there are far more features that should be observed simultaneously. Five types can be distinguished:

Type 1 is the most attractive: it is possible to improve feature A and feature B concurrently. Let us call this *complementary improvement*. This was promised years ago in all resolutions of the communist party Central Committee in the pre-1989 Kádár period. It is also promised in various party manifestos and political speeches today.

But in fact it is very rare. Let us remain with the same two subject-areas as before. It is possible to envisage a change in the education syllabus that would make people’s knowledge easier to transform and transfer. This will assist innovation, improve the dynamism of the system, and at the same time reduce structural unemployment. If the intention is to go beyond slogans in achieving complementary, simultaneous improvement, opportunities for type 1 institutional reforms must be sought with great ingenuity and expertise. And any found must certainly be introduced.

Type 2 is not bad either: it is possible to improve feature A without causing feature B to deteriorate. Let us call this type *Pareto improvement*.

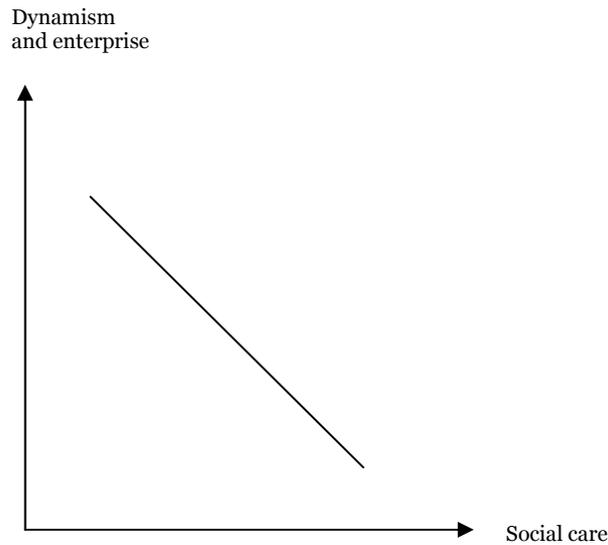
Before defining *type 3*, let us take a quick look at *types 4* and *5*. *Pareto deterioration* and *complementary deterioration* are mirror images of types 2 and 1. While types 1 and 2 must be sought with assiduity, types 4 and 5 must be given a wide berth. Self-evident though this warning may be, there have been examples of reforms that have been damaging in several or all respects.

We have skipped over type 3, or the case of *trade off*, because it is actually the commonest and the one that poses the hardest decision-making dilemmas. It is worth considering this in more detail.

Figure 1 calls for several kinds of explanation: how to measure the variables belonging to the axes, what actual shape the trade-off curve has, and how steep the curve is, i. e. what price has to be paid for one unit of improvement in feature A in terms of deterioration of feature B. Readers should not demand too much. This is not the graph of a regression analysis based on real data, just an illustration of an idea.

Figure 1

Trade off – dynamism and enterprise v. social care



Let us begin with an example. To repeat an earlier statement in the study, the more dynamic a capitalist economy is, i. e. the stronger the system-specific propensity is asserted, the more structural unemployment appears, i. e. the stronger the other, unfavorable system-specific propensity becomes. Structural unemployment can be alleviated if the state or unions or the two together intervene to make it harder for employers to dismiss labor. Various regulations are made to reduce employers' right to fire workers. Conditions may be attached to dismissal, perhaps that the dismissal intention should be agreed with the union beforehand.

Such curbs on firing amount to an important institutional change, i. e. a reform. On the one hand they safeguard jobs at that particular time and protect the dignity and security of employees. On the other, they tie the hands of firms, preventing, in the well-known Schumpeterian phrase, the second stage of "creative destruction," the end to the old that impedes the arrival of the new. In this case, it impedes the creation of new, more advanced jobs by impeding the elimination of old, obsolete jobs.

To take another example, many people clench their fists to hear that some entrepreneur, manager, businessman or other is earning hundred times the average income. Yes, but where should the line be drawn and how? Even if many people get rich by dishonest means, it is the chance of great (yes, enormous) gain that provides the incentive for the dynamism of the firm. What bureaucratic authority or political decision-making body can say where the line should run, what amount but no more is needed as an incentive?

Let nobody try to give a cheap answer to such grave dilemmas. Let nobody say, "jobs have to be protected and a limit placed on excessive incomes without lessening the dynamism of the economy." Fine, if that were the case, we would be in the space above the trade-off curve, or in the earlier terms, we would be facing a type 1 or type 2 (complementary or Pareto-improvement) reform. If anybody can offer such a reform, let it be implemented immediately. But nobody can deny that the far commoner kind of reform is type 3, where something is sacrificed for something.

Varieties of the capitalist system

People's sense of justice calls for étatist-corporatist interventions. Even people who do not rely on state support, are advocating that kind of activity. But the system-specific dynamism of capitalism, capable of great achievements, will appear where and when firms are less

restricted.

There is a notable literature on this subject, connected with another line of research, into classifying the “varieties of capitalism.” Researchers are attempting to arrive at a workable typology. In most cases a distinction is drawn between two “pure types,” with the specific systems of various countries at various times dispersed around one type or the other.

Often cited in the debates are the studies that appear in *Hall and Soskice* [2001], whose authors contrast the “coordinated” market economy with the “liberal” market economy. (These seem neutral terms, although that of the first classification suggests great advantages, giving the impression that the economies it covers are better coordinated than the “liberal” ones.)¹³ Another participant of the discourse, *Phelps* [2008, p. 78] is highly critical of the first class, calling it a corporatist formation that he is not even prepared to term capitalism. Capitalism, Phelps argues, is a name only deserved by a system to which the entrepreneur’s role is central.¹⁴

Research into this problem belongs within the wider subject-area discussed at the beginning of the study. All I wanted to do here was to state the problem. The various innate inclinations of capitalism cannot be picked and chosen in desired proportions, to suit one’s political position or the weights given to them in a personal set of values. There are a great many trade-off relations among capitalism’s system-specific features. Weakening a detrimental propensity usually means weakening the favorable ones as well. And in reverse, encouraging a favorite propensity will strengthen some unfavorable ones as well.

This brings us close to classification debates occurring on the political, rather than the academic plane. It is debated, sometimes coolly and sometimes angrily and passionately, by professional politicians, influential journalists and television personalities, and in some cases by a wider sphere of people with an interest in politics, what kind of political system they wish to have around them. The research whose initial steps have been described in this study is intended to encourage that debate. Capitalism is a system susceptible to reform. It is worth making sure that change is towards the most favorable variant of capitalism. But circumspect analysis must be done to clarify what chances the reform has and what price must be paid for the alterations. This study is mainly intended to contribute a few words of warning to this great thought-provoking, clarifying debate. Above all it seeks to encourage *realism*. Whatever the intention, whatever the dream, the reality of the capitalism in which we live defines the limits of what can be done.

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¹³ Issue can be taken with the approval implied in the name of the first classification. Think back to the British strike movement in the years before Margaret Thatcher’s government. Time and again, small craft groups could halt production in big firms or even whole industries, causing immeasurable damage to the coordination of production on a national economic scale. And why would society-wide “coordination” result from repeatedly upsetting the macroeconomic equilibrium by allowing the expenditures of the welfare sub-systems to run away from revenues?

¹⁴ *Baumol, Litan and Schramm* [2007] go still further in naming their classifications, sharply contrasting two categories named “good” capitalism and “bad,” the former being dominated by dynamism, innovation and corporate activity.

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