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WHY IS ECONOMIC PERFORMANCE EVEN WORSE WHEN COMMUNISM IS ABOLISHED?

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If the government controls everything, the economy does not work. To have a successful economy, a society needs to give the market a larger role -- and government a smaller role -- than the communist countries did. This view is now generally accepted in the East as well as the West. The peoples of the formerly communist countries have accordingly decided in favor of capitalism as well as democracy and are cutting back the economic role of government.

As new markets have emerged and the role of government scaled down, economic performance in the Soviet-type societies should have improved. In fact, it has gotten worse -- in the Soviet Union, much worse. Why? If too much government control of the economy brought about the failure of the communist economies, why did not economic performance improve as communism was abandoned and government control cut back?

Many people have come to suppose that a transition from one set of economic arrangements to another necessarily reduces output, but in fact it does not. The economic liberalization that Deng introduced in China not long after the death of Mao promptly generated large increases in production. After the defeat of the right-wing dictatorships of World War II, it was almost universally assumed that the German and Japanese economies would take decades to recover from wartime devastation, changed boundaries, and totalitarian controls, yet they soon enjoyed economic miracles. Even the Soviet-imposed transition <u>to</u> communism in East-Central Europe, for all its tragedy and brutality, was not associated with at least any protracted reduction in output.

At a loss to explain the severity of the economic problems after the collapse of communism, many seek refuge in metaphors: "it is easy enough to make fish stew out of an aquarium, but you cannot make an aquarium out of fish stew." But why should a transition from communism to a market economy be more difficult than the transition the other way? The conventional wisdom is that markets do not need to be painstakingly constructed by government -- they emerge spontaneously and thrive under laissez faire. Certainly the markets of early times, like the market economies that gave rise to the industrialization of Western Europe and North America, were not the outcomes of any government plan to establish market economies. To create a communist economy, by contrast, detailed plans and extensive bureaucracies must be put in place.

Thus neither the familiar assumptions about the spontaneous emergence of market economies nor the new metaphors will do. Just as Marxist ideas were not able to make communism work, so familiar Western ideas have not been able to explain the difficulties of the transition to a market economy.

In part, economic performance during the transition is poor because a thriving market economy is not, contrary to what some say, simply the result of "letting capitalism happen" -- not something that emerges spontaneously out of thin air. It requires a special set of institutional arrangements that most countries in the world do not have. The most prosperous countries happen to have these institutional arrangements, but they take them for granted. These arrangements are usually overlooked in ideological debate and in scholarly research and thus their importance is not generally appreciated in either the mature market economies or in the societies in transition.

The nature of these neglected institutions is evident from the key word in discussions of the transition: "privatization". The meaning of this word is clear when it is applied to the developed democracies with market economies, such as Britain in the time Margaret Thatcher was Prime Minister. These societies have well-defined private rights and elaborate public mechanisms for protecting them. When private rights and clear and secure, a government enterprise can be unequivocally privatized; when they are not, the meaning and consequences of privatization are obscure.

When individuals or firms in the developed democracies with market economies make legitimate contracts with one another, they are confident that these agreements will be enforced by the government, and that any dispute about a contract will be resolved by judges who have no stake in the dispute and whose jobs do not depend on the current political leadership. The individuals and the firms in these societies can also be confident that their rights to private property will be protected by public officials who will, if need be, call upon the coercive power of the government to protect those rights. In an anarchy, an individual might have possessions, in the sense that a dog possesses a bone, but there can be no private property without government.

Indeed, private property in general is not secure unless there is a government of a very special type -- one in which no government official has the power to deprive an individual or firm of property without due process of law (as interpreted by an independent judiciary) and the payment of compensation. Similarly, contract rights are not secure unless the society's institutions give even opponents of the current political leadership, and foreign no less than domestic firms, impartial government enforcement of contracts.

Interestingly, the only societies that have protected individual rights to private property and to contract over the long run are democracies -- a dictator always has the capacity to expropriate property and to set aside the decisions of any court.

Private rights to property and to contract enforcement scarcely existed under communism, and they are mostly still ill-defined, insecure, or inaccessible in the societies in transition. Because of the inadequacy of private rights, these societies do not have a full and effective array of markets. They do not, for example, have access to capital markets in which their firms can borrow long-term or raise capital by issuing corporate stock, nor many markets that attract foreign investment. Markets are therefore not generating nearly as much new income as they should.

And not enough new income to offset the decline -- or rather the collapse -- of production in the state-owned enterprises. Why is output falling in the state sector? Mainly because democracy, though indispensable to maintaining property and contract rights and market economies over the very long run, does not extract as much output from the system of planning and state enterprise as the ruthless totalitarian dictatorships did.

To see why, consider the incentives facing Stalin and other communist dictators in the first decade or two after World War II. The totalitarian control of the Soviet-type societies was then so complete that a dictator had much the same interest in the productivity of the society that the owner of a private firm in the West has in the firm's productivity. If the output of the Soviet economy increased, the First Secretary of the Communist Party could use most of this increase for his own purposes -- for military strength, international influence, and political power. He had what I call an "encompassing" stake in the society -- a powerful incentive to make the domain he "owned" as productive as he knew how to make it.

Though all communist regimes were handicapped by their aversion to markets, Stalin and his immediate successors for a time were able to exploit the competition among their subordinates to obtain a considerable and increasing yield from their domain. Those subordinates who obtained the most production from the resources under their management them were rewarded and those who were uncompliant were punished. The performance of the managers of the different establishments in a given industry could be roughly estimated by comparing how much output each produced in relation to the resources he had to manage.

As long as each subordinate believed that his advancement was best served by outdoing his colleagues in obtaining more output from the available resources, the centrally planned economies served their dictatorial owners relatively well. The Soviet-type societies were growing relatively rapidly and many people expected that they would ultimately surpass the United States.

As time went on, however, the subordinates in each industry or locality were able to take advantage of their potential monopoly of information about the productive processes that they managed. Without information from below, the center had no way of knowing how much it is possible to produce from a given amount of resources. If all of the factory managers in an industry discreetly or even tacitly cooperated in lowering their superior's expectations about how much it was possible for them to produce, all of the subordinates would be better off. If they avoided situations where each of them had an incentive to outdo the others in productivity, as they could do if the separate enterprises were collected into one giant bureaucratic establishment with no competitor or standard of comparison, then their lives would be a lot easier. It took some time -- and probably also the end of punish-on-suspicion purges -- for the subordinates in an industry or locality to succeed in covert collusion at the expense of their superior. It took even longer for collusion to emerge in many industries, localities, and layers of subordination, and for the large merged enterprises to become, in effect, stand-alone insider lobbies.

But when this happened the Soviet-type societies were bound to be less productive -- each enterprise, locality, or coterie of subordinates did not have the encompassing stake in the output of the economy that the dictator did. In contrast to the dictator, the subordinate unit or coterie would gain little or nothing from more output from the economy as a whole, and accordingly had little or no reason to anything to increase the efficiency of the society. As enterprises, localities, and coteries became stronger, the nomenklatura or "new class" became more privileged, the center became less powerful, and the economy became more sclerotic.

Ultimately, this devolution reached the point where the total income of an industry or sector was divided among all of the enterprises, with those that were simply a drain on the society getting almost as much as those that generated a surplus. New investment did not go to where it would be most productive, but to those enterprises with the most bureaucratic influence. In the last years of communism, the encompassing interest of the center was not nearly as strong a force for guiding investment and extracting output as it had been earlier.

When the communist governments collapsed, they were in most cases replaced by relatively fractionalized democracies, so the encompassing interest of the center virtually disappeared, and the capacity to extract output from the state-owned economy vanished with it. The new democratic governments have usually been weak -- in the last Polish election, for example, the most successful party got less than 13% of the vote, and in the Soviet Union, the center is virtually powerless. The large state-enterprises, on the other hand, continue to be organized and politically powerful. Indeed, under democracy they can lobby more openly than before and their workers can strike as well. As part of the government, the managements and workers of the state enterprises are still on the inside, and they claim entitlements to public funds akin to those claimed by civil servants and pensioners. So there is virtually no force to impose coherent plans upon or to extract output from the state sectors of the societies in transition. Thus performance in the state sector is even worse than it was in the last years of communism.

We are now in a position to see that the conventional wisdom that privatization of state-owned firms is the essence of the transition from communism to a market economy is wrong. In part, it is wrong because societies cannot realize the potential of a market economy unless they have institutions that protect rights to private property and to contract enforcement. Without institutions that define and protect private rights, the gains from privatization are uncertain. With the right institutions, the societies in transition will reap gigantic gains from new firms and from foreign capital and enterprise.

The conventional preoccupation with privatization is also wrong in part because it assumes that the state enterprises and the huge amounts of capital that were invested in them are necessarily commercially valuable. Obviously, some state enterprises, and especially those that control a lot of natural resources, are worth a lot. Yet we know from experience in market economies that firms often need to be broken up, restructured, merged, or eliminated, and that capital invested a relatively small number of years ago is often not worth using because it is obsolete or unsuited to the changed conditions. In the formerly communist countries, many state enterprises were misconceived to begin with and capital investments in them were not guided by market forces. Indeed, as we have seen, in the last decade or two of communist rule, the pattern of investment was guided as much by the bureaucratic influence of the enterprises as it was by the encompassing interest of the center. Consequently, many of the large state enterprise in the societies in transition are worthless -- the debate about privatizing them is much ado about nothing worth having.

As vested interests or lobbies, the large state enterprises are politically powerful, even when they use up resources that have greater value than the outputs that they produce and are thereby a net drain on the society. Much of the debate about "privatization," then, should be transformed into -- or frankly recognized to be a debate about -- "liquidation."

The all-important question is how, by developing social safety nets and generous severance payments, the workers in these firms can be protected and given employment in productive new firms. The most difficult task, given the lobbying power of the big enterprises, is to avoid protecting or subsidizing firms that waste society's resources -- to redirect society's compassion toward individuals rather than enterprises.

Debate about who should own an enterprise that is to be privatized is also inherently divisive and protracted. Political divisions and delays are harmful even when, because the enterprise in the end proves not worth having, they were pointless.

By contrast, everyone can gain from the development of the property and contract enforcement rights and other institutions that the private sector needs. Everyone can also gain by denying protection or subsidization to "needy" enterprises that use up resources that are worth more than the products they produce and helping needy individuals instead. If the societies in transition from communism can avoid dissipating their resources on enterprises that are a net drain on the society, and if they can also make certain individual rights to property and to contract enforcement are clear and secure, then they will soon enjoy incomparably higher standards of living than they have ever experienced before.

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