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# THE TRANSFORMATION OF SOCIALIST ECONOMIES: ALTERNATIVE APPROACHES AND EARLY LESSONS OF EXPERIENCE

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# THE TRANSFORMATION OF SOCIALIST ECONOMIES: ALTERNATIVE APPROACHES AND EARLY LESSONS OF EXPERIENCE

Abstract:
The paper describes three approaches to the strategy of the transition from socialism to a market economy: the rapid privatization strategy, the evolutionary school, and the government planning approach. These approaches rely on different underlying assumptions about the nature of the formerly socialist societies and the tasks confronting them in making the transition to a market economy, and the paper draws out these different assumptions. A number of policy issues are discussed in light of these three approaches, such as the speed of price liberalization and currency convertibility, the pace of privatization of large state enterprises, and the role of property rights and legal infrastructure reform. The consensus view of Western advisers as of about 1991 is confronted with the events of the first few years of transition experiences.

Keywords:
transition, privatization, evolutionary approach, hard budget constraint, price liberalization, currency convertibility, property rights, division of labor, sequencing.

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Short title: THE TRANSFORMATION OF SOCIALIST ECONOMIES

# THE TRANSFORMATION OF SOCIALIST ECONOMIES: ALTERNATIVE APPROACHES AND EARLY LESSONS OF EXPERIENCE

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## I. Introduction

The economic problems of the transition from communism to a market economy constitute a new area of analysis and commentary for Western observers. The dramatic events of 1989 and subsequent years, during which many countries have renounced central planning as a principle of economic organization and have proclaimed their desire to move to a market economy and a democratic polity, have pushed these policy issues of the transition into a central position among the unsolved economic problems of the day.

The disappointing experiences of the societies attempting this transformation have contributed to intense criticism of the strategies favored by the International Monetary Fund, the World Bank, and the majority of Western observers and advisers. In particular, as the title of this symposium suggests, there has been criticism of "shock therapy" and the strategy of the "big bang". These terms have been used in a variety of senses, and it will be important to distinguish them in the discussion that follows. It will be contended here that some of this criticism has been well taken, while other parts of it have been wide of the mark.[1]

Certain propositions, listed below, have attracted wide agreement among economist observers who have addressed the issues of the transition. Others are the subject of intense debate among the experts. Most of these propositions are based not on observation of the actual events of the transition but on considerations from economic theory and the historical experiences of other countries. However, as experiences of countries abandoning communism and central planning accumulate, it is highly instructive to compare these propositions with the emerging record of events. Subject to the limitations of the expertise of the present author, this paper attempts to make these comparisons and to draw appropriate lessons of experience.

What are some of the propositions emerging from the burst of literature on this new set of problems?

1. The tasks of the transition.

Communist economic organization was not efficient, but it did constitute a system, that is, a set of interrelated parts. A market economy is an even more complex system, and it has the characteristic that it does not function well unless all of its basic features are in place. Creating a functioning market economy out of either a functioning communist one or the remains of collapsing communism requires a very major set of tasks to be accomplished. A generally agreed upon list of these tasks is as follows. First, there is an urgent need for new rules and laws, courts to enforce them, and lawyers and judges who understand them. Laws and rules are needed for commercial transactions, contracts of all kinds, labor-management relations, health and environmental protection, accounting standards for purposes of taxation and investor protection, bank regulation, property ownership, landlord and tenant rights, and so on. Second, there are important public management tasks: (a) price restructuring and liberalization, and anti-monopoly policy, (b) maintaining macroeconomic balance, including managing the budget and the supply of credit, (c) implementing a new taxation system that will collect taxes from the private sector, and (d) setting up a safety net, with targeted assistance replacing subsidies on commodities and to enterprises. Third, there are tasks related to privatization: (a) small privatization, or the sale of retail shops, trucks and buses, restaurants, repair shops, and the like, (b) large privatization, or the privatization of the large enterprises that dominate the economy, (c) privatization of dwellings and land, and (d) financial reorganization, or the cleaning up of the balance sheets of enterprises and state banks so that both the banks and the enterprises can be privatized. One point to note about this list of tasks is that large privatization is only one of many that need to be performed; in many early discussions of the transition, the task of large privatization attracted most of the attention, perhaps partly because it is intellectually the most challenging of the issues for economists. However, it was rather quickly recognized that the transformation process involves much more than the privatization of the large enterprises that dominate these economies.

The transformation of formerly communist societies involves not just these changes in economic institutions but also a new set of political institutions. In most of these countries there is a strong popular aspiration for the type of democratic government found in the West, but the institutions of a functioning democracy do not immediately spring into place. Some steps can be taken very quickly; governments can remove restrictions on free speech and free press and they can hold free elections. They can also pass laws proclaiming individual rights. But setting in place the political institutions (such as court systems, autonomous local governments, and effective political parties) that deliver the benefits of democracy is another major task. This task is not part of the focus of the present paper, but it must be kept in mind in evaluating the performance of the societies in transition to a market economy and democratic polity.

2. Sequencing is a legitimate issue for debate.

Given that a market economy does not function well unless all of its basic features are in place, an initial reaction of many observers was that the transition governments must do everything at once. An argument that was frequently made was of the following form. A market economy cannot function effectively without x, and therefore x should be put in place as soon as possible. An interesting feature of these comments was that x often lay in the area of expertise of the commentator. Thus tax specialists insisted on the immediate conversion of the revenue collection mechanisms, labor economists wanted to free up wages so that the labor market could function, banking people wanted to privatize the banks immediately, trade economists wanted to set up payments unions, and many observers wanted to privatize the large enterprises without delay. The logical error of this type of argument became apparent very quickly. The government cannot do everything at once, partly because of political and administrative limits on decision-making capacity and partly because some of the tasks themselves are inevitably time-consuming. Consequently governments face the necessity to make choices regarding the order in which various tasks are attempted and the degree of priority to be attached to each.

Some people have taken the position that all sequencing debates are nonsense, because events are so unpredictable that no planning is possible. This is not a defensible position. There are clear choices that have to be made regarding the order in which policy initiatives are launched. Some have argued that privatization should precede stabilization and that demonopolization should precede price liberalization. There is debate about when labor markets should be liberalized and when firms should be free to set employee compensation without central government regulation. When should the currency be made convertible, for the current account and for the capital account? The statement that sequencing is a legitimate issue does not imply that policy makers can make accurate forecasts of future events or that precise schedules of policy steps can be drawn up and followed. It just means that the order in which certain policy steps are best taken is a legitimate area for debate and that there are much better and much worse sequences of policy steps.

3. Declines in output are inevitable.

One of the features of the collapse of communism in Europe and the former Soviet Union has been the decentralization of political authority. An important consequence has been that a very elaborate division of labor and exchange of goods, which was managed by coercive organizations based in Moscow, lost its institutional support. In the absence of an institutional basis for market exchange, trade has been severely disrupted. This disruption has presented the countries of Central and Eastern Europe and the republics of the former Soviet Union with a classical problem of cooperation. While all would be better off if they cooperated to preserve on a temporary basis the previous patterns of exchange, the individual actors, given the behavior of the others, find it in their interest to seek new markets and sources of inputs (Panagariya [34, 1993]). Under these conditions output declines throughout the former communist trading blcc were inevitable. Moreover, these declines have been aggravated by the counterproductive monetary and pricing policies of the Soviet Union and Russia, whose output declines have affected the other countries in the region. Note that output declines have been severe even in the slowly reforming (or nonreforming) economies such as Ukraine and Belarus.

Of course even apart from the disruption of trade, the transition from communism to a market economy seems impossible to manage without substantial declines in output (Winiecki [44, 1991]). There need to be major changes in institutional arrangements, as described in the tasks of the transition listed above, as well as large changes in the composition of output, such as the contraction of the military and heavy industry sector and the expansion of services. When property rights are secure, contract enforcement mechanisms are in place, and governments routinely provide physical infrastructure and other public goods, as in functioning market economies, massive redirection of production can take place with little loss of aggregate output (as in wartime and postwar conversions). But when the need for massive structural change arises in conditions where these institutions are embryonic, substantial output declines combined with substantial idleness of resources are hardly surprising.

The above propositions are intended to be noncontroversial among people who understand economics and have thought about the problem of the transition. But among well informed and thoughtful observers there are many areas of profound disagreement. To a very large extent, these differences reflect fundamental differences in assumptions about the nature of the societies attempting transformation and the characteristics of the transformation that is required. The views put forward in much of the literature are, as mentioned above, based largely on theoretical considerations and the historical experiences of countries other than the ones undergoing transformation. It would seem to be very useful to look at the record of events to illuminate which of the assumptions and insights of these schools have been validated or contradicted by the emerging experience of transition economies. Given the limited experience available, this has to be a very preliminary assessment.

The next section outlines three different approaches to the transition. Section III discusses selected policy issues in more detail, and describes some areas of consensus and areas of disagreement as of about 1991, a date by which many observers had presented their views but by which there was very little transition experience on which to draw. Section IV then considers what the recent experiences indicate for the validity of the assumptions and claims of the different approaches.

## II. Approaches to the Transition[2]

The three approaches to the strategy of the transition outlined in this section do not exhaust the alternatives, but they cover a wide range of opinion among economists. Underlying each strategy is a set of assumptions about the nature of the problems of the transition. Each strategy makes sense, given the assumptions underlying it. The task of the present section is to describe these assumptions.

These three approaches will be called the rapid privatization strategy, the evolutionary approach, and the government planning approach. Very briefly, the rapid privatization strategy favors getting most of society's assets into private hands as quickly as is feasible, via mass privatization schemes, and letting the market take care of the restructuring of enterprises. The evolutionary approach is skeptical that mass privatization schemes will work as intended and relies much more on the emergence of new enterprises to expand the private sector. Finally the government planning approach emphasizes the inability of markets to bring about the desired changes in the near term and recommends that government agencies play a major role in restructuring the economy.

The government planning approach was not one that attracted very many adherents early on in the debate about the transition. There was great distrust of the old communist bureaucracies, with respect to both their competence and their willingness to carry out the necessary steps to make the transition successful. Some commentators put the question very starkly: If we believe the communist bureaucracy could reform the economy, why should communism be replaced? This question is surely inappropriate, because the political situation has changed dramatically. People now have a new vision of how society should be organized and it is not inconceivable that governments, under new direction, should be able to take productive steps. The real issue is how much reliance should be placed on the government to restructure enterprises before they are privatized. This issue has increased in salience as privatization has turned out to be much slower than many observers had expected. Thus the notion that the government should play an active role in restructuring and investment decisions has attracted more adherents as the other approaches have encountered difficulties[3]. We shall return to this issue following a more detailed discussion of the other two approaches.

The case for rapid privatization of the large enterprises can be explained as follows[4]. These enterprises contain the bulk of the assets and the labor force of the economy. The resources are being used inefficiently and will continue to be so used until they are put into the hands of genuine owners. Commercializing these enterprises and forcing them to operate according to market principles is only the first step. In the absence of an effective representative of capital, the enterprises will distribute available resources to the employees, neglecting investment, or if prevented by wage controls from that course, they may undertake investment projects with low social returns. Experience in Yugoslavia and Hungary has shown, it is argued, that "market socialism", in which publicly owned or self-managed enterprises deal with one another through market mechanisms, is not compatible with efficient resource allocation, entrepreneurial innovation, and hard budget constraints. If, on the other hand, an enterprise has private owners, these owners will put pressure on management to cut costs, reorganize, downsize, and do whatever is necessary to make the enterprise profitable. If management efforts fail to accomplish that goal, the enterprise will go under and release its resources through a process of liquidation.

It can be argued that enterprise performance will deteriorate while it remains publicly owned and the central planning agency relaxes its control over the firm's decisions. The managers are then even more free to make personally profitable deals with managers in other enterprises, at the expense of the firm's profits and the public treasury. The state-owned enterprises (SOEs) are also free to indulge their preference for dealing with other state-owned enterprises rather than with the new private sector, and thus the new private firms have a hard time breaking into the market. Deals will also be made with private firms run by insiders, at the cost of the SOE's profits and asset position. These practices can only be stopped, it is argued, when private owners, who have something to lose by them, can replace management.

Given the need for rapid privatization, a chain of argument leads more or less inexorably to mass privatization schemes with vouchers and financial intermediaries. It should be noted that the proponents of rapid privatization by no means ignore the other tasks of the transition that were sketched above. But they argue that all these changes should be done quickly, so that the market economy can be made operational as soon as possible.

The proponents of the evolutionary approach[5] claim that a society cannot suddenly change from one economic system to another by the "artificial", or "constructivist" creation by the state of private owners. They are skeptical of mass privatization schemes that appear to set up organizations and institutions that exist in Western countries; such organizations and institutions will not, they argue, function in the intended manner. The institutions of capitalism and the business organizations that exist in the West emerged in an evolutionary process; the emergence of market economies from socialism will have to follow some sort of an evolutionary process as well.

Murrell starts from some basic assumptions about the nature of organizations and societies. Uncertainty is pervasive and information is very costly. Organizations consequently develop routines and codes which narrow the range of choices that individuals face and which make their behavior more predictable to others. Organizations that were created and that functioned in the environment of central planning will have routines that are non-functional in the environment of a market economy. Thus one should not expect the SOEs, or any large organization, to exhibit much adaptability in the face of radical changes in the environment.

Under classical central planning there were many external constraints on the way enterprises could use their resources; relaxation of these constraints under reform socialism created the soft budget constraint, as described by Kornai and McKinnon. In this regime the firm was still engaged in negotiations with the central authorities over how it used its resources. Under capitalism of course, firms are normally quite free in their decisions about how to use their labor and capital resources, but they face a hard budget constraint. Forcing an organization to shift from a regime of tight external controls or a regime of loose controls and a soft budget constraint to one of freedom of action but with a hard budget constraint requires an enormous change in the internal functioning of the enterprise.

As a terminological matter, it is very important to distinguish the notion of "hard budget constraint" from "effective control over expenditures". The former concept implies that the enterprise has freedom of action with respect to the total amount and composition of its expenditures, but it faces the certainty that there will be a reckoning with owners or lenders. "Effective control over expenditures" can be brought about either through a hard budget constraint or through direct controls that deprive the enterprise of freedom of action. Both the rapid privatizers and the evolutionary school strongly favor effective control over expenditure, but the evolutionists stress that creating the rules that enforce hard budget constraints is a difficult process.

There is widespread agreement among commentators on the transition that macroeconomic balance is essential. It is hard to see how a market economy can begin to function in an environment of rampant inflation. Thus control over the budget is absolutely critical, and one of the legacies of reform socialism is a budget deficit brought about by the decline in the flow of profits taxation from the enterprises to the treasury (McKinnon [26, 1992])[6]. Where the evolutionary school differs from the rapid privatizers is not in the importance of achieving budgetary control but in the means for doing so. The rapid privatization school focuses on the end state of the market economy, and says, "Let there be hard budget constraints". The evolutionary school doubts that such pronouncements will be effective and suggests retaining some of the old methods of control over SOEs during an interim period. In particular, SOEs would not be permitted to undertake investment projects or raise employee remuneration without authorization from the central government. (See McKinnon's [26, 1992], p.119, classification of enterprises with respect to the degree of freedom they would enjoy from government supervision.)

Neither the evolutionary school nor the rapid privatizers assign much responsibility to the government in carrying out the restructuring of enterprises. The latter would leave the task to the market, while the former tends to regard the old SOEs as doomed and not worth saving. The approach referred to above as the government planning approach considers them not to be hopeless wrecks and it considers the government to be capable of carrying out this task. As mentioned above, this point of view is looking more reasonable to many observers as privatization stalls and the enterprises flounder. In the next section we turn to a discussion of some particular policy issues in the light of the general approaches that have been described.

## III. Some Policy Issues: Areas of Consensus and of Disagreement in 1991

Let us start by considering transition policies in a country which has control over its currency and which is not suffering from extreme macro-economic imbalance. It is generally agreed that the transition will be much more difficult in a situation of monetary chaos and impending hyperinflation and that if possible such a situation should be avoided. What to do under these conditions is of course a serious policy question, but it will not be the focus of the discussion in this section.

There quickly emerged a consensus view among many (although not all) economists on the elements of a sensible package of transition policies. I will sketch the consensus view as it emerged (say in 1991) before there was very much actual experience of the economies in transition. First, an early step should be price liberalization and current account currency convertibility[7]. The views on this point were probably influenced by the relatively favorable experience on this point in Poland in 1990. Practically overnight shortages disappeared, markets cleared, and exports to the West expanded rapidly while those to the Soviet bloc began a precipitous decline as a result of forces that the Polish authorities could not control.

Because not all observers are in agreement on the desirability of this step, I will briefly review the arguments for it[8]. For those of the rapid privatization persuasion, there is no need to spell out the arguments, since to them the case for it is self-evident. But the interesting point is that, to my mind, even for those of the evolutionary school, there is no economic reason not to proceed with this step, and many reasons to do so. Whether one is concerned to provide an opening for new enterprises or to facilitate the transformation of the old state enterprises or to promote privatization, prices need to reflect scarcity values and markets need to clear. Under the evolutionary approach one may favor continuation of the old relationships among firms, but it is highly desirable that these be conducted at realistic prices, so that firms can begin to calculate their profitability in the new environment. Note that price liberalization does not imply the immediate attempt to replace direct expenditure controls by hard budget constraints. But it is a necessary step for many subsequent steps in a sensible transition.

There is a common view, especially among Russian economists, that price liberalization should be delayed until enterprises are privatized and monopolies are broken up. In my view, and that of most Western observers, this is misguided. Evaluation of the enterprises, which is difficult in any case, is virtually impossible when prices of inputs, outputs, and factors are badly out of line with scarcity values. Mass privatization under these circumstances would involve giving to the population pieces of paper (vouchers, company shares, or mutual fund shares) of very uncertain value at a time when the rules and institutions of a market economy are not yet in place. It is hard to see how such a scheme could provide effective corporate governance in the critical early stages of replacing central planning with market mechanisms.

Critics of price liberalization in Russia have argued that the price explosion that followed the January 1992 liberalization was aggravated by the monopoly power of the enterprises and that demonopolization should have preceded price liberalization. But sureiy the great bulk of the inflation was due to monetary factors rather than monopolistic pricing. To be sure, monopoly is a serious concern, and one that needs to be addressed by a government anti-monopoly agency, but the salient point in the present context is efficiency is likely to be less damaged .....

One of the arguments against immediate price liberalization has been that firms would exploit their monopoly power. This is a serious concern, and one that can be addressed by other policy measures, but the general point is that efficiency is likely to be less damaged by monopolistic pricing than by markets that do not clear. Harberger triangles resulting from monopoly pricing are likely to be generally small in relation to the efficiency losses that arise when, because markets are not allowed to allocate resources, firms cannot obtain inputs or services at any price. Another argument against price liberalization is that it adversely affects the income distribution; again, this is a serious consideration, but there are far more efficient ways of protecting the poor than price controls on consumer necessities. The appropriate step of course is to set up targeted assistance programs to those in need.

The second element in the consensus program is that steps need to be taken to prevent severe macroeconomic imbalance. These include cutting budgetary expenditures, implementing a new taxation system to keep revenues from falling too rapidly, and limiting credit expansions, especially to state enterprises. By 1991 it was already evident that there were strong pressures for fiscal deficits and excessive credit expansions in most of the formerly socialist economies. While there was consensus on the need for macroeconomic balance, there was a considerable range of opinion (in particular between the rapid privatizers and the evolutionary school) on exactly how to bring that about.

Third, there was no disagreement on the need for new laws and regulations and institutions and organization to implement them, although some observers placed more emphasis on these changes than others. There was also agreement that small privatization could and should be rapid and should not be held up by restitution claims. (A prevailing opinion among economists was that these claims should be handled by monetary compensation rather than physical restitution, but there was also dissent from this view.) There was little dissent to the argument that consumer subsidies and subsidies to enterprises should be replaced by targeted assistance programs based on income and employment status.

While there were areas of broad consensus, there were also many questions on which there were strong disagreements and a wide range of opinions. The first of course is the speed and the mechanisms of privatization of the large state enterprises. This issue interacts with policies toward direct foreign investment, so there was disagreement on that issue as well, despite the general consensus that such investment could be highly beneficial under the right circumstances. These issues are also related to the problem of restructuring the banking system and the difficult issue of inter-enterprise credit. All of these issues involve the underlying debate among different approaches. The rapid privatizers want to get on with it as quickly as possible. A critique by the evolutionary school might be explained as follows. Let us think about the process of change from the point of view of the government leadership. There are a number of key actors whose behavior will determine the outcome. Among these key actors are the managers of SOEs, the newly appointed Boards of Directors of enterprises, lower-level officials in the national ministries, local government officials, and actual and potential entrepreneurs. How can the government leadership set in motion forces that will lead to convergence toward market economy institutions?

It should be recognized that there is enormous uncertainty about the future course of events. The world is normally full of uncertainty, and that is one reason why most people do not normally contemplate radical changes in their daily lives. They continue to follow past patterns of behavior with marginal adjustments as long as that is a feasible option. It is hardly surprising that many national and local officials are continuing in past patterns, with moderate adjustments to the new situation. There are working relationships between supplier and user enterprises, between enterprise managers and bank officials, and between local government officials and enterprise officials. Some of these relationships facilitate productive activities, while others are undoubtedly privately profitable but socially unproductive.

The evolutionary point of view argues that the best strategy for change is to proceed incrementally. Since a great deal of past patterns of behavior will necessarily continue for some time, the top leadership should attempt to contain the most harmful aspects of this behavior, while opening avenues for new types of activity. Clearly there is much variation in the willingness to innovate, in the population at large and among the key decision makers in the public and private sectors that were mentioned above. By opening avenues for innovators in the public and private sectors to explore, the leadership can enable change to occur and can arrange for successful innovators to be rewarded. Successful innovators will be emulated; given the pervasive uncertainty of the world, people rationally are strongly influenced by examples of those they consider to be their peers. Thus a small number of successful innovators can lead to waves of followers.

The key decision makers will be watching the evolution of events, and will be deciding whether and in what direction to change their patterns of behavior. They will be more impressed by their observations of actual behavior of others than by government pronouncements. In particular, dramatic government pronouncements that are not followed by corresponding changes in behavior will weaken the effects of future pronouncements. On the other hand, a government that proceeds with credible, incremental changes can bring about substantial cumulative changes over time. Observers will be responding to the second derivative as well as the first. Therefore an evolutionary approach does not necessarily imply a lengthy transition, only one that proceeds incrementally.

What do these considerations suggest about the case for rapid privatization? Several arguments can be advanced to support the proposition that the key to a successful transition does not lie in the rapid privatization of the large state enterprises. First, the physical assets were constructed under the old system and they are simply not worth much with the new set of world prices and new quality standards associated with Western markets. Being cut off from Western technology and sheltered from international competition, large sectors of the economy are using obsolete equipment and production processes (Pohl [35, 1991]). Some of the factories have been estimated to generate negative value added; that is, they use inputs whose value at world prices are worth more than they output they generate. Second, the assets come with labor force attached, if enterprises are privatized. Imagine a Western company contemplating taking over an existing organization and trying to modernize it, or adopting the green field approach, and building a new factory next to the old one, and hiring selectively. It seems plausible that the green field approach would frequently be preferable, in light of the characteristics of organizations described above. Thus even if the physical assets would be worth something, as organizations they are not worth much. Third, even if as organizations they are valuable, dividing them up is going to be a divisive process that will inevitably take time. Moreover, if the process is done rapidly, it will be messy, and some people will make fortunes while others will be left with neither jobs nor assets. This outcome could create a backlash against the market system.

If large scale privatization will not be rapid or will not work well, then what is best strategy for a successful transition? Under the right conditions, the new private sector, or the new companies that emerge, may provide the main driving force of the economy. For such companies to emerge and prosper in a socially productive way, the other tasks listed above must be accomplished. These require budgetary control, new taxation systems, cutbacks in government subsidies, while the safety net targets assistance to those in need. Letting the prices be set in markets seems to be essential, or the prices will not reflect scarcity values and the wrong incentives will be given. And there need to be clear property rights and mechanisms of contract enforcement.

With respect to the role of government agencies in the transition process, both the rapid privatizers and the evolutionists tend to be skeptical of the ability of the bureaucracies to make good decisions about the restructuring of enterprises. The rapid privatizers would leave these decisions to the market following privatization, while the evolutionists (particularly Murrell) would try to wind down the old enterprises slowly, so that they can release resources to the nascent private sector, without expecting too much in the way of improved efficiency of these firms. Another stance would be that these enterprises are not hopeless wrecks and that they could be salvaged through restructuring, but the market failures in these economies are so great that this restructuring needs to be carried out by the government during the perhaps lengthy period before the firms are privatized. This is the view that I have called the government planning approach.

What is the case for relying on the government rather than the market to restructure enterprises? There are a number of arguments. First, purely from an efficiency point of view, Tirole [40, 1992] makes the argument that in the early phases of the transition, before capital, labor, product, and managerial markets function very well, it is most efficient to subject managers to low-powered rather than high-powered incentives. To my mind, the political economy considerations are even more compelling. The efficient restructuring of some of the large, old enterprises will involve laying off thousands of workers. A danger in rapid privatization is that when the new owners of the enterprise attempt to exercise their property rights to make the company more profitable, there will be resistance in the forms of strikes, sabotage, violence, and lobbying efforts to persuade the government to limit the property rights of the new owners. It would seem that the political acceptability of mass layoffs would be greater in an environment in which the person or persons deciding to fire large numbers of workers was not being enriched in the process.

A different argument for governmental restructuring prior to privatization is based on the need to limit monopoly power. To my mind there is an extremely persuasive case for the breakup of multi-unit enterprises prior to their being privatized through sale or mass privatization. This case has been well articulated by Newbery [31, 1991] and Newbery and Kattuman [33, 1992].

We have discussed the 1991 consensus and some of the areas of disagreement. The next section discusses what light the country experiences have thrown on the consensus view and the debates.

IV. Lessons of Experience

With regard to many of the critical issues under debate, it is too early to tell which of the points of view will be treated kindly and which unkindly by events. Still, it is interesting to look at the first few years of the transition to see what lessons can be drawn for the validity of the assumptions of the different approaches.

1. Despite widespread fears beforehand that convertibility would not work at an early stage of the transition (see, for example, the statements by Levcik and Nuti in Williamson [41, 1991]), price liberalization and currency convertibility have worked quite well in the three leading countries of Poland, Hungary, and Czechoslovakia (Berg and Sachs [2, 1992], Dervis and Condon [9, 1992], Dyba and Svejnar [11, 1992], Aghelvi et al. [1, 1992]). Shortages have disappeared and the populations have clearly benefitted from the increased variety of goods available and the disappearance of queues. Moreover, the high prices of foreign exchange seem to have facilitated the remarkable expansion of exports to Western Europe (Rodrik [37, 1992]). Most of these exports have come from state-owned enterprises, perhaps to the surprise of those who thought that these firms were unable to make adjustments (Webster [43, 1992], p. 70).

To my mind, the fact that Hungary did not liberalize at one stroke in no way undermines the case for doing so in other economies. Hungary had undergone considerable price restructuring and liberalization in the 1980s under communism and by 1990 had a price structure not far removed from market-clearing prices (Hare and Revesz [18, 1992]).

2. Privatization of the large state enterprises has turned out to be more difficult than many observers thought. In every country the government's announced program of privatization has

lagged far behind schedule. An interest-group theory of politics provides a ready explanation for the resistance to privatization and for the delays in the process. (For recent information see RFE/RL Research Report [36, 1992], and Frydman, Rapaczynski, and Earle [16, 1993]).

The economists' consensus program for the transition called for the government to re-establish its ownership rights over the large enterprises (Hinds [19, 1990]) as it commercialized them; in the period of decentralization under communism, the authority of the center receded and that of the managers and workers in the enterprises increased. The idea that the state could simply take back the implicit property rights that employees had acquired has turned out to be quite wrong. The attempt to transfer ownership rights to new owners through mass privatization has led to political stalemate in Poland and Slovenia, as described in Ellerman [13, 1993]. Ironically, where the communist regime did not permit decentralizing reforms, as in Czechoslovakia, there has been less resistance to mass privatization.

The initial approach of many Western advisers and donors was privatization of the large enterprises through stock market sales. Part of the support for sales came from the hope or expectation that the proceeds would generate substantial revenues for the state budget. However, the valuation process has turned out to be much more difficult than anticipated and substantial revenues from sales to domestic residents have not materialized in any of the countries. The types of privatization that have turned out to be most successful in Hungary and Poland are ones that rely on the initiative coming from within the enterprises, such as management-worker buyouts, the so-called "privatization by liquidation" in Poland (Economist [12, 1993]), and the spontaneous privatizations in Hungary.

The jury is still out on the eventual results of the voucher privatizations in the Czech

Republic, Russia, Mongolia, Lithuania, Latvia, and other countries. One clearly has to make a distinction between de jure privatization (or the distribution of titles or shares) and de facto control over the assets by the new owners. Still, the fact that the first wave of the Czech privatization has been successfully carried out should probably come as something of a surprise to those observers who have not been surprised by the difficulties encountered elsewhere. Obviously, societies differ greatly in their administrative capacities, in their overall rule obedience (Clague [7, 1993]), and their willingness to accept market outcomes, and consequently particular schemes can succeed in some societies and not in others. (I would predict that the Czech voucher privatization will probably come to be seen as successful, but the Czech Republic is doing many things right in its transition and it is a very rule obedient society. I seriously doubt that the distribution of shares in enterprises under conditions of monetary chaos and breakdown of payments mechanisms, as in Mongolia and Russia, will lead to effective corporate control, or indeed will come to be seen as having been a productive step. A key question will be whether the owners are actually able to exercise their rights. A market economy needs secure property rights, but these require not merely pronouncements by the government but also acquiescence in the exercise of these rights by the population.)

3. In all three of the leading countries, the rapid growth of the private sector has come through small privatization and the creation of new enterprises, rather than the transformation of the prior system's large organizations. In Poland this process has been particularly dramatic in retail, wholesale, and foreign trade, in construction, and in restaurants, and it is beginning to beginning to occur in manufacturing (Economist [12, 1993]). (Agriculture remained largely private in Poland under the Communists.) Thus the record indicates that the speed of privatization of the

economy is not gauged by the speed of privatization of the large state enterprises. It seems clear that the explosion of entrepreneurial activity in these countries has been greatly facilitated by the sensible macroeconomic policies that have been followed and by the rapid enactment of laws pertaining to company organization and property rights (Gray, et al. [17, 1991]).

One of the worrisome areas in all three economies is the banking system. The new banks that have been created out of the old banking system carry on their books enterprises debts of very uncertain value. The authorities need to be concerned about the danger of a banking system collapse at some point in the future (Durski and Eastwood [10, 1992]). The difficult problems of this sector need not, however, have delayed the enactment of collateral, bankruptcy, and real property law.

4. A number of observers have suggested that Hungary is likely to have a more successful transition than other countries because of its long experience with markets under communism (Dervis and Condon [9, 1992], Hare and Revesz [18, 1992]). The contrast with Czechoslovakia is particularly interesting, because that country had very little experience with reform communism and hence very little recent experience with markets. The transition experiences of these two countries is very likely to provide interesting evidence on the speed with which institutions can change, but it is too early to make definitive statements. I think some observers ought to be surprised that Hungary has not already emerged with the clearly better record of performance than Czechoslovakia during the transition, but the data (which are admittedly very incomplete in coverage of the private sector) indicate that the two countries have had similar declines in output and export expansions, and Hungary's inflation rate remains higher than that of the Czech Republic.

The contrast between the two countries also illustrates a dilemma of privatization. If a country avoids mass privatization schemes, as Hungary has proclaimed its intention to do, then foreigners would seem to have an advantage over domestic residents in buying up the assets being privatized, simply because domestic residents don't have much wealth and want to diversify their portfolios with hard currency assets. In principle, the danger that foreigners could buy up the national assets at rock-bottom prices would be avoided if shares in these assets were distributed to citizens, who could then resell them to whoever wanted to buy them. If the potential value of these assets (such as prime location land or access to raw materials) to foreign companies were public knowledge, citizens would be able to sell them for something within striking distance of the potential value of these assets in the hands of efficient foreign companies (Froot [15, 1992]). However, this solution requires the implementation of a mass privatization scheme, in which assets are given away. (Note that Kornai [22, 1991], while rejecting most mass privatization schemes, has endorsed the idea of giving shares in companies to pension funds and charitable organizations. There are plans in Hungary to give some state assets to the Social Security Fund (Frydman et al. [16, 1993] p. 137).

5. Since the failure of the August 1991 putsch there have been many dramatic events in the former Soviet Union. One of the events which was not hard to predict was the severe dislocation of inter-republican trade[9] as the authority of the central government broke down. What lessons can be drawn from this experience? First, I think it is clear that cooperation among the republics on trade and payments will not be forthcoming in conditions of rampant inflation and continuing price controls. The incentives of individual republics to curtail the export of underpriced goods in return for rapidly depreciating currency, which may not be redeemable, is overwhelming

(Panagariya [34, 1993]). The elaborate division of labor in the Soviet bloc was based on coercion, and when that disappeared and was not replaced by realistic prices and a functioning payments mechanism, the exchange of goods broke down. It is not clear under what conditions cooperation will emerge, but it certainly will not under the conditions mentioned. I think that one implication of this experience is that programs for economic reforms in individual republics should be constructed in such a way that their success is not conditioned on the cooperation of other republics. There is a tendency for an international organization to want to promote inter-republican cooperation in trade and payments[10], and such cooperation would undoubtedly be highly productive if it were to happen, but both the logic of game theory and the available experience indicate that countries will not go very far in sacrificing their perceived immediate interest for the sake of inter-republican cooperation in these conditions of dramatic change.[11]

Is the transition going well or badly? It depends on one's point of reference. Following the collapse of the Spanish Empire in the New World, it took the countries of Latin America many decades to recover their former levels of per capita production. There was an elaborate division of labor not based primarily on market mechanisms and with its collapse it took a long time for new institutions supporting exchange to emerge.

I am fairly optimistic about the leading countries of Hungary, Poland, and the Czech Republic, and also about Slovenia and the Baltic Republics. It seems to me that these countries have the advantage of a decisive rejection of communism (even in Lithuania), so that they are not contending with a powerful ruling group or interest group that rejects the principle of a market economy. They also have the advantage of geographical proximity to Western economies; this location facilitates the development of trade with the West, but more importantly it has provided these countries with cultural influences and role models that make the convergence of individual behaviors on the institutions of market-based democracies relatively easy[12]. Countries that are farther away from Western Europe generally tend to have a less passionate desire to become part of the European Community and the existing European institutions are less compelling examples for them to emulate.

END NOTES

1. As will be explained in more detail below, these terms are sometimes used to refer to a strategy in which the transition is accomplished as rapidly as possible in all its aspects, while in other usages they refer to much more narrowly defined policy steps, such as the dramatic correction of a budget deficit or the simultaneous liberalization of most prices.

2. This section draws in part on Clague [6, 1992], which provides further elaboration of some of the arguments presented here.

3. For examples of the emergence of the view that governments should play an active role in restructuring enterprises, see the comments by Peter Isard and Susan Woodward in IMF Survey, January 11, 1993. For earlier statements that restructuring should be left to the market, see Blanchard et al. ([3, 1991] p.32) and the references in the next footnote.

4. For elaboration of these arguments see, for example, Hinds [19, 1990], Lipton and Sachs [24, 1990], Borensztein and Kumar [4, 1991], Fischer [14, 1992], and Sachs [38, 1992].

5. See Kornai [21, 1990; 22, 1991; 23, 1992], McKinnon [25, 1991; 26, 1992], and Murrell [27, 1991; 28, 1992; 29, 1992; 30, 1992].

6. For some recent figures confirming this tendency see Tanzi [39, 1993].

7.The statement that there was a consensus on price liberalization and currency convertibility by 1991 is subject to severe qualification and is made here partly for reasons of organizational convenience. See the discussion of this issue in the next section on the lessons of experience. The consensus refers to mainstream economists and does not include many social scientists with unorthodox views on the operation of a market economy. It also fails to include some prominent economists such as McKinnon and Murrell. Still, as argued in Section IV below, experience has tended to vindicate this step and hence I don't place this issue among the central bones of contention in the debate today.

8. For additional considerations see the discussion of "marketization" in Clague ([5, 1992] p.9-10) and McKinnon ([26, 1992] p.120).

9. In October 1991 I wrote "These problems [of the transition]...may be much more salient in the economies emerging out of the Soviet Union (if, as seems likely to the present author, the authority of the center collapses, the ruble succumbs to severe inflation, and trade among the republics suffers from drastic dislocation as local authorities make decisions independently of the center)" (Clague [5, 1992] p. 21).

10. John Williamson ([42, 1992] p.34) points out that the IMF was still pushing for a ruble area in April 1992, by which time that option had become a hopeless dream.

11. As republics move toward market pricing at world prices and develop their own convertible currencies, cooperation in trade will not require much if any sacrifice of republican self interest. It seems clear that not all republics are likely to do this in the near future, but still it seems to be in the interest of individual republics to do so, and international technical assistance and capital resources could usefully be provided to those that attempt this transition.

12. I am not referring to entrepreneurial inclinations. I don't see any new evidence from the transition experiences to indicate that lack of supply of entrepreneurial talent is a serious obstacle to the emergence of a market economy in any of the formerly socialist societies. Wherever spot markets have been permitted they have appeared, and very rapidly.

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