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PROMOTING DEMOCRACY AND FREE MARKETS IN EASTERN EUROPE

Edited by Charles Wolf, Jr.

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Promoting Democracy and Free Markets in Eastern Europe

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A Sequoia Seminar

Edited by
Charles Wolf, Jr.

ICS PRESS
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Promoting Democracy and Free Markets in Eastern Europe

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Preface

When ICS Press undertook to publish the Sequoia Seminar Publications series, of which this volume is the sixth, it did so out of enthusiasm for the series' theme, "Including the Excluded: Extending the Benefits of Development." Eastern Europe, the subject of this book, is in some ways more developed than much of the world, but was until recently excluded from the benefits of political and economic freedom. This volume is of vital importance because it addresses questions of how the United States and Americans can promote the efforts of East Europeans to liberate themselves from economic and political overcentralization. It examines in detail a region that has inspired much hopeful rhetoric but not enough attention to programs that will advance, rather than hinder, its reintroduction to the bracing realities of freedom.

Some advocates of aid to Eastern Europe suggest the extension of a "new Marshall Plan." This volume examines what the Marshall Plan and other foreign assistance programs have actually entailed; how the needs of Eastern Europe today compare with those of prior recipients, including Western Europe after the Second World War;

and how practicable and efficacious a revived Marshall Plan would likely be. All too often, questions of how to effect the political and economic liberalization of the former Soviet bloc are treated as if they might have a single answer; the contributors to *Promoting Democracy and Free Markets in Eastern Europe* examine these issues separately, resulting in much fruitful discussion of whether the issues are complementary, and if not, which should take precedence. The volume also offers a chance to learn from the earliest results of U.S. government programs instituted after the Iron Curtain crumbled.

Charles Wolf, Jr., was co-editor of a 1990 ICS Press publication, *The Impoverished Superpower: Perestroika and the Soviet Military Burden*, which exposed the full extent to which the USSR's economy was devoted to the support of its gargantuan military complex. He has here gathered some of the most incisive and knowledgeable students of East European affairs and of the strengths and limitations of U.S. aid programs; he has edited their thoughts into a collection of lasting significance and immediate relevance. ICS, working in conjunction with Sequoia Institute, is pleased to have a hand in bringing this important volume to those for whom the future of Eastern Europe, and of political and economic liberalization, are subjects of much hope and concern.

Robert B. Hawkins, Jr.
President and CEO
Institute for Contemporary Studies

San Francisco, California
March 1992

Foreword

Do "free markets" precede, or follow, "democracy"? There are prominent advocates on each side of the argument regarding which of these is a necessary precondition for the other. In contrast, the contention that free markets and democracy emerge simultaneously is distinguished most by its lack of advocates.

Nevertheless, in 1989, in the face of this absence, as if defying all odds, the United States Congress enacted, and President Bush signed, the Support for East European Democracy (SEED) Act, providing funds and instruments to "contribute to the development of democratic institutions and political pluralism" and simultaneously to "promote the development of a free-market system." And, as if that challenge were not enough, the countries identified as beneficiaries of this legislation had virtually no experience with, nor any of the ingredients of, market economies or democratic policies. In any other year, so presumptuous a commitment would have been deemed more foolhardy than daring.

The year in which the Berlin Wall came down, however, was no ordinary year. So rapid and fundamental were the changes throughout the communist and once-communist world that the otherwise risky became prudent. In such a year, the government of the United States committed itself to promote a possibility that had no historical precedent: the simultaneous emergence of self-sustaining free markets and democracies. It is to examining the chances of this initiative's success that this book's contributors have addressed themselves.

Accordingly, the pitfalls as well as the promises of promoting democracy and free markets in Eastern Europe are thoroughly explored in the pages of this volume. More important, it contains a wealth of suggestions for ameliorating and even transcending the problems encountered by people en route from a circumstance in which democracy and free markets have been effectively prohibited to one in which they can emerge, develop, and be sustained. At the same time, because each of the contributors to this book is as cognizant of the norms of history as of its exceptions, none expects a short or painless journey for Eastern Europe.

The dramatic events within the communist and once-communist world also account for this volume's being an exception among the several publications that have ensued from the series of seminars introduced in 1987 by Sequoia Institute with the sponsorship of the United States Agency for International Development (USAID). The expertise and focus of the agency, Sequoia Institute, and the Seminar series on "third world" development were uniquely challenged by the agency's new requirements resulting from the implosion of communist regimes in Eastern Europe and from the SEED Act that ensued. In response, the principal responsibilities assumed by Sequoia and myself in conducting and producing the seminars and publications of the series were consigned by Sequoia, for this particular volume, to another organization and individual. In this case, it was easy to entrust such authority to the RAND Corporation, and especially Charles Wolf, Jr., dean of the RAND Graduate School of Policy Studies, because of the high quality of their work.

Indeed, already an admirer of Wolf's treatment of free markets and democracy (and the "political economy of command oligarchic systems") in *Markets or Governments: Choosing between Imperfect Alternatives*, a RAND Corporation Research Study (Cambridge: MIT

Press, 1988), I could readily see in that work the essential elements of the platform desired for launching this inquiry into the prospects for Eastern Europe. My pleasure with the present book, then, is compounded by confirmed expectations.

These expectations are extremely consistent too with the policy endeavors over the past decade of USAID. The agency's support for these seminars represents a commitment to encourage the reexamination of established precepts and practices, pursuant to the formulation of more effective development policies. In accordance with this objective, the series strives to enlarge the supply of talent and ideas that is dedicated to development issues. A principal component of this effort, of course, is the publication and dissemination of each seminar's proceedings.

In addition to the support of the administrator of USAID, Ronald W. Roskens, and Assistant Administrator, Reginald J. Brown, the cooperation of numerous agency personnel has been instrumental to the success of the seminar series. Within the Bureau for Program and Policy Coordination, the USAID technical office most responsible for this endeavor, Clifford Lewis and Fred Kirschstein provided vital assistance in enabling the seminar represented by the present volume.

At the RAND Corporation, Charles Wolf's prodigious contributions were complemented by those of Burton M. Wachtel, Donna R. Betancourt, and Michael Rich. And, for their unstinting efforts in bringing this manuscript to press, Peter Hayes and Janet Mowery of ICS Press are owed special mention.

The opinions expressed in any of the volumes of this series are necessarily shared by neither Sequoia Institute nor the Agency for International Development. Nonetheless, the diversity of ideas and evidence found in these pages is expected to contribute to the formulation of better ideas and development prospects than would otherwise occur.

Jerry Jenkins
Series Director/Editor

March 1992

PART I

INTRODUCTION

1

Charles Wolf, Jr.

Transforming Command Systems

The fall of the Berlin Wall in November 1989 was one of the "defining moments" of global history in the post-World War II period. It confirmed the collapse of communism in Poland and heralded communism's impending fall in East Germany, Czechoslovakia, and Hungary. It presaged the emergence of democratic leaders and elections in central and Eastern Europe. The fall of the Berlin Wall also reflected the consequences of Mikhail Gorbachev's *perestroika*, *glasnost*, and "new thinking." It probably also accelerated the process that formally ended the Communist party's legal monopoly of political power in the Soviet Union and led to the dissolution of the union at the end of 1991.

The remarkable momentum of these pluralizing and democratizing changes brought with them in 1990 the unification of Germany and the reigniting of age-old national and ethnic passions and rivalries within the Soviet Union, the Baltic states, and the twelve other Soviet republics, as well as in Czechoslovakia, Yugoslavia, Romania, Hungary, and Poland. Some of these currents of change recall the deep-seated antagonisms and conflicts of the past and portend not "the end of history," as Frank Fukuyama has suggested, but rather its "reemergence."

These political changes have been accompanied by a massive, almost unanimous, outpouring of rhetoric extolling the benefits of free-market systems and contrasting them with the stultifying rigidity of centrally planned command economies. Recognition of the failures of command economies and the need to transform them has been the source of this remarkable shift in rhetoric.

The unanimity and ubiquity with which markets have been advocated in the former Soviet Union and Eastern Europe, as well as in China and the third world, obscure profound divergences over what the various terms of the debate mean and what they imply for the transformation of command economies into market-oriented ones. These divergences are latent in such frequently used but self-contradictory terms as "market socialism" (a term invented by the Hungarian economist Janos Kornai, but subsequently rejected by him), "regulated socialist markets" (a term favored periodically by Gorbachev and certain "conservative" communist economists), and what some Chinese leaders have described as a system between capitalism and socialism, which they call "socialism with Chinese characteristics."

The underlying disagreements about transforming command systems into market ones concern points of detail, but in this instance, as in others, the essence is in the details. These relate to whether markets should be "free" or "regulated," competitive or "social," whether the markets' intended reach should be extensive and predominant or partial and limited, whether transformation should be rapid or gradual, whether the emergent system should be open to international competition allowing free movement of capital and commodities or protected from it, and finally, whether the scope of the government sector, at the end of the process, should be extensive or narrowly circumscribed.

It is not surprising that these divergences are so deep. The rhetoric of markets and marketization has been adopted by a remarkably diverse group of advocates, including communists, ex-communists, erstwhile central planners, social democrats, "liberals," and "radicals," as well as new and aspiring entrepreneurs in the prospectively transforming command economies. As a result of this diversity of views as well as of participants, the ensuing policy debate has often been muddled and the essentials of the transformation process have been frequently misunderstood.

At the request of the United States Agency for International Development (USAID), and in collaboration with the Sequoia Institute of Washington, D.C., RAND organized a conference on "Supporting Democracy and Free Markets in Eastern Europe" in Santa Monica, California, on September 21–22, 1990. The purpose of the conference was to consider whether and how specific types of actions, policies, and programs can advance the objectives set forth in the enabling legislation passed by the Congress and signed by President George Bush, the Support for East European Democracy (SEED) Act of 1989. The objectives established by this legislation are to "contribute to the development of democratic institutions and political pluralism," and "promote the development of a free-market system"—through use of the funds and instruments provided in the act.

The United States and the West have been in the "aid business" for more than four decades—a period that has included aid to Greece and Turkey in the immediate post–World War II period, the European Recovery Program, President Truman's "Point Four" program of technical assistance, and the ensuing development assistance program to the third world. The present context in Eastern Europe, and the responsibilities that are set forth in the SEED legislation, are different in several important respects from these precedents. For example, the Marshall Plan's programs had more or less finite goals of restoring and revitalizing prewar systems and institutions, and these goals provided a calculable basis for estimating the funds required for their realization.

The post–World War II series of U.S. and other government programs to assist the development of the less-developed countries focused on project and program assistance as well as technical assistance in order to expand physical and human capital inputs and bring about rapid growth. The purposes set forth in the SEED legislation—namely, to promote democracy and free markets—are more ambitious than those ascribed to those earlier programs. Moreover, the funds available for achieving its formidable objectives are modest indeed: for example, the total amount of U.S. aid that has been appropriated through 1991 for the countries of Poland, Czechoslovakia, and Hungary amounts to $14 per capita. Of course, larger amounts of funds will be forthcoming from Western Europe and Japan. At least in the case of Germany, however, the amounts likely to be allotted will be considerably constrained by the enormous financial demands accompanying the unification of eastern and western Germany.

Not only are the outside funds available for promoting democracy and free markets quite modest, but the most effective means and sequences for advancing these ambitious objectives pose formidable challenges. To some extent, the SEED legislation should be viewed as providing symbolic—albeit valuable—support for the aspirations of the East European peoples and governments for democracy and free markets. Both democracy and free markets are complex and finely articulated systems. They can be rooted in differing cultures and traditions, as suggested by the vitality of democracy in India (despite the limited role of free markets there), as well as by the Japanese and South Korean experiences with both free markets and democracy. However, the indigenous "rooting" process depends critically on national leadership and the achievement of national consensus. These ingredients cannot be readily packaged and exported from well-wishers abroad.

Yet external encouragement, support, and counsel can be invaluable in helping to advance democracy. They can help to provide the legal and informational frameworks that will encourage the institution of appropriate constitutional checks and balances, protect the rights to expression and participation of minorities and interest groups, facilitate the development of a free and competitive press, and establish the rule of law.

In promoting free-market systems, external technical assistance can also be helpful in establishing the necessary ingredients of such systems: namely, systems of monetary and fiscal control and discipline, deregulation to link prices and wages to costs and productivity, privatization and legal protection of property rights, the breakup of state monopolies, a social safety net to protect those who may become unemployed as transformation proceeds, and a move toward currency convertibility to link the transforming economies to the world economy and to competition in international markets. In the final analysis, however, the "rooting" of democracy and free markets—that is, the implementation and adaptation of the relevant theory and technical advice—in Eastern Europe, as well as elsewhere, depends on the people and the leadership of these countries, who are building on a ground swell of receptivity when moving in these directions.

This book comprises the papers and discussant remarks contributed at the RAND conference.[1] It is divided as follows: Part II, "Precedents and Experience"; Part III, "Pluralism and Democracy"; Part IV, "Free-Market Systems"; and Part V, "Ongoing U.S. Government Assistance."

The chapters in Part II address the relevance of the precedents, the experience, and the institutional and human "capital" derived from prior U.S. government-to-government assistance programs, including especially the Marshall Plan, the North Atlantic Treaty Organization (NATO), and development assistance to the third world. In Chapter 2, Thomas Schelling, noting that the Marshall Plan is sometimes invoked as a possible model for the current extension of aid to Eastern Europe, clarifies what the Marshall Plan was, how it operated, and notes some lessons learned from it. One major difference between now and then, he observes, is that the United States was the sole source of aid, indeed the sole source of dollar capital inflow. In determining aid allocation, U.S. aid was matched against agreed estimates of each country's "needs" for additional dollar imports. One of the lessons from the Marshall Plan, according to Schelling, is the difficulty of terminating aid, because termination is often construed as the severance of a relationship.

In Chapter 3, Nicholas Eberstadt discusses "A Skeptic's View of Aid." Eberstadt observes, ironically, that the sorts of policy advice that USAID has usually offered to developing countries over the past two decades would have been more likely to lead the East European countries into the same sorry economic situation in which they now find themselves—one characterized by serious debt problems, state-owned enterprises, and structural distortions—than to lead them toward reliance on markets, private enterprise, and self-sustaining growth. Eberstadt expresses doubts that the prior experiences of success in U.S. development efforts—namely, the Marshall Plan, Japan, West Germany, South Korea, and Taiwan—involved elements that are likely to be echoed or replicated in Eastern Europe under current conditions.

The chapters in Part III explore whether and how pluralism and democracy can be advanced, as proposed in the SEED legislation, through actions, programs, and policies to be pursued—or avoided—that will encourage the development of appropriate checks and balances in the exercise of government authority, promote participation by existing and emerging groups and interests in the East European countries, and provide protection of minority rights and values. In Chapter 4, Graham Allison and Robert Beschel address the question, "Can the United States Promote Democracy?" After reviewing the theoretical literature on the subject, they "find it puzzling that . . . students of democracy are almost unanimous in their skepticism or negativism about the U.S. promotion of democracy." Their own assessment is more optimistic. They offer thirteen "principles for promoting democracy"—some relating to a favorable external environment and others concerning the infrastructure of democracy and strategies for democratization. For each of these categories and actions, Allison and Beschel propose a set of "dos" and "don'ts."

This consideration of the general issue of advancing pluralism and democracy is followed by chapters by James Brown and Alex Alexiev, respectively, which treat questions of how these objectives can be furthered in Eastern Europe, as well as what may hinder their attainment. In Chapter 5, "Helping Eastern Europe: Thoughts, Suggestions, and Some Mild Obsessions," Brown writes that "economics are paramount and all-pervasive" and that the "premature introduction of competitive, pluralist politics in Eastern Europe could jeopardize the entire prospect of civil society." Among the specific suggestions he makes for U.S. actions are that educational exchanges take place at every level, that the role of the U.S. Information Agency be strengthened, and that Radio Free Europe be refurbished and redesigned.

In Chapter 6, Alex Alexiev focuses on special problems of Bulgaria, Yugoslavia, and Romania—the "southern tier." His discussion emphasizes the bleak prospects for democracy in Romania and Bulgaria, where the renamed Communist parties retain a predominant influence and incumbency. He further envisages the breakup of Yugoslavia, with Serbia taking an authoritarian path and Slovenia and Croatia likely to move toward democratization.

Part IV is concerned with promoting free-market systems by undertaking, or avoiding, various actions and programs relating to monetary and fiscal measures, price and wage deregulation, capital market development, legal frameworks to protect property rights, privatization, and dispute resolution. In Chapter 7, Leif Olsen addresses the question of how to promote free markets in Eastern Europe. Toward this end, he addresses successively the need for appropriate legal frameworks, privatization, price and wage deregulation, the creation of credit markets, the role of foreign capital and joint ventures, and the need for social security and an unemployment insurance system.

Steven W. Popper's Chapter 8, "Aid from Western Governments: The First Steps," urges that these "first steps" should emphasize the stimulation of private initiatives, facilitation of contacts between citizens of the West and of Eastern Europe, provision of expertise on the construction and rehabilitation of institutions, and assistance in building the skills necessary for a successful transformation to market systems. Popper points out the danger of enacting initiatives that may prove too challenging to the institutions of East European countries still struggling with problems of stabilization.

In Chapter 9, "Reform in Eastern Europe: What Must Be Done? What Can Outsiders Do?," Lawrence H. Summers groups his recommendations under three categories: (1) stabilization of the macroeconomy, (2) building the institutions of capitalism, and (3) creating the laws and rules of capitalism. He expresses doubt that the necessary transformation should be made "excessively rapidly." He has reservations about too-rapid privatization and argues that "selling off all the [state] enterprises quickly is just not realistic."

In Part V, dealing with ongoing U.S. government assistance to central and Eastern Europe, two U.S. government officials describe and discuss the design and content of U.S. government assistance programs.

In Chapter 10, "U.S. Government Assistance to Central and Eastern Europe," Kenneth Juster summarizes the "new policy standard" designed to differentiate U.S. assistance to each East European country in terms of its progress toward four objectives: (1) political pluralism, (2) market-oriented economic reform, (3) enhanced respect for human rights, and (4) a friendly relationship with the United States. One of the priorities of U.S. assistance is the development of democratic institutions and the rule of law, and a second priority is technical training and assistance in support of market-oriented economic reform. Juster describes the content and scale of recent and current efforts in both of these domains.

In Chapter 11, "USAID Programs in Central and Eastern Europe," Carol Adelman describes several lessons from prior U.S. aid experience that the current programs in Eastern Europe are intended to reflect. These lessons include the following: that countries should be rewarded by the provision of assistance after they have undertaken free and fair elections and implemented sufficient economic reform; that projects should be undertaken on a regional rather than country-specific basis; that assistance should be earmarked as intended to be temporary or transitional; that technical assistance and training should be emphasized over transfers of cash or equipment; and that the administrative apparatus for the aid programs should be streamlined.

From Command Economies to Market Economies

Implicit in many of the chapters, as well as in the conference discussion that accompany them, is a "systems approach" to the transformation of centralized, command societies into pluralistic, market-oriented ones. This approach is generically applicable to the transformation process, whether the locale of its application is Eastern Europe, the republics of the former Soviet Union, China, or any of the centrally controlled economies of the third world.

To be sure, each locale differs in its historical circumstances, cultural affinities, institutional antecedents, and existing physical, social, and political infrastructures. But the differences, while important, are incidental to an essentially similar task. Transformation depends on implementing simultaneously, or at least contemporaneously, a package of six closely linked and mutually supporting elements:

- monetary reform to ensure control of the money supply and credit
- fiscal control to ensure a budgetary balance and to limit monetization of a budget deficit if one occurs
- price and wage deregulation to link prices to costs and wages to productivity
- privatization, legal protection of property rights, and the breakup of state monopolies, to provide for competition as well as worker and management incentives that reflect changes in relative market prices
- a social "safety net" to protect those who may become unemployed as transformation proceeds
- currency convertibility to link the transforming economy to the world economy and to competition in international markets

The first two elements (monetary reform and fiscal control) and the fifth (the social safety net) create the broad macroeconomic environment that enables the incentive mechanisms of the other three elements to move resources toward more efficient and growth-promoting uses. The government's role is both crucial and paradoxical: crucial in initiating all of the elements, yet paradoxical because the process that the government initiates is intended to diminish its ensuing role, displace its overextended functions, and reduce its size in favor of market mechanisms.

Each of the six elements is less likely to be effective without the reciprocal support provided by the other elements. Hence, attempts to reform nonmarket economies by piecemeal steps are more likely to founder than to succeed.

Consider, for example, the link between the first two elements. Monetary reform is necessary to limit growth of the money supply to a rate that accords with the growth of real output. It is also a necessary means of providing access to credit on the basis of borrowers' economic capabilities and their associated risks, rather than on the basis of their political connections or credentials. A competent entrepreneur with a good idea should be able to obtain credit not available to someone whose principal distinction is membership in the governing political party or kinship to a government official.

Fiscal reform requires a budget process that constrains government expenditures to a level approximating that of revenues, and precludes or limits "off-budget" subsidies and other transactions that would disrupt monetary discipline, as well as budgetary balance. Recourse to extrabudgetary subsidies to bail out deficit-ridden state enterprises has been standard procedure in the Soviet Union, China, and other command economies; fiscal and monetary reform should preclude its recurrence. Usually, the complementarity between monetary and fiscal reform is facilitated by institutional separation between the finance ministry (or treasury), and the central bank or banking system.

The third element—deregulation of prices and wages—requires monetary and fiscal restraint if prices and wages are to be linked to real costs and productivity, while avoiding general inflation. Goods that are in short supply or are costly to produce should experience price increases relative to those that are more abundant and less costly. In turn, these price increases will provide signals and incentives for increased and more efficient production. Similarly, wages paid for more productive labor and skills should be expected to rise relative to those that are less productive. The newly established parities among costs and prices should operate in the public sector, as well as the private sector.

For deregulation of prices and wages to promote efficient use of resources, the fourth element—privatization, legal protection of property rights, and the breakup of state monopolies into competing entities—must be implemented at the same time. This requires an appropriate legal code and appropriate procedures for resolving disputes over property transactions and acquisitions, as well as litigation associated with prior ownership claims.

The fifth element—establishment of a social security system as a "safety net"—is also essential for the transformation process to succeed. Without it, the process may create fear of widespread unemployment, social stress, and political instability, thereby seriously impeding the transition.

In most command economies, social protection—against illness, disability, age, and unemployment—has principally been the responsibility of state enterprises. As privatization proceeds, these responsibilities are likely to become one of the principal functions of government, financed by taxation and by payments levied on the insured. In the initial stage of transformation, taxation will probably have to bear most of the burden, although the real *incremental* burden imposed on the economy by the social safety net is likely to be manageable.

The final element—currency convertibility—is essential to complete the transformation process. It will link internal markets and their prices, wages, productivities, and technologies to those of international markets, providing the opportunity for comparative costs and comparative advantage to operate for the benefit of the transforming national economy. With a convertible currency, the transforming economy can determine which goods and services it can produce at relatively low cost compared to the costs of other countries, and which it produces at relatively high cost. In response to convertibility, exports of the relatively low-cost goods will expand, as will imports of the relatively high-cost ones.

If the other elements of the package—especially monetary and fiscal discipline and market-determined prices—are implemented effectively, currency convertibility with a floating exchange rate can be embarked upon and sustained with minimal hard currency reserves, contrary to a frequent argument about the need for large reserves as a precondition for convertibility.

The interactions and mutually supporting relationships among the six elements of the transformation process are summarized in Figure 1.1. The lines indicate the contribution by one element to the effectiveness of another to which the arrowhead points. (For example, monetary and fiscal reform contribute to the effectiveness of price and wage deregulation.)

In sum, the process of transforming command, nonmarket economies to market ones is both better understood and more practicable than one might suppose after listening to much of the public debate. Transformation is a systems process encompassing the interactive and mutually supporting elements described above. Trying to transform a centralized command system to a pluralistic, market one without the synergy provided by all of these elements is like trying to swim with only one arm and one leg.

Democracy and Free Markets

Beyond the specification of the essential attributes of democratic systems—division of governmental powers, checks and balances in the exercise of such power, free press and free elections, a genuine rule of law and established procedures for changing the law, and so on—preferred techniques, programs, and sequences for promoting

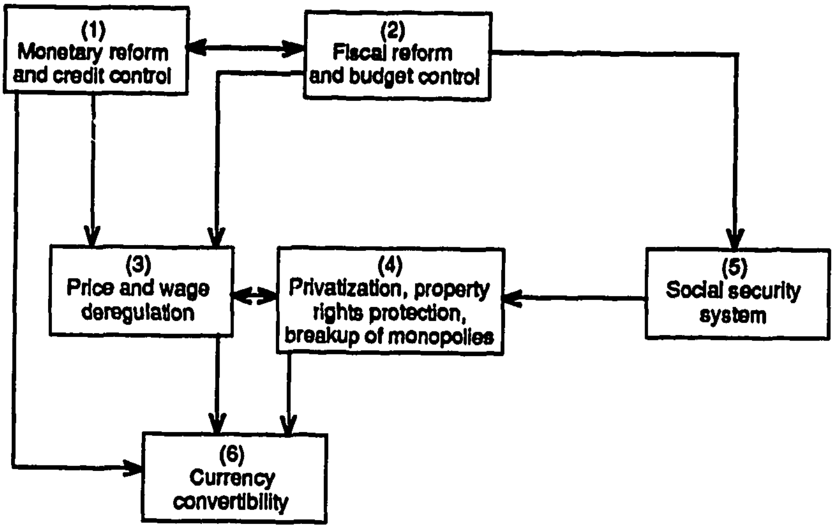

Figure 1.1. Components of Transformation of Command Economies. **Source:** Charles Wolf, Jr., "Getting to Market," *The National Interest* (Spring 1991): 43–50.

democracy are not well understood, let alone fully tested and proven. Equally unclear is the precise and predictable relationship between democracy and free markets. According to some views (for example, the works of Friedrich A. von Hayek and Milton Friedman), free markets are an essential precondition for democracy. According to other views (Anders Aslund), democracy is a "necessary condition" for free markets.

A further complication is introduced by considering the relationship between democracy and markets in the long run and in the short run. For example, it is possible that, in the long run, democratic systems will result in free markets because decentralization of economic power will follow decentralization of political authority. It is also possible that free markets may contribute to democracy in the long run by a process in which dispersion of economic power results from market competition, and decentralization of political power follows from dispersion of economic power. Yet it is also possible that those relationships need not hold in the short run.

A variety of experiences in individual countries underscores the complexity of the relationship between democracy and free markets. South Korea, Taiwan, Singapore, and Chile have experienced several decades of free markets, together with highly authoritarian political systems. On the other hand, India has had a functioning democracy for four decades together with a socialist rather than a market system. Turkey has had a similar experience until its relatively recent and gradual move toward a market-oriented economic system.

These complexities arise because the channels for linking economic power and political power are numerous and imperfect, and can be blocked or lubricated. Both democracy and free markets are complex and finely articulated systems. They can be rooted in differing cultures and traditions, and they can also fail to take root in differing cultures and traditions. Whether the indigenous "rooting" process prevails depends critically on national leadership and the achievement of national consensus—elements whose emergence can be assisted from abroad, but cannot be readily packaged and exported. There is no single formula for ensuring democracy and free markets. Their linkage requires a sophisticated blend of the tools, analysis, and paradigms of modern political economy, combined with knowledge and experience in the context of specific countries and regions.

Unresolved Questions

In the course of the conference discussion, the participants failed to reach consensus on several issues and questions. These areas of contention, representing possible topics for further investigation, include the following issues:

- *Should the primary aim of aid programs be breadth in the aid effort, or concentration on a few projects and sectors?* Arguing for a broad scope is the plain fact that the "needs" are extensive; there is also no clear body of knowledge that convincingly supports the concentration on particular sectors. Advocates of a narrow focus stress that funds and talents are limited, and that the risk of scattering aid in a series of half-measures is substantial.

- *Should aid donors be more concerned with developing a "fair" press or a "free" press?* Supporters of the premise of a fair press voiced concerns about the appearance of sensationalist, demagogic tabloids, and advocated the development of a balanced and responsible press. Advocates of a free press argue that any new entrants into the media market enhance competition and the expression of diverse views and, moreover, that government advisement that restricts free expression is more of a danger than a protection.
- *Are political reform and economic reform complementary, conflicting, or independent? Does one precede the other?* Some of the conference participants expressed the view that premature democratization could impede serious economic reform by removing the strong central authority needed to rationalize and enforce change. Others argued equally strongly that political reform is essential to accompany economic reform so that the latter will be embedded in a democratic context.
- *Should the pace of privatization be fast or slow?* Proponents of a measured pace of privatization expressed the fear that hurriedly privatized assets would fall into the hands of illicit groups—the *nomenklatura* and black marketeers, for example—because these are the groups with sufficient wealth to bid for the privatized assets. As a consequence, further reform efforts might be discredited in the eyes of the public, resulting in a slowing or reversal of change. On the other hand, those who advocate a rapid pace of privatization suggested that the sooner ownership rights are transferred from the state, the sooner and more likely are market discipline and significant economic restructuring to take place. Still other participants argued that it is not appropriate to make a uniform choice between fast and slow privatization. Housing, services, and small enterprises, for example, might be privatized

rapidly, while the privatization of large state enterprises might be delayed until appropriate employee ownership plans were developed and a sufficiently broad distribution of assets could be achieved.

These issues, as well as others addressed in this book, were highlighted at RAND's exploratory 1990 conference on the SEED legislation. To resolve them will require further research and experience, as well as continuing discussion and debate. The challenge of promoting democracy and free markets will be high on the global agenda of the 1990s and beyond, not only in Eastern Europe but in the republics of the former Soviet Union, China, Cuba, Vietnam, North Korea, and in much of the less-developed world as well.

Part II

Precedents and Experience

2

Thomas C. Schelling

The Marshall Plan: A Model for Eastern Europe?

The Marshall Plan is occasionally invoked in discussion of aid for Eastern Europe. Sometimes the reference is only to the spirit of the Marshall Plan, implying a large-scale focused effort, not unlike a call for a "Marshall Plan" for U.S. inner cities. Sometimes a more literal comparison is intended: what worked for Western Europe in the late 1940s and early 1950s, it is argued, may be what Eastern Europe needs in the early 1990s. This paper is written mainly to clarify what the Marshall Plan was and how it operated.

The Marshall Plan did not inaugurate American foreign aid. Lend-lease to Britain and the Soviet Union and a few other countries had amounted to almost $50 billion by the end of the Second World War, at a time when the U.S. annual gross national product (GNP) was about $175 billion; lend-lease constituted about one-sixth of total U.S. war expenditures. (Subtracting "reverse lend-lease" and some repayment, the net cost of the program was $37 billion.) After the war, relief and rehabilitation programs amounted to approximately

$16 billion before the inauguration of the Marshall Plan. Furthermore, after the beginning of the Marshall Plan in April 1948, other aid programs, mainly intended for areas outside Europe, continued.

The Marshall Plan was different from other aid programs in that it was indeed a "plan." Other aid had been given as necessary for relief, rehabilitation, and assistance in allied-occupied Germany and Japan, and to stabilize the pound sterling; the Marshall Plan was to have a beginning and an end. The economic problems of Western Europe were believed to be finite and solvable. The United States called on the countries of Western Europe to put together a plan, not just for receiving U.S. aid, but for recovering economic independence within a foreseeable period. The governments of Western Europe were expected not only to demonstrate what aid they needed from the U.S., but how with United States aid they could complete their recovery from the war.

It was furthermore to be a European plan, not fifteen national plans. It was to be European in two respects. First, because trade among the countries of Western Europe was exceedingly constrained by a system of bilateral trade negotiations, usually dictated by the desire for bilateral balance, more flexible, market-determined, and multilateral trade was considered essential to Europe's recovery. The expansion and multilateralization of intra-European trade was to be a central part of the plan.

Second, it was to be a European plan in that the potential recipients, immediately after Secretary of State George Marshall's commencement address, were to put together a joint scheme indicating the amount of aid they would collectively need in order to complete timely recovery. Each nation's requirements were scrutinized and cross-examined by the other European nations. An exorbitant claim by one nation was perceived to be a threat to the aid that the others could receive, and the result was a negotiated total.

After the funds were appropriated and became available, the Committee for European Economic Cooperation became the Organization for European Economic Cooperation (OEEC) and was immediately given the task of proposing the appropriate breakdown of the second year's aid among recipient countries. The word "cooperation" in the titles of both the European organization and the U.S. Economic Cooperation Administration (ECA) was taken seriously.

The notion of a plan was reflected in the institutional arrangements. The OEEC was located in Paris, and so was the U.S. ECA's overseas central office. Additionally, the United States had in each country an ECA mission, attached to the embassy. Each mission dealt directly with the host government on matters concerning aid, and each worked with the government in developing its plans and estimates for the following year.

For each aid recipient, with the exception of occupied Germany, U.S. aid was the dominant relationship with the United States. It was not merely another dimension of diplomacy. For most or all of these countries the most difficult problem of economic management was their balance of payments with those areas of the world from which imports had to be paid for in dollars, or for those commodities from anywhere that had to be paid for in dollars. Depending on the country, U.S. aid covered between one-third and three-quarters of dollar imports. U.S. annual aid to Europe in this program was about $4 billion, or about 1.5 percent of U.S. GNP. That percentage would amount to about $75 billion now.

For the European countries the significance of the aid was usually measured in terms of the fraction of dollar imports that it covered; translating the dollar amount into percentages of recipient-country GNP depended on the exchange rate used. Britain, for example, received $1.2 billion during 1948–49; at the exchange prevailing at the beginning of 1948, $4.03 to the pound, this was worth 300 million pounds or approximately 2.5 percent of Britain's GNP of twelve billion pounds. In September 1949, after devaluation, the same dollar amount was worth 430 million pounds, or 3.5 percent of the same GNP. The pound was still substantially overvalued; an equilibrium exchange rate in the presence of U.S. aid might well have brought the aid figure to 5 percent of GNP, and an equilibrium exchange rate in the absence of aid, used as a measure, would have put the percentage even higher. Probably for Western Europe as a whole, a figure of upward of 5 percent is reasonable.

The aid was all "government to government." A small part was in the form of loans; most of it was grants. In principle, the aid amounted to a grant to the central bank of the recipient country. For practical purposes one can think of the aid as being commingled with other dollar resources available to the central bank, used to sell to importers who paid their local currency to the central bank and spent the dollars on imports. Virtually none of the aid was earmarked for particular activities or projects in the recipient countries. Later, beginning in 1951, there would be a strong identification of U.S. assistance with military procurement and construction, but during the Marshall Plan years the aid did not explicitly go to these or any other specified sector or industry. It simply filled a gap between the dollar imports that were deemed necessary for economic progress and the dollar earnings from all domestic sources (not excluding the drawdown of reserves) that could reasonably be expected. (There were a very few minor attempts to have U.S. aid directly identified with specific projects—workers' housing in France, for instance, or projects undertaken jointly by two or more countries—but such efforts were unsuccessful.)

Procurement Authorizations and Counterpart Funds

The actual technique for dispensing aid was not nearly so simple as a straightforward grant to a central bank, and it is of some interest to examine how the technique employed may have influenced results. The money for each country was essentially earmarked at the U.S. Treasury. When, say, a Dutch importer went to his bank for foreign exchange, presenting a valid import license—all these countries had exchange controls, and foreign exchange could be procured only by an importer with a valid license specifying the commodity and the country source—his bank would obtain through the central bank either dollars from the foreign exchange reserves or a "procurement authorization" (PA) issued by the Economic Cooperation Administration. The PA was essentially a voucher that the U.S. exporter could cash at the U.S. Treasury. To the importer it usually made no difference whether he had a draft on an American bank or a PA.

Meanwhile, back at the bank, the local currency that the importer paid to get the PA was sequestered into an account called a "counterpart fund." These funds were the property of each country's government but, according to the bilateral agreement covering the entire aid arrangement, could be spent only by agreement with the United States. The United States could veto the use of the funds but could not require the use of the funds. (Five percent of the counterpart funds were separated into an account that could be directly used by the United States for administrative and other purposes directly related to the Marshall Plan. The most often remembered use of this "5 percent account" was to pay for restaurant meals.)

An interesting question is why the PA system was instituted. Another question is what difference it made. The 1946 stabilization loan to Britain, unlike the Marshall Plan, was a straightforward line of credit. The difference between the two schemes, however, went beyond the distinction between loans and grants, because the small loan portion of the Marshall Plan was subject to the same procedures as the grant portion. The Congress evidently did not like the idea of making outright grants to Greece or Italy or France, preferring something like "aid in kind" for purposes of paternalistic and other controls. Yet another question is what kind of control the PA system constituted and how it was used.

PAs as Control

In none of the country programs that were submitted to the OEEC for scrutiny and cross-examination, and in none of the tentative country programs that were discussed with the country ECA missions, was the slightest attention ever paid to the PA procedure.

Every mission had a program officer and a finance officer, and some of the larger missions had industry representatives, agriculture representatives, and labor representatives, who served much like attachés. Every mission also had a comptroller, who concerned himself with monitoring procurement operations; nobody else in the mission paid attention to the issuance of procurement authorizations. The PA procedure was not used to assert any kind of program control, or any control over what the countries imported with their dollars.

The PA procedure made it possible to identify for the Congress the specific imports that the U.S. aid had "paid for." It was a way of making the aid dollars appear not to be fungible with other dollars available at the central banks. If Congress considered nylon a luxury, as on one occasion it did, and thought nylon should not be financed under the Marshall Plan, the ECA could refuse to issue PAs for nylon. The country could then procure the nylon from its own dollar reserves. That much was window dressing.

Congress did exert pressure on European imports, and the PA system may have been moderately useful to the Congress in applying that pressure. Congress wanted Europe to import more American tobacco; it may have been slightly helpful that Congress, in overseeing the program, could demand that more PAs be issued for American tobacco. Congress did require that half of all aid shipments be in American ships, but PAs were unnecessary to police that. Initially there were restrictions on the export of agricultural machinery, which was in short supply in the United States, but again the PA system probably did not contribute to monitoring those exports. Possibly the PA system helped prevent fraud, and maybe central banks welcomed the system for that reason, although this is only a guess.

The Strategy of Control

There is a lesson here, perhaps, on how to "control" the use of aid money. It is sometimes thought that a granter of aid, if he or she cannot entirely trust a recipient, whether it be a foreign country, a city, a family, a university, or even the donor's own children, should insist that the aid money should be spent on "hard-core necessities." If hard-core necessities are things so necessary that they would be the highest priority purchases of the recipient anyway, however, that criterion simply leaves all discretion to the receiving party. If the only way to exercise control is by determining for what the aid money is to be spent, it is best to estimate the resources available to the recipient, identify the things that the recipient cannot possibly do without, match those things against the recipient's own resources, treat one's own funds as marginal, and allocate them in accordance with the donor's preferences, not the preferences of the recipient. If, for example, a parent plans to pay two-thirds of his or her child's college expenses, and if tuition amounts to two-thirds of the child's total expenses and absolutely has to be paid, paying the tuition simply means that the child's own resources, one-third of the total, will be spent as the child pleases. If, instead, the parent pays half the tuition and procures, with the other half of the aid, the child's room, board, clothing, entertainment, haircuts, athletic facilities, books, soap, and toothpaste, the "donor" completely determines the child's life-style (unless he or she can trade away the toothpaste and classical concert tickets for marijuana and a rock concert).

There is a better way, however—better in terms of relations between the granter and the recipient, and that's the way it was done in the Marshall Plan. The parent and the child in our example seek a common understanding of the resources available to the child and jointly work out the child's needs, starting with tuition and going on through all the other things that a college student needs to spend money on. Together the parent and child work out a budget; the two may argue about issues such as buying books or the quality of room and board, but eventually they negotiate an overall budget to which the parent contributes his or her share. Now, of course, the parent needs either an honor system or a way to monitor the child's actual expenditures.

The Marshall Plan operated in similar fashion: the overall programs were negotiated, substantially among the European countries themselves as part of the aid-division process, including how they would allocate, among broad categories of goods, the dollars they expected to be available. The United States approved these overall budgets when it was reasonably content with them; it did not insist on knowing which commodities were to be bought with which dollars. It could monitor a country's use of its dollar resources, and substantial departures from the original budget could be negotiated or discussed in the course of the year. The country's own statistics on imports and the issuance of import licenses were important if the United States wanted to monitor overall transactions; the PA system was of no particular help. U.S. intervention in these countries' imports during any year varied, from much in the case of Greece, to little or none in the case of the United Kingdom.

Commodity Composition of Aid

The commodity composition of European dollar imports in the Marshall Plan is interesting. There is sometimes a naive expectation that aid for a postwar recovery program, with high levels of investment expected in the recovering countries, should consist largely of capital goods. There is, similarly, an expectation that aid in support of a military buildup will consist mainly of militarily useful goods. In the first fifteen months of the Marshall Plan, however, purchases of machinery and vehicles accounted for only 8 percent of the funds. Imports of raw materials and semifinished products were only about a quarter of the total. Nearly 60 percent was food, feed, fertilizer, and fuel. Four years later, when economic assistance was being given in support of the defense programs of the NATO countries, one might have expected the aid to consist of metals, machinery, and the other items that contribute to defense production; but food, feed, fertilizer, and fuel still accounted for two-fifths of the total.

This, however, was just a reflection of comparative advantage. Most postwar reconstruction requires chiefly local resources.

Dredging canals, restoring roadbeds, building and rebuilding housing and factories, all require domestically available labor. These enterprises also require fuel for vehicles and for electricity. A significant part of capital investment must be devoted to increasing the stock of farm animals; feedstuffs require a large investment component as animal stocks are built up.

The same is true of a military buildup. Armies need to enlist people who otherwise would be in the civilian labor force; they need to house, transport, and equip them. Armies need vehicles and ammunition, as well as other technologically unsophisticated goods. Supporting the NATO buildup was not altogether different from supporting the rebuilding of the European economies. Comparative advantage determined the composition of the dollar imports, and the only reason to have expected military aid to include much advanced military equipment would have been a need for either high-technology equipment that only the United States could produce, or surplus military equipment disposed of as the United States modernized its own forces.

Counterpart Funds as Leverage

As with the PAs, a question arises as to what use the U.S. government could have made of its nominal joint control over the counterpart funds. If a country had a modern central bank fully integrated into the government, as was the case in the United Kingdom but not in all countries, counterpart funds should have represented merely a bookkeeping entry. If the central bank held government notes, they could have been cancelled against the counterpart funds, and the counterpart funds would have disappeared. Anytime the government wanted to spend counterpart funds, it could as readily have obtained credit from the bank and let the counterpart funds sit in an idle account. In terms of functional finance, the counterpart funds should have had no economic significance whatsoever.

The bilateral agreement, however, by providing that these funds should be sequestered and utilized only as jointly agreed with the

United States, provided a kind of legal justification for the United States to engage the recipient government in discussion of its fiscal and monetary policies. If the United States considered a country's policy too expansionary, it could open discussion of the government's planned use of counterpart funds; a discussion that could take place only in the context of the government's overall fiscal and monetary policies. The U.S. interest in engaging in such discussions varied from country to country, but counterpart funds were a kind of diplomatic entry into a government's budget plans.

Even a government as financially sophisticated as that of the United Kingdom, however, could not quite ignore the counterpart funds. Britain had a Labour government, and the party's backbenchers were always more liberal in their spending philosophy than the government; to them, the counterpart funds looked like money just waiting to be spent. The government could argue that if its budget and revenues were optimized with respect to employment and inflation, the counterpart funds were not real resources and spending them would be no different from getting a new line of credit from the Bank of England and spending that. But the argument did not satisfy the backbenchers, and the British government proposed to the United States that the counterpart funds be cancelled against equivalent government debt at the Bank of England and thus made to disappear. This raised concern in the U.S. Congress, where some representatives and senators had opposed the nationalization of British transport and mining, which had been financed through the central bank, and did not want Marshall Plan funds used to pay for the further nationalization of industry. Thus the British government proposal to wipe out the counterpart funds by offsetting them against debt found itself caught between its own supporters in Parliament and U.S. congressmen, both of whom took the counterpart funds to be real.

Occasionally the United States and the recipient government jointly made political use of the counterpart funds. Typically, in a cabinet-style government, pressures to spend come from many different directions, some budget programs are popular and some are not, and the government may wish to promote certain activities and soft-pedal others. By getting the United States to indicate that counterpart funds would be readily released for certain expenditures that the government and the United States believed deserved support, and that counterpart funds would not be released for various other purposes, the government could gain bargaining power for the programs it preferred. The United States could also be made to serve as a scapegoat when programs were not funded.

There were countries whose monetary systems made access to central bank credit difficult for their governments. Turkey was one. In the "defense support" stage of economic aid for Europe, beginning in fiscal year 1951–52, U.S. aid was occasionally granted for the explicit purpose of allowing a recipient government a higher level of domestic expenditure. Among U.S. administrators this was referred to as "budgetary support," and was invariably given to allow increased military expenditure. Here, again, it was thought to be not enough merely to demand that the counterpart funds be directed to military purposes. There had to be an understanding of what a recipient's military outlays would be in the absence, or in the presence, of aid, with an ability for the United States to monitor the outcome; otherwise the "substitution effect" could have destroyed any relation between the aid and an increase in military spending.

Defense Support

The widespread belief that the net effect of an expenditure is revealed by what is purchased directly with the money was remarkably persistent, and it allowed the U.S. executive branch to engage successfully in something close to deceit. When the Marshall Plan's enabling legislation, the Economic Recovery Act of 1948, was supplanted in 1951 by the Mutual Security Act, and the aid for Europe that was not actually military equipment was named "defense support," the executive branch was able to identify increased domestic military expenditure in the European countries as the direct result of dollar aid. To some extent, the allocation of counterpart funds to defense helped make the connection. But as the Congress became less and less interested in what it called "economic aid" and more interested in what it called "military aid," and the executive branch wanted to provide more dollar assistance than the Congress would approve, military aid funds were increasingly used for OSP—"offshore procurement." OSP was simply the purchase of military equipment in Europe to be delivered to the military forces of the European countries. Just as the PAs were identified with specific commodity imports, OSP was specifically identified, dollar for dollar, with military equipment delivered at U.S. expense to European armies. As far as any European central bank was concerned, "exporting" military equipment to the United States government for delivery to NATO had the same effect as would equivalent dollars provided at the central bank and counterpart funds spent on the equipment, or as would the old PA procedure if it had been used and the counterpart funds so spent.

The OSP program was initially envisioned as a way of buying equipment in one country for delivery to another, but eventually even that facade was not maintained, as equipment was procured, for example, in France for delivery to France.

The French war in Indochina was especially popular with the Congress. To help improve the French dollar balance of payments, the U.S. aid program—with military assistance dollars—picked up the tab for all kinds of supplies being shipped to the French forces in Indochina, amounting to more than $1 billion. The United States paid no attention to what was actually "purchased"; the whole object was simply to cover enough expenditure to relieve the French balance-of-payments deficit. If the Congress had found the construction of schools and hospitals in France to be more popular in the United States than the Indochina War, the United States could have paid for schools and hospitals—as long as they were going to be built anyway—and the war in Indochina would have been financed out of the French defense budget. Either way, the central bank of France would have received the same dollars to dispense to French importers.

Integration and Unification

At the outset of the Marshall Plan there were some high expectations of West European unification, economic and political, to be arrived at through the kind of cooperation that the administration of the Marshall Plan might enforce. Except in France, however, where Robert Schumann was busy putting together the European Coal and Steel Community, the interest in unification died away. It continued to be a major preoccupation of many people administering the Marshall Plan in Washington but not among those administering the plan in Europe. There was one area, however, where the United States did force a kind of "unification" on the Marshall Plan recipients. This was the area of European trade and payments.

Intra-European trade had continued to be constrained by bilateral agreements between governments. These typically were annually negotiated plans that specified the value of goods to be imported in rather detailed categories. The agreements included possible swing credits and specifications of the currency in which any net balance (beyond the swing credits) would be settled. The obligation a country incurred in the agreement was to issue import licenses, up to the amount specified in each category as to be imported from the partner country. At the time, no country's currency (except that of Belgium) was convertible into gold or dollars; a few had currencies that were convertible into sterling. The whole arrangement was quite constrictive of trade, and difficult to avoid.

The European Payments Union (EPU) was a U.S. idea for freeing up intra-European trade. It was to be a system in which all bilateral trade accounts would go through a central clearinghouse where accounts, though not convertible into dollars, would be kept in dollar equivalent values. To overcome any European reluctance to set up such a system, the Economic Cooperation Administration asked the Congress to set aside $300 million out of the aid total exclusively for the initial financing of the EPU. The $300 million was too good to let go, and the European governments took the bait; negotiations throughout 1950 led to the creation of the EPU.

European payments were still "planned" but became more flexible. U.S. aid could now be conditioned on a recipient country's extending "drawing rights" to the payments union. Drawing rights were simply claims on the country's currency. As an accounting matter, some fraction of the country's counterpart funds was made available to the EPU, with which the union's deficit with that country was to be settled. The $300 million EPU fund could be used to procure drawing rights. An equivalent total of drawing rights was then extended to countries expected to be in intra-European deficit. The new system was a long way from free trade and convertible currencies, but it was an important beginning. It was established entirely on the initiative and at the insistence of the United States.

Exchange Rates

A mystery on which I can shed no light is the almost complete inattention at the time to exchange rates. With all U.S. aid being determined by, and focused on, estimated dollar deficits, with all of the economic inefficiencies likely to accompany exchange controls and administered licensing of trade, a central concern should have been the appropriate rates of exchange between the European currencies and the dollar. In the more than two years I spent in Europe, from September 1948 to December 1950, the only reference I ever heard to free exchange rates was a question raised by Milton Friedman during a brief visit. More important, I never heard or saw reference to any discussion of what an appropriate level of administered exchange rates might be. Of course, exchange rates are a volatile subject, and if the United States were to lean on a European government to devalue, it would try to do so in the greatest secrecy. But one would think that, in designing both the philosophy and the operational details of the EPU, the concerned American officials would at least discuss among themselves the prospects for European currency devaluations, whether they were needed, and to what levels they might go. If there had been such discussions I should have heard them. One would not have expected open discussions in the OEEC about one country or another's exchange rates, but still one might expect some very general discussion about the need for realigning exchange rates. I heard none and saw none.

Maybe it was the imposing presence of Bretton Woods: exchange rates were not to be fooled with. I think it was just neglect. Partly it may have been that most of the American economists who went to Europe with the Marshall Plan or worked on it in Washington were not international trade and finance economists. Whatever the explanation, it was a monumental blindness that persisted for several years.

United States as Sole Aid Source

An enormous difference between the era of the Marshall Plan and the present day is that the United States was then the sole source of aid, indeed the sole source of dollar capital inflow. The United States was in complete command. There was no need to coordinate with or compete with other granters; recipients could not play one granter against another (the way developing countries later played the United States and the USSR against each other). There was no granter strategy of leaving certain countries unattended or certain needs unmet in order to pressure some other granter into making up the difference. There was no congressional concern about what other granters were or were not meeting their fair share of the burden. There was no jockeying for preferred position as major exporter to particular recipient countries.

Anti-inflationary Aid

U.S. aid was anti-inflationary in two ways. It substantially enhanced domestic production of consumer goods by providing critical raw materials. (Food in the form of grain is a raw material, as is fuel for generation of electricity.) And the import surplus financed by U.S. aid directly absorbed significant purchasing power. (It would have absorbed more if exchange rates had been cut in half.) Raising consumption was more critical in some countries than in others; improved living standards in Italy, for example, may have had important domestic political repercussions and weakened the Communist party. Increased consumption may appear to be a transient benefit; but a boost in the availability of consumer goods in a country that is undergoing reconstruction can help a government through a critical year or two by both raising living standards and reducing inflationary pressure.

At the time of the Marshall Plan there was private capital inflow from the United States to Western Europe, largely from companies that had operated in Europe before the war, often taking the form of equipping or modernizing American-owned facilities. The amount of such capital then was small compared with U.S. government aid. The reverse may possibly be true in the rebuilding of Eastern Europe.

Criteria for Aid

There was never a formula for distributing Marshall Plan dollars; there was never an explicit criterion such as equalizing living standards, equalizing growth rates, maximizing aggregate output or aggregate growth, or establishing a floor under standards of living. Dollar balance-of-payments deficits were a point of departure, and the negotiations took into account investment needs, traditional consumption levels, inherited technologies and industry-agriculture mix, war-induced capital needs, opportunities for import substitution and export promotion, and opportunities to substitute intra-European trade for trade with countries having hard currencies. Although these considerations entered into the negotiations, they never constituted anything like a formula. Aid levels per capita were never paid much attention.

All of these considerations were drawn into a focus on the dollar balance of payments. What was scrutinized in the OEEC negotiations and by the United States was not the use to which aid was specifically to be put, but the entire program of proposed dollar imports. With a few unimportant exceptions, none of the aid was directly targeted on particular projects, industries, or kinds of infrastructure. That changed when the Korean War activated NATO and the name of the Marshall Plan's enabling legislation was changed to the Mutual Security Act. Aid was then negotiated to accord directly with defense buildup programs. Except for the window dressing of counterpart funds being used in defense budgets, however, the aid itself was not targeted at particular military objectives. Even OSP was only an expedient, although for a while it was thought that it might be used to help standardize some NATO military equipment.

The Forms of Aid

People thinking of how best to provide aid to Eastern Europe think of particular tasks that may need external financing: modernizing equipment, rebuilding infrastructure, replacing obsolete factories, modernizing the production of electricity, chemicals, metals, and so on. If that is the approach taken, then all of the Marshall Plan's fuss with procurement authorizations can be dispensed with. There remains another choice, however. U.S. aid can be directed to particular urgent government projects, such as sewage systems, which might or might not be financed anyway; by the substitution principle, the main impact simply may be that the recipient government will acquire dollar assets while proceeding with the sewage project that was so urgent it had to be undertaken anyhow. The United States could, alternatively, require a government to submit an investment program for the coming one, two, or three years, with an indication of what could be done with U.S. aid and what could be done without it; the United States could then scrutinize the resources available to the proposed recipient government and the investment needs and negotiate an investment program which U.S. aid would, in part, finance. The United States also might offer dollars to a government, which would make loans on the basis of those dollars to private business, with the United States either supervising the selection of particular projects or reviewing a plan of all expected private investment, and with a negotiated agreement of what might be included in an enlarged plan incrementally financed by U.S. aid.

The United States could, of course, agree to finance only the imported components of some incremental public-private investment plan, but in a period when trade negotiations are in some disarray, when trade rivalries are great, and when there is great attention on the U.S. balance of payments, that kind of programming, especially if a system like procurement authorization were resurrected, might focus too much congressional and public attention on U.S. exports.

The Congress may in the end leave no choice but to finance only, or almost only, U.S. exports, especially if Japanese grants or loans to Eastern Europe are tied to purchases of Japanese goods and services. The Marshall Plan experience reminds us, however, that what is directly financed with the U.S. dollars will bear little or no relation to what is being constructed or modernized in the recipient country. If the Congress wants an accounting connection between U.S. aid and tangible projects, the counterpart funds arrangement or something like it will best serve the purpose.

The Time Dimension and Flexibility

In the Marshall Plan, U.S. aid was matched against an agreed estimate of a country's "need" for dollar imports. The budgeting period was the fiscal year. Whether the actual need proved to be close to the estimate depended on a number of factors, only some of which were within the control of, or subject to the influence of, the recipient country. For example, the estimates took into account the expected success of export promotion and import substitution, availabilities from nondollar sources, internal rationing, and overall fiscal policy. A major strategic issue was how rigidly or how flexibly to adhere to the original figure as the year developed and as discrepancies arose between the initial plan and the experienced need. The issue was never satisfactorily resolved. The argument for flexibility was that there were too many uncertainties to expect actual need to correspond with a year's forecast; even if all quantitative projections proved correct, there could be variations in the prices paid for dollar imports. There were also counterarguments for holding to the plan and not bailing out a country that got into unanticipated difficulty, and for not attempting to recapture allotted aid if a country's exports did better than expected—namely, to provide an incentive for the recipient government, and to avoid the difficulty of sitting in perpetual judgment on a country's performance. One thing that was not done was to withhold aid in reserve for major contingencies. Had a quarter or a fifth of total aid been set aside and not "programmed" to particular countries, there might have been an unmanageable incentive for recipient governments to develop unexpected needs early in the year before other governments had drawn down the reserve with a demonstration of their own needs.

Neighborly Comparisons

Differing amounts of aid to India and Pakistan, to Israel and some Arab countries, and even to Italy and Yugoslavia have inspired invidious comparisons between aid programs. The comparisons were less troublesome in Western Europe during the Marshall Plan period, partly because there were neither political hostilities nor military rivalries. I do not even remember any particular resentment of aid to Germany at the time.

A question that may arise is whether U.S. aid for Eastern Europe should be handled strictly bilaterally, with aid to one country insulated as much as possible from aid to any other in the region. There were great advantages, especially for the ensuing cooperation in NATO, of having made the Marshall Plan a team effort; I do not perceive obvious corresponding advantages in the current East European setting, and the potential disadvantage is the greater opportunity for rivalry when aid to two or more countries is constrained by a common overall total. A way to minimize invidious comparisons may be to avoid synchronizing individual aid programs in a common calendar. The Marshall Plan, after a slightly irregular start in early April 1948, marched to a regular fiscal year calendar. An implication of awarding aid for a fiscal year is the expectation of continued aid in the next fiscal year. There is no strong reason why aid should be programmed on an annual basis. (I do not believe the World Bank does it that way.) In principle, a donor could establish a fixed sum to be exhausted on some agreed schedule, perhaps with funds appropriated annually but always against a previously established, ultimate ceiling.

One of the lessons to be learned from the Marshall Plan is that it is exceedingly difficult to terminate aid. The temptation is to taper it off indefinitely. The termination of an aid program is often construed as the severance of a relationship, a termination of interest in the economic success of the recipient country. No matter how ceremonially a donor tries to establish the finality of a lump-sum aid figure, no recipient will ever believe that more will not be forthcoming if it is needed badly enough.

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Nicholas Eberstadt

A Skeptic's View of Aid

The collapse of Soviet power in central and Eastern Europe may well have propelled the newly liberated countries there into an era not only of change but of uncertainty. Yet one implication of the revolutions of 1989 was immediately clear: the region would soon receive a "development assistance" program of foreign aid from the United States. Since the late 1940s, when the United States invented this utterly new form of statecraft, American policy makers have striven to promote self-sustaining economic growth and liberal democratic rule through long-term, government-to-government resource transfers in literally dozens of countries around the world.

At this writing, sure enough, the United States is attempting to fashion such an aid program for Eastern Europe's new governments. Though many of its details have yet to be formalized, or even announced, this program promises to be a major undertaking. It also proposes to affect a great number of people. Excluding eastern Germany (now the responsibility of the Federal Republic of Germany), the population of the region numbers nearly one hundred million. That total does not count Albania and Yugoslavia, though these countries could eventually be inducted into the new programs as well.

On the eve of this new aid initiative, it may be appropriate not only to consider the particulars and prospects for a still embryonic program, but to reflect more generally on the performance of American development assistance to date.

A Thought Experiment

We can begin our review with a simple "thought experiment." What would we expect the economies, societies, and polities of Eastern Europe to look like in 1990 if those five countries had all been recipients of American development assistance over the previous two decades?

Like all such experiments, this one is speculative, and thus perhaps necessarily inconclusive. But we can perhaps pursue our experiment by comparing various characteristics of the countries of Eastern Europe immediately after their revolutions of 1989 and those of the dozens of African, Asian, and Latin American countries that enjoyed steady flows of bilateral American development assistance funding during the 1970s and 1980s—especially those characteristics bearing on what might be called "economic health."

One strikingly unhealthy characteristic of the East European states was their inability to manage their external debts. Over the course of the 1980s, the relationship between these states and the international economy revealed itself to be increasingly dysfunctional. Their problems in coping with external commerce and finance were illustrated, and underscored, by debt crises. The governments of Poland and Romania (and also Yugoslavia) not only failed to repay their international creditors on the schedules to which they were contractually committed, but sought and obtained debt relief agreements from them. At the time of its liquidation, the international finances of Hungary's communist government had also become precarious. After the German Democratic Republic's collapse, previously secret documents showed that the state's external hard currency debts were nearly twice as great as officially acknowledged. And a few months after the demise of the Todor Zhivkov regime, Bulgaria suspended its repayments of both interest and principal to its hard currency creditors.

These debt difficulties were systemic: that is to say, they were centrally affected by the policies and practices of the governments in question. As Roland Vaubel has observed, "The ultimate criterion of whether debt servicing has become more difficult or not is whether the borrower's rate of return exceeds the interest he has to pay. . . . It depends on the use of the funds."[1]

During the 1980s, debt crises were also characteristic of the states that had been long-term recipients of bilateral American development assistance. In the mid-1980s, by the U.S. government's count, seventy-four countries in Africa, Asia, Latin America, and the Caribbean were receiving direct economic assistance from the United States Agency for International Development (USAID);[2] almost all of them had been receiving such aid in the early 1970s, and most continue to receive it in the early 1990s. By the World Bank's count, forty-five of those countries negotiated debt relief agreements during the 1980s alone.[3]

Compounding the financial difficulties of Eastern Europe's communist states was their determination to maintain nonconvertible currencies: that is, to guarantee the validity of the money they printed only for those international transactions they specifically approved. Though Hungary attempted a regimen of limited convertibility, for all practical purposes the currencies of Eastern Europe were nearly worthless in the open market before 1989. Indeed, they were designed to be. Nonconvertibility, as intended, restricted the role of international trade in the local economy.

Nonconvertibility, or limited convertibility, is also characteristic of the currencies minted by the states that have been receiving economic assistance from the United States over the past two decades. A qualification may be in order here. Demonstrating the soundness of a country's money has been problematic since the Smithsonian Agreements of the early 1970s; today, no government honors the gold standard unconditionally. Even so, one may note that few third world treasuries manage to keep themselves afloat in our era of fluctuating exchange rates. By the count of the International Monetary Fund (IMF), only ten of the more than seventy countries today receiving bilateral economic assistance from the United States are deemed to have independently floating (that is, spontaneously convertible) currencies[4]—and there are reasons to believe this may be a generous estimate.

In any event, the trade exposure of many long-term U.S. aid recipients appears to be as limited as that of Eastern Europe's economies—in some cases, even more so. By the most recent (though hardly perfect) estimates of the World Bank, the ratio of exports to gross domestic product (GDP) in 1988 was higher for Hungary than for Haiti, Bolivia, or Paraguay—smaller and ostensibly poorer countries, for whom the benefits of increased trade participation should be self-evident. Sub-Saharan Africa, for its part, is said to maintain a ratio of exports to outputs that is no higher than Poland's—indeed lower, if the region's most populous country, Nigeria, is excluded from the grouping![5]

In the late 1980s, the countries of Eastern Europe were still ranking members in the "distorted world of Soviet-type economies," to borrow an apt phrase from Jan Winiecki. They bore the scars of decades of socialist control planning, and suffered its disfigurements. The structures of their economies had been severely deformed. Their central governments had arrogated utterly dominant roles for themselves within the local economy. They had amassed vast networks of state-owned enterprises. Without regard to consumers, these governments had directed forced-pace transitions of investments out of agriculture and into state-owned heavy industries. They depressed private consumption and diverted funds into state investment, not on the basis of economic calculation, but as a matter of political principle.

The fact of these far-reaching distortions in Eastern Europe is no longer contested—least of all by the peoples upon whose economies they were wrought. Parallel distortions, however, are just as evident in the economies of long-term recipients of American aid.

Figures compiled by the World Bank and the IMF make the point.[6] According to the IMF, for example, central government expenditures accounted for about 40 percent of gross domestic product in Poland and Romania in the late 1980s, and for over 50 percent in Hungary. These are high shares by any international measure. Yet they are not out of keeping with the estimates for some of the long-term development assistance countries. According to IMF figures, for example, the ratio of central government spending to national output in Egypt—the principal U.S. aid recipient in Africa—was about the same as in Poland or Romania during the 1980s. The Comoros, Jamaica, Jordan, Tunisia, Zambia, and Zimbabwe are some of the other long-term recipients whose ratios of central government spending to output are at roughly the same level. The annual figures for the Seychelles (also a long-term recipient of U.S. development assistance) are generally higher than Hungary's. Moreover, the IMF's highest published ratio (a seemingly impossible 108 percent) is for Guinea-Bissau—yet another long-term recipient of U.S. economic aid.

The "war" against agriculture, and against the consumer, in fact looks to have been taken even further in some aid-recipient countries than in Soviet-occupied Europe. The World Bank estimates that agriculture accounted for roughly one-seventh of Hungary's output in 1988; by the bank's reckoning, the share of agriculture in the economies of Zimbabwe, Jamaica, Peru, and Jordan were all lower—even though these societies were also said to be poorer than Hungary. The share of output accruing to industry is said to be lower in Hungary than in such places as Zambia and Haiti, even though these long-term recipients are thought to be much less prosperous. Although apparently impoverished, such long-term aid recipients as the People's Democratic Republic of the Congo and the Ivory Coast have nevertheless managed to achieve ratios of private consumption to national product nearly as low as in Poland under the regime headed by General Wojciech Jaruzelski. Another impoverished long-term recipient, Somalia, is said to have exceeded even communist Poland's inflated rate of gross domestic investment![7]

For obvious reasons, the communist governments of central and Eastern Europe did not attract significant quantities of foreign capital for direct private investment during the 1980s. Such inflows were also negligible for long-term recipients of American development assistance during those years. Indeed, though one could make too much of this fact, it appears that during the latter part of the 1980s, communist China succeeded in drawing more direct private investment from abroad into its officially protected enclaves ("Special Economic Zones") than those seventy-odd Asian, African, and Latin American recipients of U.S. development assistance combined.[8]

Systemic inability to attract voluntary investment from abroad speaks to the business climate of the countries in question. When foreign capital is not accorded special, separate privileges (as it is in China today), such inability is broadly revealing of the climate for the local populace as well. The factors affecting business climate are typically difficult to quantify, but no less important for that. They include such things as the state of civil order, the extent to which law presides, and the degree to which the rights of the individual are recognized (including his right to property). Note that these factors bear directly not only on commercial conditions, but on the quality of the civil and political liberties that the local citizenry may be said to enjoy.

One can, of course, identify a number of characteristic differences between the policies and practices of today's East European states on the one hand, and the group of states distinguished by their long-term participation in U.S. development programs on the other.[9] But while a variety of characteristic differences may be noted between the countries of newly noncommunist Europe and the group of long-term U.S. development aid recipients across Asia, Latin America, and Africa, what seems most striking is precisely the *lack* of distinct differences in so many important areas of policy and result.

It is true that our "thought experiment" did not look at recipients of aid from other Western countries or from international financial institutions, even though these bilateral and multilateral flows account for an increasing share of total concessional transfers. It also neglected the circumstances in these two groups of countries before the onset of U.S. aid flows or of communist central planning;

consequently, we did not trace their actual development paths. Our experiment nonetheless points to a fundamental question. If the present conditions of the states of Eastern Europe cannot be distinguished by such meaningful economic and political criteria from those under governments that have been obtaining American funds and advice for development those last few decades, why should U.S. aid and advice be expected to help Eastern Europe evolve away from its current characteristics—much less in the directions of self-sustaining economic growth or open, liberal polities?

The Decline of American Foreign Economic Assistance

The tragic fact is that American development assistance policies, for many years, have been more likely to lead a prospective beneficiary toward an East European-like economic morass than to help it escape from one. Though this assertion sounds hyperbolic, it is literally true. The case of the East European economies themselves, among others, attest to it. While the United States had no bilateral aid programs for the Warsaw Pact states, it did engage some of them through its multilateral development assistance programs. The United States, after all, is the largest shareholder in the World Bank. In the years before the revolutions of 1989, the World Bank extended to the communist governments of Hungary, Poland, and Romania a cumulative total of over $4 billion in loans—including loans for policy reform. Under American review and sponsorship, the World Bank not only lavished these communist states with aid but with praise of their policies and programs![10]

How did U.S. development aid come to fall so short of its stated aims of promoting economic health and self-sufficiency? By way of answer, we might recall some of the events that were instrumental in transforming America's foreign aid programs into a project with so very little to offer.[11]

In its early years, American development aid (or "technical assistance," as it was called at the time) was extended to governments in what was known as the "free world" to help them participate more fully in the liberal international economic order that had been created after World War II. To American policy makers, the primacy of private and commercial effort in the pending task of inculcating global prosperity was self-evident. So too, in their minds, was the link between government policies and local prospects for material advance. In a world newly complicated by both atomic weapons and the Cold War, exceptions to the rules governing such aid were sometimes declared and deviations from accepted practices were sometimes tolerated. They were, however, just that: exceptions and deviations. The objectives and principles of U.S. development aid were not in doubt.

American development assistance programs were tested by many minor challenges in the 1950s and 1960s, but they were shaken to their foundation by the Vietnam War. A confusion between political and economic objectives of foreign aid, already evident in the discussions that surrounded USAID's founding in 1961, was permanently impressed upon the agency by the Johnson administration's decision to harness it to the war-winning effort. The development programs that emerged in the field in response to these pressures—refugee relief, relocation projects, pacification programs, and the like—were not, in fact, meant to be judged by economic criteria. Severing the link between living standards of local populations and the productive capacities of their economies had previously been regarded as a matter of enormous practical and moral hazard; during Vietnam, U.S. aid programs embraced the principle of such a separation, and sought to enforce it widely in practice.

Ironically, the new approach to development assistance applied in Vietnam was soon globalized by American critics of the war itself. By the early 1970s, the foreign aid budget was the battlefield for a sort of guerrilla war against the U.S. president by a Congress discontented with the course and conduct of his Southeast Asian policy. After repeated failures to obtain its requested foreign aid appropriations, the Nixon administration agreed to a congressional rewriting of the aid mandate in 1973. This was the "New Directions" legislation, which still remains in force. The New Directions language instructed USAID to focus its attention directly on the poorest of the poor: not only to reach them, but to "satisfy their basic needs and [enable them to] lead lives of decency, dignity, and hope."

This "Basic Human Needs Mandate," as it came to be known, not only authorized but seemingly required development policy to involve itself in the raising of local living standards through direct provision of goods and services—much as it had done in Vietnam. Though theoretical arguments were advanced to explain the contributions such activities would make toward the goal of self-sustaining development, the practical result was to mandate long-term relief programs for recipient populations. Perhaps significantly, the New Directions legislation did not require, or even urge, American development agencies to monitor the impact of recipient governments' policies and practices on the economies they supervised, even though that impact may have been of more than passing consequence to the circumstances of local populations (to say nothing of the most vulnerable elements within them).

With the lessons of Vietnam thus perversely codified into its new operating procedures, USAID commenced what may be described as an uninterrupted institutional decline. Financial resources, to be sure, were at the ready: America's bilateral grants for overseas development assistance nearly doubled in real terms between 1973 and 1989, and public support for relieving the intense distress of the world's poor, to judge by opinion polls, remained abidingly strong. But the institutions administering development aid seemed beset by a sort of malaise. Changes in institutional culture, though always hard to document, nevertheless seemed self-evident to many observers. Vietnam had taken its toll on the morale and reputation of USAID; no longer could that agency expect to attract the "best and brightest," or even to retain those it already employed. With the new Basic Human Needs Mandate, recipient (and, ineluctably, constituent) services had become much more important; policy evaluation, correspondingly less so. In its first decades, the American aid program had prided itself on the quality of the advice it could dispense. In the 1950s, these American advisers had included some of the most successful captains of industry; in the 1960s, some of the finest minds from academia were among their numbers. After New Directions, the participation of such people no longer seemed so necessary; in any event, their views and assessments ceased being solicited in a regular manner. Such signals from the top necessarily affected the rank and file as well.[12]

Although the Camp David Accords of 1978 called for substantial increases in American foreign aid allocations, they also occasioned a further diminution of the official capacity to administer development programs. By the late 1970s, it would have been unthinkable to submit the state of Israel to USAID's ministrations—and equally unthinkable that Israel would have agreed to the accords if USAID's services had been pressed on it as part of the bargain. The solution was to arrange for direct budgetary transfers from the U.S. Treasury to the Bank of Israel—completely circumventing the risk of advice, or visits, from USAID personnel. Cairo, for its part, came to be the site of a very large USAID mission, but its busy regimen of project selection, management, and review had all the trappings of a charade. American aid officials, for the most part, could not hope to trace the actual daily flows of the funds they transmitted (or the purposes these actually served) when their counterparts in recipient governments wished for them to be hidden. Moreover, Egyptian officials understood the simple truth that Washington had predetermined each year's aid authorization, and, that the local mission was obligated to release it in full. To interfere with the aid flows to Cairo, no matter how ill-advised local uses of those monies might be, would risk violating the Camp David understanding, and thereby possibly threaten the foundations of Israeli-Egyptian peace.

In barely three decades, American development aid programs, which had originally been based on the premise of strict conditionality, had become a vehicle for unconditional resource transfers. Within a decade of Camp David, in fact, unconditional transfers were the rule rather than the exception for American foreign assistance. By fiscal year 1989, according to USAID's own estimate, over 65 percent of its grants to developing countries were from a special fund allocated expressly for political purposes, and authorization levels for particular countries were "restricted," or predetermined, for all but 2 percent of those monies.[13]

Given Ronald Reagan's rhetoric, his 1980 electoral victory might have been expected to presage far-reaching changes for the U.S. aid program. In fact, however, the Reagan administration did little to alter the substance or direction of development assistance programs. (His administration's two greatest interventions into existing operations—its cutoff of the annual $50 million bequest to the United Nations Population Fund (UNFPA) and its establishment of a tiny private enterprise office within the huge USAID apparatus—may be fairly described as minor.)[14] Whatever the reasons for this paradox, its consequences were clear. The capacity for, and even interest in, imposing conditionality on flows of development assistance did not recover. The sorry state of conditionality, in turn, brought "graduations" of recipient countries from the U.S. aid program to a virtual end—despite the fact that graduation, by its very nature, is one of the criteria by which the success of policies designed to promote self-sustaining economic development can be readily measured. In the 1960s, USAID could boast of such graduates as Taiwan and South Korea. In the 1970s and 1980s, its few graduates included Vietnam, Cambodia, Laos, and (for a time) Nicaragua. The circumstances of departure for these latter graduates, one may note, had less to do with their economic health than with their new governments' attitudes toward America.

In 1989, an unusually frank report by USAID acknowledged these and other problems. According to the study (known as the Woods Report, after Tighe Woods, the administrator who commissioned it):

> Somewhere between 1949 and the present, the original concept of development assistance as a transitional means of helping developing countries meet their own needs has been lost. . . . All too often, dependency seems to have won out over development. . . . Only a handful of countries that started receiving U.S. assistance in the 1950s and 1960s has ever graduated from dependent status. . . .

> Where development has worked, and is working, the key has been economic growth. And this is largely the result of individual nations making the right policy choices. . . . A strong, expanding American economy, a healthy trade climate, and the development assistance provided by profit-based and nonprofit private organizations are also critical elements. Direct U.S. development assistance, overall, has played a secondary role. . . . Radically reshaping future official assistance programs . . . must be both an immediate concern and a major long-term national priority.[15]

What of the role of American aid in fostering political reforms in recipient countries? Long-term receipt of American development assistance has certainly not prevented a transition toward a more open and participatory political order, as events in much of Latin America and the Caribbean in the 1980s attested. Similar transitions, however, took place in Latin American countries that did not enjoy U.S. economic aid at that time. Moreover, political tendencies among long-term recipients in other regions during the same decade were not characterized by corresponding liberalizations.

Unfortunately, the bilateral programs' economic record over the past generation seems fairly uniform, and the factors accounting for that performance look to be reasonably clear. At this juncture, an East European government seeking assistance (rather than simply cash) from America's existing aid apparatus might be judged as engaging in a singular act of faith, for there is little to suggest that these programs presently contribute to economic liberalization or development, and there is considerable evidence to the contrary.

Foreign Aid "Success Stories"

The record of America's postwar international economic policy is hardly one of unremitting failure. Quite the contrary: the postwar international framework that the United States helped to fashion and support is surely one of the more extraordinary successes in the history of international relations; indeed, it is one of the few systems whose success may have exceeded the hopes of its creators.

Moreover, specific American interventions are widely viewed as having spurred development in particularly troubled or unpromising locales. American assistance, for example, is today commonly described as instrumental to the postwar recoveries and expansions in Western Europe and Japan, and later in the dynamic growth of such "newly industrializing economies" as Taiwan and South Korea. Advocates of aid initiatives for Eastern Europe sometimes make their case by broad analogy with these generally earlier experiences. (The more sophisticated variant of the argument acknowledges some present shortcomings in the development assistance process, but suggests that local conditions in Eastern Europe are sufficiently propitious that the region may avoid the difficulties now characteristic of programs elsewhere.)[16]

We shall examine some of these conditions in Eastern Europe itself in a moment. First, however, let us look at some of the particulars of the success stories ascribed to American economic development policy. How pertinent are they to development assistance programs as we know them today?

Western Europe

Like the words "democracy" and "free enterprise," "the Marshall Plan" is a phrase that evokes a warm and favorable reaction from many audiences. Its popularity, in fact, is indicated by the very frequency with which it is used to describe new proposed programs of domestic or international public spending. But while the plan is often invoked in discussions of development aid, knowledge of its actual objectives, applications, and results are strangely lacking.

As its official name—the European Recovery Program (ERP)—reminds us, the Marshall Plan's aim was to restore devastated economies. The stated objective was to help Western European recipients reattain prewar levels of output. Although two decades of brisk and virtually uninterrupted economic expansion came on the heels of the plan, the ERP itself was not designed to foment "self-sustained growth." Quite simply, it was not a program for "development." Specific aspects of the Marshall Plan, moreover, raise questions about its actual contribution to the recovery.

Under Nazi occupation, the vanquished economies of Europe had been brought under a comprehensive system of controls, through which they were to be harnessed into the German war effort.[17] After World War II, some of these controls stayed in place in most of the liberated economies. Moreover, the ECA (the American apparatus within the ERP) actually required recipient states to engage in economic planning in order to obtain their aid. Needless to say, this approach did not discourage statist impulses on the part of beneficiary governments. At the time, the governments of Western Europe embraced a variety of economic philosophies; naturally, reactions were not uniform. In more than one country, ECA aid was used to postpone rather than hasten economic adjustments or privatizations, while in Italy, there actually emerged the spectacle of a government struggling—against the wishes of its ECA financiers—to pursue a liberal economic program!

In its first two years, moreover, the Marshall Plan established a complex system of bilateral drawing rights among recipients of Marshall Plan aid. The result of this "Little Marshall Plan" (as it was called) was to subsidize governments with overvalued currencies and large trade deficits and to penalize governments that attempted to maintain discipline in their accounts. Ludwig Erhard, West Germany's minister for economic affairs from 1949 to 1963, once estimated that Belgium lost four-fifths of its dollar aid in the first years of the Marshall Plan due to these perverse incentives.[18]

Erhard's general assessment of the plan is worth recalling, not least because he was so closely and completely involved in the West German *Wirtschaftswunder*. While making clear his gratitude for American generosity, he also pointed to some unintended consequences of the early Marshall Plan aid:

> Countries whose policy was nationalistic, or pursued camouflaged or open inflation, used the Little Marshall Plan simply as a welcome subsidy. Thus the Marshall Plan proper was abused to provide a premium on nationalism rather than to favor a healthy international

> market economy and international cooperation. . . . The aim was to assist difficult payments positions in order to eliminate them for the future: but in fact the crisis risked being perpetuated rather than eliminated.[19]

More recent scholarship has affirmed Erhard's assessment. In recent years scholars have approached the Marshall Plan from widely divergent philosophical perspectives, yet they have been drawn toward very similar conclusions. According to such reassessments, the ERP's contribution to European recovery may have been more complex and less dramatic than is commonly assumed today.[20]

This is not to say that American aid was inconsequential to the West European economic recovery and subsequent boom. To the contrary: the United States played an important, even decisive, role in these events, although precisely how it did so is not always understood or appreciated today.

Two U.S. interventions require special mention. The first was the American security guarantee that was provided to Western Europe, initially through the informal "Pax Americana" of 1945 to 1949, and thereafter through the formal obligations of the North Atlantic Treaty Organization (NATO). America's political and military commitment to the West European regimes instilled them with a quality they would otherwise have manifestly lacked: credibility. That credibility conduced to stability, and it promoted business confidence not only within the localities in question, but on the part of foreign investors as well.

Second, the Marshall Plan gave a belated push to European integration—that is, to economic liberalization. Alongside the founding of NATO came the organization of the European Payments Union (EPU). The EPU laid the basis for currency convertibility among its members (although full convertibility was to come only later). In so doing, it also generated competitive pressures for the reduction of trade barriers and tariffs among its members. In retrospect, the EPU can be seen as having paved the way for the specialization that helped to propel the postwar economic advance of Western Europe. But even at the time, contemporary observers counted the EPU as one of the Marshall Plan's most important accomplishments[21]—no less important, perhaps, in that it helped to undo some of the work that the plan itself had originally financed.

Japan

The U.S. occupation of Japan—"Japan's American interlude," as one scholar has described it[22]—lasted from August 1945 until April 1952. Accustomed as we have become to Japanese prosperity, it may be difficult to remember just how hard-pressed the country was during those years. At the end of the U.S. occupation, Japanese economic conditions seemed favorable only in comparison to the catastrophic year following the unconditional surrender. In 1951, industrial output was still significantly below its 1937 levels. Foreign trade did not reattain its prewar volumes until the mid-1950s—well after the occupation was concluded. By almost any economic measure, Japan's postwar recovery was slower than that of Western Europe.

Between mid-1945 and mid-1950, the United States extended considerable financial assistance to Japan. Under the program known as GARIOA (Government and Relief in Occupied Areas), total transfers during that period exceeded $1.8 billion (or between $7 billion and $8 billion in today's dollars). None of this aid, however, was earmarked for "development," and only a portion of it was allocated to the tasks of reconstruction. Much of this aid went directly to relief, in an effort to prevent widespread starvation through direct handouts or by provision of supplies to make-work industries. On this regimen of relief, recuperation was halting; as late as 1949, the official index of manufacturing activity was at barely half its 1937 level.

Relief-oriented aid was only part of what was hurting the economy. Allied officials were, for several years, ambivalent about the prospect of a Japanese economic recovery. Their attention was instead concentrated upon imposing a radical political and social transformation upon the archipelago. As one observer commented, "Whatever the political and social merits of these measures, they certainly made no immediate contribution to economic recovery. Most of them actually impeded it. 'Punishment and Reform' is indeed an apt description of the first phase of the American policy."[23]

Recovery and expansion were facilitated, if not actually led, by a shift in Allied policy toward what Michio Morishima has called the "San Francisco regime" (after the site of the signing of Japan's 1951 peace treaty with most of its erstwhile enemies).[24] Regional events—including the collapse of the nationalist government in China and the communist surprise attack in Korea—had impressed policy makers in Washington with the importance of Japanese recovery.

In itself, the determination that the occupiers would not positively obstruct economic restoration was of course significant. As for interventions to encourage economic growth, the inadvertent played a role alongside the deliberate. The Korean War, for example, was a great windfall for the Japanese economy, insofar as it resulted in a regional trade boom and occasioned major infusions of U.S. capital into the domestic economy. America's subsequent designation of Japan as the principal forward base in its Asian security system, for its part, not only affected the intangible quantity of business confidence in the country, but brought very tangible economic benefits as well. In the five years after the outbreak of the Korean War, U.S. special procurement expenditures in Japan totaled $4 billion.[25] Other U.S. military activities had a further impact on the domestic economy. America's less accidental contribution came through what Jerome B. Cohen once called its "sponsorship" of Japan. In his recounting:

> After the signing of the peace treaty . . . , the United States government sponsored Japan's re-entry into world trade relationships, concluding reciprocal trade agreements with Japan, securing admission to the General Agreement on Tariffs and Trade, and using its own tariff concessions to other nations to secure favorable treatment for Japan. United States firms concluded a large number of technical assistance contracts with Japanese companies which enabled them to obtain the latest know-how, patents, copyrights, and machinery and equipment, as well as training for their technicians.

> The U.S. International Cooperation Agency [the precursor to US-AID] established a Productivity Center in Japan to help Japanese industries become more efficient and competitive.[26]

In short, the United States made it easier for Japan to undertake the outward-looking economic policy that its leaders already clearly wished to pursue.

Any account of the "American interlude" in Japan that neglected the political and social revolutions wrought by the occupiers would be critically incomplete. Indeed, many people in both Japan and the United States would argue that the occupation's principal accomplishment was to prepare the country for liberal democracy.

The American-written constitution that was presented to a defeated Japanese nation is still in force today. That very aspect of its authorship speaks to the exceptional circumstances under which Japan's political and social transition away from dictatorship was executed. Two contemporary observers put it well:

> The United States, as the occupying power, had practically absolute authority and control in Japan. . . . The United States was uniquely free to determine and expedite its policy. Japan was not divided into zones of occupation. . . . The Far Eastern Commission . . . in the main deferred to American leadership and supported the United States in the policy it pursued. [American policy in Japan] was the choice of the United States as exclusively as foreign policy can ever be the free choice of one country.[27]

The extraordinary nature of that situation should require no further emphasis. One may note, however, that despite America's nearly complete latitude in reshaping political structures and legal arrangements in Japan, a growing number of Western students of Japan today question the degree to which the country qualifies as an open society or a liberal order.[28] The debate about the openness of the modern Japanese order is unlikely to be concluded, much less resolved, any time soon. In itself, however, that debate may remind us of the limits that may be expected of policies to promote democratization—even under the most favorable auspices imaginable.

Korea and Taiwan

Unlike Japan and Western Europe, the Republic of China and Korea received significant amounts of American assistance expressly for the purposes of "development." Between 1949 and 1961 alone, USAID's predecessor organizations transferred over $1.2 billion to Taiwan and over $2 billion to Korea (sums that would be much higher if adjusted to their purchasing power in today's dollars). Thereafter, a remarkable economic boom ensued—and continued—in both countries. Between the early 1960s and the later 1980s, according to official statistics, real output per capita increased by a factor of over six in South Korea, and by still more in Taiwan. In their broad outlines, the experiences of these two countries would seem to present the strongest case for the positive potential of development assistance.

The case looks somewhat different, however, when it is examined more closely. During the period of maximum development assistance inflows, for example, South Korea's economic growth was unexceptional. Between 1953 and 1962, by one estimate, the South Korean gross national product (GNP) rose by 4 percent a year;[29] economic growth per capita would have been less than 1.5 percent a year by that reckoning. Remembering the potential for postwar recovery that still offered itself to Korea after 1953, the country's economic performance might fairly be described as poor during those years.

The phenomenon of indifferent growth in the face of massive inflows of aid was, inescapably, related to official policies. The government of President Syngman Rhee may have had many virtues, but it created a distorted and politicized economic environment that discouraged savings, investment, and trade, among other things. Students of the Korean economy have even described the Rhee policies as "aid-maximizing,"[30] in the sense that the South Korean government seemed willing to imperil its own economy to prove the need for the foreign bequests it wished to obtain.

Rapid economic growth commenced in South Korea in the

1960s, after the regime of President Park Chung Hee embraced an export-oriented regimen. The factors influencing that decision were diverse; not the least of them was surely Park's coup itself. But U.S. aid also figured in the shift, albeit not in a manner that is widely understood. In late 1962 American officials discreetly informed their Korean counterparts that U.S. economic aid would be cut back sharply in the coming years, and eventually curtailed. A dispatch in the *New York Times* several months later captures the flavor of the event:

> The United States has quietly decided to reduce economic assistance to South Korea, a country whose economy is heavily based on such assistance. The decision was taken considerably before the current political struggle between the military regime and civilian leaders. . . . Leading South Korean officials have been told privately to expect reduced aid. For months they declined to believe that Washington meant what it said, but now some of them believe it and, in the words of one American, are in a "dither" about it. . . . Any future government, civilian or military, will find the flow of United States grants thinner and more carefully controlled. Washington has decided it can no longer underwrite all the shortcomings of the South Korean economy.[31]

In the years before this unexpected announcement, U.S. economic assistance had accounted for as much as half of the South Korean government's official revenues.

Korean policy makers themselves have had little to say about the connection between the prospect of foreign aid reductions and the decision to pursue export-oriented growth. One study of the period, however, explained it in the following manner:

> With the collapse of the Syngman Rhee government in 1960 and the installation of a military government, economic policy clearly shifted from reconstruction and stabilization to a program of rapid industrialization based on exports. The shift of policy reflected the changed circumstances confronting the economy. . . . At the same time, the U.S. government announced that assistance would be terminated in the near future. Consequently, expanding exports seemed the soundest way of replacing the impending loss of

> foreign exchange, as well as of creating employment in the major urban centers.[32]

While South Korea's export-oriented strategy should by no means be seen as inevitable, the decision to reduce, and even terminate, development assistance appears to have contributed to the pressures that led to its triumph.

In Taiwan, circumstances were not as extreme, but the patterns were similar. Between 1953 and 1962, economic growth per capita in the Republic of China is thought to have been more rapid (roughly, 3.5 percent a year) than in Korea, but it also accelerated sharply after 1962. Just as in Korea, albeit at a somewhat earlier date, the Taiwanese government had been informed that American economic aid would be shut off; just as in Korea, the government subsequently embraced an outward-looking economic policy.

The impact of aid reductions on Taiwanese economic policy has been carefully recalled by K. T. Li, who, as a minister in the Nationalist (Kuomintang, or KMT) government, was long responsible for framing such policy.

> In anticipation of the termination of U.S. aid, serious efforts had been made by the government in 1959 to improve our investment climate. The promotion of exports was begun in earnest at about the same time, with the United States becoming an increasingly large buyer of our products. So, with the phase-out of the U.S. aid program in 1965, the donor–recipient relationship between our two countries was transformed with virtually no interruption to one of business partnership, based principally on trade and investment.[33]

One should not conclude that American aid was extraneous to the progress of these highly successful economies. Both countries faced very real military threats from communist rivals; the survival of neither Taiwan nor South Korea was a foregone conclusion. The American security commitment to both countries figured incalculably, but importantly, in their development. More than that, American military aid played a major role in their domestic economies. For although this fact is often overlooked, economic or development assistance accounted for only a minority of the grants the United

States extended to the governments in Taipei and Seoul. Most of the American aid was earmarked for military and security programs.

K. T. Li's reflections on the actual contributions of U.S. aid to his country are worth quoting in this regard:

> It is reasonable to assume that without the United States having made the commitment to support a strong Chinese armed forces to protect Taiwan, we could not now write about the successful development of the island. In at least that sense, aid was a necessary condition. Although it is less clear how necessary [economic] aid was after the mid-1950s, my feeling is that it certainly gave us a breathing space for shaping up and carrying out a policy of self-sustaining growth and provided a climate for outward-looking development.[34]

A parallel reading might be appropriate for Korea as well. For both Korea and Taiwan, America's political and military support preserved the possibility of rapid economic growth. Rapid development itself, however, seems to have been brought about, in part, by the systematic reduction of development assistance funding.

Circumstances in Eastern Europe

Reviewed as a group, the "success stories" of U.S. economic assistance programs do not seem to offer any immediate or obvious encouragement to those now contemplating new aid initiatives for Eastern Europe. Few of the components that figured decisively in those earlier successes are likely to be replicable today. It is no longer necessary to replicate many other components since they already exist.

For example, although the several states of Eastern Europe may or may not ultimately choose to join the NATO alliance, they are unlikely to require the sorts of security guarantees and military aid from the United States that Western Europe, Japan, Taiwan, and South Korea variously enjoyed. The very fact of their newfound independence from Soviet orbit only emphasizes the remoteness of that contingency; it is hard to imagine that these countries, long subjugated to a Soviet-style dictatorship, would now voluntarily invite the

United States or other governments to exercise temporary but complete mastery over their arrangements to fashion new constitutional or civil orders. The international trade and finance markets so vitally important to earlier U.S. aid success stories are already in place; they need no duplication for East European countries to avail themselves of them. As for terminating flows of development assistance, the United States is apparently no longer capable of conferring this potentially important benefit on recipient economies.

What about conditions in Eastern Europe itself? How might these inform the design of a potentially useful program of development assistance for the region? Can the nature of current problems, and opportunities, in these areas give us any insights into the prospective impact of such a program, assuming that it could in fact be formulated and implemented?

Here, a few broad observations must suffice. First and foremost, it may be misleading to think of Eastern Europe as a "region." "Eastern Europe" was defined, and indeed created, by the Soviet occupation that was common to the populations of these territories. With the passing of that episode, many of the differences that preceded the formation of Eastern Europe as a region are again more easily distinguished. The populations of the region differ in languages, religions, cultural heritages—even in their alphabets. They also differ in their political and legal traditions. There is no reason to expect that those differences will be erased in the near future, any more than they were under the common experience of occupation.

Second, political developments at the moment vary significantly from one state to the next. In Prague, the current minister of finance, Vaclav Klaus, is an avowed disciple of Milton Friedman; in Romania, by contrast, both polity and personnel are characterized by continuities between the old regime and the new. As one observer has commented, "The age of uniformity is over."[35] Naturally, this must be true as well of prospects for political liberalization and economic development.

Third, as one perhaps would expect of a newly liberated area, conditions are still evolving, and retain at least a degree of fluidity. In the months since the "gentle revolution," for example, Czechoslovakia has officially become the "Czech and Slovak Federative Republic"; the difference is more than a matter of semantics. Perhaps paradoxically, the volatility of the political landscape at the moment not only reduces the utility of a detailed focus on current events (such as proposed or pending measures for policy reform) but it also limits the ability to generalize about problems and opportunities.

In a sense, however, the diversity and fluidity of conditions in Eastern Europe today are boons rather than hindrances to analysis, for they serve to emphasize the economic and political problems that are most central to the prospects for these populations.

At the moment, two obstacles to economic and political development in the region seem to stand out above all others. Though they affect each country in a somewhat different measure, they are common to them all. Moreover, they are sufficiently serious as constraints that they may indefinitely postpone the reunion of these countries with the rest of Europe, both economically and politically, if they are not relieved. Not surprisingly, both obstacles devolve from the region's "Soviet interlude."

The first, and arguably most important, is the pervasive institutional maladaptation that communist rule occasioned. Such maladjustment, unfortunately, goes beyond even the irrational process of central economic planning and the cumbersome, expensive system of socialist enterprise management (though these are also its legacy). In their exercise of power, the socialist rulers of Eastern Europe spent more than four decades destroying the institutional framework for a civil order in these countries. Their war against the civil order was not only understandable, but necessary, for the totalitarian claim upon society is absolute, and any doctrine or arrangement which recognizes the realm of the private, or implies the propriety of limited government, must automatically be its enemy.

To a significant degree, Eastern Europe's communists succeeded in their quest to destroy the institutions of the civil order and to replace them with their own. Their accomplishment may have mattered less for its distortion of economic structures than in its perversion of the law. "Socialist legality" came to dominate the rules and thus the workings of everyday life. The phrase, of course, is a contradiction in terms. Devised to ratify the socialist state's completely unrestricted exercise of power, the norms of this legal order were necessarily arbitrary, provisional, and subordinated to politics.

Anders Aslund has detailed what he calls the "legal degeneration" that colored the environment in which Eastern Europe's private enterprises struggled to survive.[36] The attack against the legal system, however, was even broader than Aslund's specific critique might be taken to suggest. It was not only the framework of property rights, and individual rights, that came under assault, but the very rule of law itself. In liquidating the "bourgeois state," Soviet-style communism undermined the foundations of the *Rechtsstaat* (a state governed by the rule of law).

The political implications of the demise of the *Rechtsstaat* should be clear enough.[37] Scarcely less important, though, are its economic implications. Economic historians of widely different outlooks, such as Douglass North and Nathan Rosenberg, have argued that the "rise of the Western world"[38]—the story of "how the West grew rich"[39]—was directly and inextricably linked to the new institutional arrangements it developed. In their accounts, perhaps none of those arrangements was more important than the framework of legal protections for individuals, which included the right of enforceable private contracts.

Though this legal and institutional framework emerged from what is widely called the "European tradition," the populations of Eastern Europe have been separated from the tradition for more than four decades. In each of the countries of Eastern Europe today, in fact, the majority of the local population has no memory of firsthand exposure to this tradition, to say nothing of personal familiarity with it.

The disrepair of this tradition suggests that the institutional obstacles to Eastern Europe's development are very much greater than would seem to be implied by today's intense discussions about, and proposals for, "privatization" of state-owned enterprises. Disendowing the states of the assets they have taken for themselves and now claim to own, will, to be sure, be an immense task. Over the course of Margaret Thatcher's eleven-year tenure as prime minister, the British government succeeded in transferring something less than 5 percent of the United Kingdom's output from government ownership back to private hands; in Eastern Europe, the privatizations now contemplated are at least an order of magnitude greater.[40] These are ambitious undertakings—but how much more ambitious appears the task of establishing a permanent, legitimate arrangement for the protection of individual rights and the enforcement of private contracts!

Institutional development is not the only enormous obstacle to development in Eastern Europe. Poland, Romania, Czechoslovakia, Bulgaria, and eastern Germany are also beset by what might be described a crisis of "human capital." This imprecise but evocative term refers to the ineluctably human factors in the production process that can be purposely augmented—or, alternatively, depleted.

Perhaps the most telling evidence of the decline of human capital among the populations of Eastern Europe has been the long-term deterioration of health conditions evidenced in both the USSR and its former satellites. That deterioration can be described in many ways, but it is represented very clearly in the local patterns of mortality. Between the mid-1960s and the mid-1980s, age-standardized death rates in the USSR and Soviet-occupied Europe actually rose.[41] (No other region of the world reported such a trend, and, in fact, no other industrialized countries have ever experienced such a general and long-term decline in public health during peacetime.) By the late 1980s—more recent figures are not yet available— Eastern Europe's age-standardized death rates, which had been similar to those in Western Europe only a generation earlier, were on average about 30 percent higher. By the late 1980s, Eastern Europe's lowest death rates (East Germany) were substantially higher than Western Europe's highest ones (Ireland). Eastern European death rates, on the whole, were also higher in the late 1980s than those reported for such Latin American societies as Argentina, Chile, and even Mexico.[42]

One need not posit a tight, mechanistic relationship between levels of health and levels of output to appreciate the significance of these differentials. By its very nature, rising mortality imposes constraints upon the productive capacities of the societies affected. Moreover, because rising mortality trends are so anomalous in the modern era, they suggest the possibility that other, more poorly measured aspects of human capital may also have been affected by the same cause.

Institutional maladaptation and the decay of the human capital (or at the very least, of significant components of it) may present all the more formidable impediments to development in Eastern Europe if these two problems prove to be closely connected rather than independent of one another. At the moment, there is little in the way of research to suggest that they are indeed organically related. It may, however, be more than sheer coincidence that these two problems should have emerged together under Soviet rule. An environment in which the augmentation and preservation of physical capital has proved so problematic, after all, may not be much more auspicious for the preservation of human capital.[43] If the problems besetting institutions and human capital are organically linked, redress might be all the more difficult; resolving the crisis of human capital, for example, might be impossible without first undoing the distortions in the local institutional structure. Even if these problems were entirely independent of one another, it is by no means evident that they should correct themselves simply by virtue of Eastern Europe's independence from the USSR.

Can American development assistance assist in relieving those obstacles to development in Eastern Europe? At the moment, it is very difficult to imagine how it would do so. USAID has no comparative advantage in helping to build the foundations of civil order; nor was it designed for helping to arrest mortality increases in industrial societies, or even for contributing to the preservation and augmentation of human capital in such places. Developing such capabilities, of course, would be beneficial, but the organization would need to start almost from scratch to do so.

What is true of the limitations of USAID applies more generally to the entire field of "development policy." That policy today is not obviously ready to engage the problems it will face in the post-Cold War world. Modern-day development economics has arguably advanced and refined a number of useful analytical tools, but their utility in surveying the terrain of a post-communist society is not currently apparent.

Under the best of circumstances, a conventionally trained "development economist" may offer helpful advice to the policy maker on how to "get prices right," or achieve balances in the macroeconomy, or devise realistic measures for stabilization. There is merit in such activities. For societies that were forced to march down the perverted path of Soviet-style socialism, however, these are hardly central to the problems at hand.[44]

Overcoming the legacy of the immediate past is likely to require bold and fundamental departures from existing practices and institutional arrangements in each of the countries of Eastern Europe. Respected local voices—Vaclav Klaus in Czechoslovakia, Janos Kornai in Hungary, Jan Winiecki in Poland, Ognian Pishev in Bulgaria, and many others—recognize as much, and urge immediate and decisive action. By contrast, Western development assistance policy makers are in the midst of a debate about the proper sequencing of the reforms they envision. By some arguments, privatization of state enterprises should not be attempted for years. The development of civil codes does not even figure consistently on the agenda.

The World Bank's recent (1990) recommendations to Poland illustrate the point. The bank urged the Polish government against undue speed in privatization:

> In recognition . . . of the fact that immediate privatization may not be advisable and/or feasible, the government needs to explore alternative forms of manager/ownership whose key objective would be to introduce greater competition and efficiency in resource use.

The bank spoke in favor of a similar caution toward capital markets:

> It would be important to lay the groundwork for a future capital market . . . so that . . . [it] could start functioning when price and other adjustments allow for an improved valuation of capital stock.

The bank advised against a " 'one-shot approach' [in which] all major adjustment measures would be implemented rapidly," warning that "the costs of the approach need to be carefully considered." Instead, it advocated as "most promising" a "third, intermediate approach" consisting of a "vigorous stabilization program complemented by an adjustment program phased over two to three years," and presumably by privatizations at some later date. The report did, however, conclude that its proposed "measures need to be supported by substantial foreign assistance"; indeed, it implies that Poland should be a recipient of various forms of Western financial aid on into the twenty-first century.[45]

In defense of such rarefied and even surreal deliberations, one may perhaps observe that they simply are not informed by that which seems obvious to local exponents of fast, radical transformations: the longer the transition to an independent, liberal order is delayed, the lower the ultimate chances of its success.

Concluding Remarks

The preceding sections may seem to paint a thoroughly bleak picture of the prospect for American, or Western, aid to Eastern Europe. However, the picture is not completely bleak. To the contrary: on at least two counts, there is reason for a certain cautious optimism about the impending aid initiatives.

The first has to do with the leadership in the East European countries concerned. Initial indications suggest that at least some of the officials who will be overseeing the receipt of development assistance will be very much wiser and braver than those dispensing it.

The September 1990 meeting of the Board of Governors of the World Bank and the International Monetary Fund was among the scenes to give a basis for such a hope. In his address to the gathering, Finance Minister Klaus of the Czech and Slovak Federative Republic announced, "We know that there have been cases where major financial assistance caused the deceleration, not the acceleration, of the necessary systemic changes that we consider of the utmost importance."[46] Though these were simple words, they were telling—for the highest officials at the World Bank and the IMF have been unable to utter them publicly, despite the tens of billions of dollars spent in loans for "policy reform" over the past decade and the obvious results associated with such lending.

The impact of aid depends critically upon the intentions of those who receive it, and put it to use. This basic fact raises the possibility that, in at least some East European locales, the consequences of development assistance may be more favorable than donors have any right to expect.

The second cause for a cautious optimism is somewhat more indelicate. For more than a generation, flows of development assistance have been directed exclusively to the brown-eyed populations of Africa, Asia, and Latin America. Today, with the advent of programs for Eastern Europe, some of these flows stand to affect the lives of a contingent with blue eyes and fair hair.

Will the United States, and other Western nations, apply existing development assistance policies to European populations with the same equanimity they have in other regions of the globe? Perhaps so. There is at least a chance, however, that the vestiges of barbaric nationalism, which has caused so much tragedy in our century, might inadvertently serve the universal good in this situation. The unhelpful consequences of assistance policies are perhaps more likely to touch the heart, or reach the ear, when meted on a population more like the majority in one's own country; the rethinking of the general practices and premises governing the disbursal of development assistance may therefore be a somewhat greater possibility. If the populations of Eastern Europe can prevail upon the bonds of seeming kinship to demand reform of an aid process that is unhelpful to them, but not to them alone, their travails may redound to the common benefit of others who struggle unheard under recipient governments.

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John Van Oudenaren

Comment

I would like to focus on the analogy between current or proposed aid efforts for Eastern Europe and the Marshall Plan, which even a rather skeptical Nick Eberstadt has characterized as a success. In doing so, I would like to broaden the discussion beyond the details of the plan itself and to look at the general question of West European recovery from World War II.

The Parallel

The Marshall Plan is often invoked by politicians and op-ed writers in discussions of East European recovery, and the comparison is frequently dismissed as misleading and irrelevant. The argument is made that Western Europe's recovery from wartime devastation is not really comparable to the task facing Eastern Europe, which involves questions of institutional maladaptation and the unprecedented problems of transition from socialism to market economy. My own view is that there are certain parallels between the two situations, and that the Marshall Plan analogy, while far from being exact, is closer than is sometimes suggested.

There is a tendency to exaggerate the physical destruction in Europe that resulted from World War II. In fact, statistics compiled by the Organization for Economic Cooperation and Development and the United Nations suggest that in many countries, for example, the United Kingdom and the neutrals, output and capital stock actually increased during World War II. Even in Germany, before its economic collapse late in the war, output was two-thirds higher than in 1936. On the other hand, the quality of the capital stock was poor. The technological gap with the United States had increased during the war, and much investment in Europe was devoted to import substitution rather than to developing new products and processes. Moreover, much of the capital stock was located in sites that were chosen for strategic rather than economic reasons.[1] These factors suggest a certain parallel with Eastern Europe, which emerged from the Cold War with historically high levels of output, but whose capital stock is old by world standards and has been developed in accordance with political rather than economic criteria.

To the extent that there was significant physical devastation in Western Europe after World War II, much of it was concentrated in the transport sector, which again suggests a broad parallel with Eastern Europe today, where many of the most severe problems are attributable to underdeveloped or poorly planned and maintained national infrastructures. Other similarities between Eastern Europe today and Western Europe in the late 1940s include the breakdown of regional trade, shortages of raw materials, large external debts, and the loss or nonexistence of external assets.

Just as there is a tendency in some of the literature to exaggerate the physical destruction of Western Europe in the 1940s, there is a tendency to underestimate the political, cultural, and bureaucratic obstacles to its economic recovery—obstacles that are at least somewhat analogous to those facing Eastern Europe today. Western Europe in 1945 did not face the task of throwing off four decades of

Marxist–Leninist economics, but its societies and political systems were by no means conducive to entrepreneurship, innovation, and technological change, as was acknowledged by such different modernizers as Charles de Gaulle and Jean Monnet.[2]

Other similarities between Western Europe in the 1940s and Eastern Europe today include political uncertainty, the residue of bitterness and distrust directed at those seen as collaborators with the old regime, and the existence of an extremely powerful external model—the United States in the 1940s, the European Community today—that is perhaps not well understood but that stands as an example of wealth and efficiency whose approval is sought and that is seen as worthy of emulation.

The Marshall Plan

Any discussion of the Marshall Plan and its possible relevance for Eastern Europe today must take account not only of contemporary and traditional historical treatments of the plan, but also of the "revisionist" and "neorevisionist" analyses of the 1980s that are based on extensive use of archival materials.[3] Much of this literature reflects the familiar tendency of historians to go overboard in debunking conventional wisdom, and some of it appears motivated by a thinly disguised political agenda—namely, the retrospective minimization of the U.S. role in Western Europe's recovery from World War II, and in its subsequent prosperity and political stability. In addition, this literature seems to overlook two factors that loomed very large in contemporary thinking: the psychological uncertainty engendered by defeat and the perceived Soviet and internal communist menace (and hence the political and psychological need for a decisive American response), and the situation in Germany, where the politics were especially unsettled and where there was far less evidence of economic recovery to prewar levels. Nonetheless, the literature does offer certain insights into the situation in the late 1940s that are relevant to Eastern Europe's current situation.

Alan Milward, in *The Reconstruction of Western Europe* (1984), makes the argument that by mid-1947—before Marshall Plan aid began to flow—Western Europe was in the midst of a substantial economic recovery. Except in Germany, there was not the widespread economic disarray that is often suggested. A consequence of this recovery, however, was a severe balance-of-payments crisis, caused by continued high demand for imports of capital goods from the United States. The main contribution of the Marshall Plan was to allow the capital goods imports and investment boom to continue, and thus lay the groundwork for the sustained boom of 1948–1974.

Milward also argued that Marshall Plan aid was not in fact important enough to give the United States sufficient leverage to reconstruct Western Europe according to its own wishes, and that this was reflected in the pattern of postwar economic cooperation. The United States had emerged from World War II committed to a liberal economic order built around the General Agreement on Tariffs and Trade (GATT) and the Bretton Woods institutions. In Milward's opinion, however, Western Europe's payments crisis, combined with politically motivated resistance from European governments and bureaucracies, destroyed the Bretton Woods agreements almost at birth. What emerged in their place was a second-best alternative based on the European Coal and Steel Community and the European Payments Union, both of which served the cause of economic recovery, but whose establishment represented at least a partial retreat from the liberal principles that the United States championed in 1945.[4]

Whatever the intentions of policy makers on both sides of the Atlantic, their actions produced circumstances conducive to rapid and sustained economic growth. This healthy economic climate included high rates of investment in both the public and private sectors. High rates of investment were made possible in part by infusions of capital from the United States, but much investment was self-financed. Self-financing, in turn, was facilitated by government policies that depressed private consumption. Even though production in many European countries reached prewar levels by 1947, total consumption per capita did not reach prewar levels until 1949 in France, 1952 in Germany, and the early 1950s in some other countries. Population growth, loss of overseas assets, and higher defense spending partly caused the lag between the recovery in production and a full return to prewar levels of consumption, but proinvestment policies contributed to this situation as well.[5]

Another feature of Western Europe in the 1940s that emerges from both the traditional and the revisionist literatures is the large and indeed growing role of governments in economic recovery. In many countries, much of industry was nationalized. This was particularly the case with capital-intensive industries, whose investment policy it was thought desirable to place under public control. Public investment was high, and national bureaucracies engaged in a large amount of what was called "indicative planning." This model of economic development reached its limits by the early 1970s and contributed to the "Eurosclerosis" of the 1980s, but it is generally credited with having helped Western Europe to recover from World War II and to embark on the path toward economic integration.

In addition to high public and private investment, West European economic recovery benefited from an emerging pattern of intraregional trade and economic cooperation. Early steps in this direction included the internationalization of the Ruhr, French access to the Saar, the formation of the Benelux customs union, and eventually the establishment of the European Coal and Steel Community. These steps were taken partly for political reasons, and their economic effects were sometimes resisted by businesses and national bureaucracies. Nonetheless, they did help to stimulate intra-European trade and lay the groundwork for the formation of the European Economic Community in the 1950s.

Eastern Europe

In discussing the prospects for economic recovery in Eastern Europe, it is useful to examine whether or to what extent the conditions for recovery that applied to Western Europe in the late 1940s are present today, and what role might or might not be played by Marshall Plan–like aid. This is not to say that a replication of the experience of the 1940s is the only path to sustained economic recovery, but it is one possible path, and as such should be taken seriously.

As has been noted, there are important parallels between Eastern Europe's economic and political circumstances today and those of Western Europe in the 1940s. On balance, however, there are at least three reasons why it is doubtful that many of the remedies that proved effective in the 1940s can be applied today.

First, in Eastern Europe the conditions for sustained levels of high investment are probably lacking. For political reasons nearly all the region's governments are interested in ensuring that their people see at least some quick payoffs from the overthrow of communism and the adoption of market systems. Governments thus have very limited latitude for pursuing policies that promote the self-financing of investments. Unlike Western Europe in the 1940s, whose model of economic prosperity was across the Atlantic and only a relatively small number of whose people had the option of emigrating, Eastern Europe today is next door to its model, the European Community, and prolonged depressed levels of consumption could set off waves of emigration or social tension.

Second, in Eastern Europe (and to some extent elsewhere as well) the role of government in economic recovery and planning has been discredited. It will be more difficult, therefore, to develop national strategies for investment priorities, as was done in the 1940s.

Third, there is little prospect of promoting economic development through intraregional arrangements such as the European Coal and Steel Community or the European Payments Union. All of the countries of the region are focused on getting into the European Community as fast as possible, and they have shown little interest in regional cooperation schemes that they fear may permanently consign them to the periphery of Western Europe. Hungary, Czechoslovakia, and Poland have expressed political solidarity with each other, but in the economic sphere they have tended to compete to be "first in line" for EC admission or to establish preferential economic relations with the Federal Republic of Germany.

Finally, there is some reason to question whether the West European nations of today will be able to play a role in Eastern Europe analogous to that the United States played in Western Europe in the 1940s. As has been seen, in the late 1940s and into the 1950s the United States not only provided aid to Western Europe, it also tolerated and even encouraged the formation of intra-European trade and financial arrangements that tended to discriminate against imports from the United States and the entire dollar area. These measures helped to speed Western Europe's recovery and to turn the dollar deficit of the 1940s into the surpluses of the early 1960s. Although the EC is moving to dismantle many of its barriers to imports from Eastern Europe, it is still a long way from countenancing positive discrimination against its own exports. Indeed, the very concept is alien to West European thinking, and perhaps nowhere more so than in Germany, where the national discussion of economic issues is dominated by Germany's self-image as *Exportweltmeister*. Prospects for export-led recovery thus are uncertain, which in turn will help to depress investment in Eastern Europe.

Conclusions

For the reasons suggested above, it appears that the Marshall Plan analogy, while not inherently inappropriate for Eastern Europe's current situation, probably cannot provide a guidepost for the economic development of the region. Although the underlying conditions in Western Europe in the 1940s are perhaps more similar to those in Eastern Europe today than is often suggested, political and economic conditions in the outside world are not conducive to a repeat of the Marshall Plan experience. This suggests that while policy makers can still learn selectively from Western Europe in the 1940s, they will also have to look to different models—perhaps East Asia or southern Europe—as well as develop entirely new paths to the economic development of the region.

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PART III

PLURALISM AND DEMOCRACY

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4 *Graham Allison and Robert Beschel*

Can the United States Promote Democracy?

This essay addresses one principal question: Is it *possible* for the United States to promote democracy and political pluralism? Are there possible actions, programs, and policies to be undertaken—or avoided—that will advance democracy and pluralism abroad?

The law that authorizes U.S. spending to promote democracy in Eastern Europe in fact proposes even more ambitious objectives:

> The President should ensure that the assistance provided to Eastern European countries pursuant to this Act is designed . . . to contribute to the development of democratic institutions and pluralism characterized by: (a) the establishment of fully democratic and representative political systems based on free and fair elections, (b) effective recognition of fundamental liberties and individual freedoms, including freedom of speech, religion, and association, (c) termination of all laws and regulations which impede the operation of a free press and the formation of political parties, (d) creation of an independent judiciary, and (e) establishment of non-partisan military, security, and police forces.[1]

As this law has been passed by the U.S. Congress and signed by the president and is now being implemented by democratic governments, is this not the answer to our question? Can academicians do more than summarize initiatives on which the U.S. government, pursuant to this act, is now spending funds? If so, on the basis of what suprademocratic authority can such critics speak?

To bring the central question into sharper focus, it is necessary to be explicit about the lenses through which we view the evidence. *Operationally* the question appears straightforward enough, and the answer obvious. Viewed *historically*, one observes cycles of enthusiasm and self-confidence about the promotion of democracy. In the upswings, the answer seems clearly to be yes; on the downside, it appears certainly to be no. Through the lens of *theory*, the subject appears much more complicated. The theorists' conventional wisdom sounds a contrary note; their prevailing answer to the question is no or not much.

An Operational Perspective

When addressing the issue from an operational perspective, it is difficult to see how any informed observer could have serious doubts about the answer to the question. Is it an accident that the nations occupied by U.S. forces after World War II are now democracies? Consider also recent events in Nicaragua. Can anyone plausibly argue that diplomacy, in developing widespread support for democratic ground rules (by, among other things, making future economic assistance contingent upon compliance), direct support for opposition parties, and international supervision and observation of elections were not significant factors in producing both Violeta Chamorro's victory and the Ortega brothers' acquiescence to this result? Who doubts that America's stance, including various specific actions like the 1990 air force flyover of Manila, affected the enthusiasm of the Philippine military for a coup to oust a democratically elected president?

In a recent public speech, Secretary of State James Baker stated that the Bush administration has chosen a new centerpiece for American foreign policy in the era ahead. Baker presented the core of the new policy: "Beyond containment lies democracy. . . . Our new mission is the promotion and consolidation of democracy."[2] Thus, senior U.S. officials argue not only that it is possible for the United States government to promote democracy, but that the United States has contributed to the renaissance of democracy in Eastern Europe, Latin America, and Asia, and that the United States will continue to promote democracy in the future.

A Historical Perspective

Historians will remind us that such ambitions are less original than they sound. Who, they might ask, first said:

> (A) It is a glorious history our God has bestowed upon his chosen people; a history whose keynote was struck by the Liberty Bell; a history heroic with faith in our mission and our future. . . . Shall free institutions broaden their blessed reign as the children of liberty wax in strength, until the empire of our principles is established over the hearts of all mankind?

> (B) We shall fight for the things which we have always carried nearest to our hearts—for democracy, for the right of those who submit to authority to have a voice in their own governments, for the rights and liberties of small nations, for a universal dominion of right by such a concert of free peoples as shall bring peace and safety to all nations and make the world itself at last free. To such a task we can dedicate our lives and our fortunes, everything that we are and everything that we have, with the pride of those who know that the day has come when America is privileged to spend her blood and her might for the principles that gave her birth and happiness and peace which she has treasured.

> (C) At the present moment in world history nearly every nation must choose between alternative ways of life. . . . One way of life is based upon the will of the majority, and is distinguished by free institutions, representative government, free elections, guarantees of individual liberty, freedom of speech and religion, and freedom

from political oppression. . . . I believe that it must be the policy of the United States to support free peoples who are resisting attempted subjugation by armed minorities or by outside pressures.

(D) Our unfulfilled task is to demonstrate to the entire world that man's unsatisfied aspiration for economic progress and social justice can best be achieved by free men working within a framework of democratic institutions. If we can do this in our hemisphere, and for our own people, we may yet realize the prophecy of the great Mexican patriot, Benito Juarez, that "Democracy is the destiny of future humanity."

Quotation B is from Woodrow Wilson; C is from Harry Truman; and D is from John F. Kennedy. Quotation A is from Senator Albert Beveridge of Indiana (one of the leading proponents of American imperialism at the turn of the century).

Through the historian's lens, one discovers a recurring confidence among advocates in the inevitable progress of democratic expansion. From Tocqueville's judgment that American democracy was "a providential fact, that it is universal, it is lasting, it constantly eludes all human interference, and all events as well as all men contribute to its progress," to Lord James Bryce's conclusion that a "trend towards democracy now widely visible, is a natural trend, due to a general law of social progress," advocates have often proclaimed the irresistible expansion of democracy.[3]

Conversely, eras of optimism are followed by periods of pronounced pessimism regarding the future of democratic regimes, institutions, and values. In 1940, when England stood alone and the Battle of Britain was at its height, doubts about democracy's future were dominant. In the mid-1970s another crisis of confidence in democracy was fashionable. Willy Brandt offered the following assessment:

Western Europe has only twenty or thirty more years of democracy left in it; after that it will slide, engineless and rudderless, under the surrounding sea of dictatorship, and whether the dictation comes from a politburo or a junta will not make much difference.[4]

In 1975, a Trilateral Commission study expressed concern about the prospects for democracy in Europe, Japan, and the United States.

Today such pessimism appears odd. Current optimism about the spread of democracy, however, may be equally misplaced. The views of pundits on this subject often display more pronounced swings than the data supporting such views would warrant. Judgments about the viability of democracy appear to be shaped by presumptions and assumptions as much as by systematic analysis.

A number of historical studies are discovering cycles in the development of democracy. One of the most penetrating students of the subject, Samuel P. Huntington, identifies four phases in the emergence of modern democratic regimes: (1) 1820–1920, when democracy spread from the United States to northern and western Europe, some British dominions, and a few countries in Latin America; (2) 1920–1942, when democratic trends were snuffed out in Germany, Italy, Austria, Poland, the Baltic states, Spain, Portugal, Greece, Argentina, Brazil, and Japan; (3) 1945–1950, when democracy expanded as a consequence of U.S. imposition of democracy on West Germany, Austria, Italy, and Japan, combined with decolonization, during which many newly independent countries adopted the political forms of the imperial powers; (4) the early 1950s through the early 1980s, which, unlike earlier periods, exhibited an oscillation rather than a dominant trend. Huntington notes:

> The number of democratic regimes seemed to expand in the 1950s and the early 1960s, to shrink in the mid-late 1960s and early 1970s, and then to expand again in the late 1970s and early 1980s. Overall, however, the net record of change in the state of democracy in the world was not very great.[5]

In a manner reminiscent of chartists (stock market analysts, not English political reformers), Huntington notes a remarkable constancy in the percentage of the world's population living in free states (as so classified by Freedom House). This proportion stood at 32 percent in 1973, after which—except for India's two years of emergency rule—it never rose above 37 percent and never fell below 35 percent. At the time of his writing in January 1984, the figure stood at 36 percent, exactly where it had been ten years earlier. Huntington's reading of these cycles contributes to his conclusion that "in the absence of major discontinuities in current trends, a significant increase in the number of democratic regimes in the world is unlikely."[6]

Even after the democratic revolutions of 1989, the majority of the world's population still lives in regimes that are either partly or wholly nondemocratic. According to Freedom House's publication *Freedom in the World: 1989–1990*, the percentage of the world's population living under democratic rule stood at 38 percent in January 1990. If the newly democratic countries of Eastern and central Europe are included, it would only raise this total to 41 percent.[7]

Such figures understate the degree to which democratic values and institutions have increased during the past decade. Examined on a regional basis, democracy has made marked advances in Europe, Latin America, and Asia. This expansion has taken place primarily among the wealthier nations. Of the countries the World Bank classifies as "High Income Economies," 74 percent are democracies. Conversely, 71 percent of the world's poorest nations have authoritarian or totalitarian forms of government.

A Theoretical Perspective

The shift from history to theory is yet more abrupt. Few subjects have consumed more man-hours of political science (and more trees) than debates about democracy. Arguments and counterarguments go back to the first half of the fifth century B.C., when the idea of direct self-rule emerged in the Athenian city-state. The concept's most notable critics, Plato and Aristotle, ultimately rejected Athenian democracy in favor of a republicanism that depended upon an essential aristocratic or oligarchic element.

Most of the dialogue since that time replays strands of the original debate, with the exception of a major eighteenth-century development that married the concept of democracy with that of representation. As Robert Dahl points out, "From classical Greece to the 17th century, the possibility that a legislature might properly consist not of the entire body of citizens but of their elected representatives remained mainly outside the theory and practice of democracy or republican government."[8] In *On the Social Contract*, Rousseau rejected representation as inconsistent with the idea of democracy.[9] Other thinkers, however, such as Montesquieu and Locke, had already begun to join the democratic notion of rule by the people with the practice of representation. John Stuart Mill cemented this relationship in the nineteenth century. Again to quote Dahl, "In his considerations on representative government, John Stuart Mill, stating in a single sentence what to him and his readers could be taken as a self-evident truth, dismissed the conventional wisdom of over two thousand years by rejecting the assumption that self-government necessarily required a unit small enough for the whole body of citizens to assemble."[10]

As representative democracy took root and flowered in the United States, both Americans and sympathetic Europeans, such as Tocqueville, celebrated this development.[11] After a century of slow but steady progress, Lord Bryce published his classic *Modern Democracies* projecting the inevitable spread of democracy. Its 1921 publication date coincided with the reversal of the previous century's trend.

Leading scholars of democracy today include Dahl, Huntington, Seymour Martin Lipset, and scores of other distinguished academicians. Their theoretical literature is both extensive and impressive. It is also complex; indeed, it tends toward even greater complexity than the phenomena it seeks to analyze. The literature is suggestive about possible causes, correlates, and conditions that contribute to the emergence and sustenance of democracy; but it is curiously unsatisfying for someone seeking to answer the action-oriented question that opened this paper. It provides little advice for would-be promoters of democracy aside from cautions about how little can be done.

We state this impression starkly, recognizing that it is open to the charge of being unfair. Indeed we hope that it will inspire—or provoke—one or more of these scholars to refute it. But to pursue our dominant impression, we offer the following, not unrepresentative, quotations from the conclusions of a number of these scholars.

Dahl sums up his inspiring, masterful, decades-long inquiry in a 1989 publication, *Democracy and Its Critics.* He writes: "That no more than a third of the countries in the world are governed by polyarchy [constitutional democracy] should not be surprising. It would be surprising, on the other hand, if the proportion were to change greatly over the next 20 years." To Lenin's question, *Chto delat?* (What is to be done?), Dahl answers: "When I reflect on the conditions favoring polyarchy, I am driven to the conclusion that the capacity of democratic countries to transform non-democratic regimes into stable polyarchies is very limited in the short run." Nonetheless, he concludes: "Yet democratic countries could make a difference in the long run, I think, if they steadily pursued a policy of supporting changes in the direction of democracy and discouraging changes away from it. . . . Democratic countries could aid in the democratization of non-democratic countries by steadily pursuing policies over many years that focus on changes in the underlying conditions that support stable polyarchy."[12] Thus to the central question of this essay, Dahl would offer a qualified yes. His book ends, however, without any enumeration of what actions might be taken.

Democracy has been a subject of study for Huntington for more than three decades. His oft-quoted 1984 article, "Will More Countries Become Democratic?" also asks, "What policies should governments, private institutions, and individuals espouse to encourage the spread of democracy?" As noted above, Huntington contends that "the prospects for the extension of democracy to other societies are not great." To Lenin's question, he first insists that only "modest conclusions . . . emerge from this review." He then answers, "The ability of the U.S. to affect the development of democracy elsewhere is limited." He does, however, identify several ways in which the United States could contribute to democratic development: (1) assisting economic development of poor countries; (2) encouraging developing countries to foster market economies and development of vigorous bourgeois classes; (3) refurbishing its own economic, military, and political power so as to exercise greater influence in world affairs; and (4) developing a "concerted program designed to encourage and to help the elites of countries entering the 'transition zone' to lead their countries in a more democratic direction."[13] Huntington's article, however, contains no specific suggestions about what such a concerted program might include.

Since the publication of *The Civic Culture: Political Attitudes and Democracy in Five Nations*, by Gabriel Almond and Sidney Verba, in 1965, there has been a steady growth of systematic, comparative studies of democracy. Among the most thorough is *Transitions from Authoritarian Rule: Prospects for Democracy*, a 1986 publication by Guillermo O'Donnell, Philippe C. Schmitter, and Laurence Whitehead. Their central conclusion relevant to our inquiry merits quotation at length. The authors write that they seek to

> capture the extraordinary uncertainty of the transition, with its numerous surprises and difficult dilemmas. . . . If we ever have the temerity to formulate a theory of such processes, it would have to be a chapter in a much larger inquiry into the problem of "underdetermined" social change, of large-scale transformations which occur when there are insufficient structural or behavioral parameters to guide and predict the outcome. Such a theory would include elements of accident and unpredictability, of crucial decisions taken in a hurry with very inadequate information, of actors facing irreconcilable ethical dilemmas and ideological confusions, of dramatic turning points reached and passed without an understanding of their future significance. In it the unexpected and the possible are as important as the usual and the probable.[14]

The most extensive comparative study, supervised by Larry Diamond, Juan Linz, and Seymour Martin Lipset, examines twenty-six developing countries in Asia, Africa, and Latin America. The overview of this study's findings appears in a 1990 publication, *Politics in Developing Countries: Comparing Experiences with Democracy*.[15] Three decades earlier, Lipset's *Political Man* pursued the search for necessary and perhaps sufficient conditions for democracy, emphasizing the link between economic development and the likelihood that a society is democratic. In one of the more famous propositions from this discussion, Lipset asserts, "The more well-to-do a nation, the greater the chances that it will sustain democracy."[16] The most recent study abandons the concept of "preconditions" and shifts instead to what the authors label "facilitating and obstructing factors" in democratic development. It discusses such factors under ten headings, one of which is "international factors." Although the authors "attribute the course of political development and regime change primarily to internal structures and actions," they recognize that internal structures have been "shaped historically by a variety of international factors." On the one hand, they caution that "the potential for democratic influence from the U.S. or other external actors should not be underestimated." In support of this claim they cite four examples: one positive, one negative, and two mixed. The Kennedy administration's bet on democracy in Venezuela was an "important supporting factor"; the Carter administration's human rights pressure on Argentina failed to force the withdrawal of the military, but nonetheless "saved many victims of indiscriminate repression in the late 1970s and was a factor in the international isolation of the military regime"; in Chile and South Korea, the U.S. role was mixed. They conclude that "at the current time, however, and no doubt in many previous decades, the most important international influences on the prospects for democracy in developing countries appear to be economic ones." The democratic consolidation in Eastern Europe will depend significantly on the "flexibility and vision" of the industrialized countries in dealing with the "critical issues of developing countries' debt and trade."[17]

These rough summaries of several examples from the literature of political science do not do justice to these authors, nor the many others who have addressed this subject. Their investigations of "preconditions" or factors that facilitate or obstruct democratic development provide a rich source of clues for present purposes. Nonetheless, we find it puzzling that, across the spectrum, students of democracy are almost unanimous in their skepticism or negativism about the U.S. promotion of democracy. A better understanding of this skepticism should be important for the purposes of this conference.

Questions About "Democracy"

Scholarly studies of democracy impart the inescapable complexity that surrounds the simple question with which we began. Legitimately, they "complexify" our inquiry by identifying more than a score of fundamental issues and questions, many of which are controversial. Such fundamental queries include:

What do we mean by "democracy"? Is democracy best understood as a phenomenon, or as an intellectual construct? Are there unambiguous criteria for distinguishing democracies from other forms of government?

The most thoughtful recent student of the subject, Robert Dahl, asserts that democracy becomes essentially an ideal, a political system that, if it could be perfected, would be completely or almost completely responsible to all its citizens. Dahl thus finds it useful to create a separate construct—which he labels polyarchy—for actual modern representative democracies with their attendant rights and institutions.[18]

For our limited purposes here we will essentially follow Joseph Schumpeter's definition of democracy, which, as Diamond, Linz, and Lipset note, requires three essential conditions:

> Meaningful and extensive *competition* among individuals and organized groups (especially political parties) for all effective positions of government power, at regular intervals excluding the use of force; a "highly inclusive" level of *political participation* in the selection of leaders and policies, at least through regular and fair elections, so that no major (adult) social group is excluded; and a level of *civil and political liberties*—freedom of expression, freedom of the press, freedom to form and join organizations—sufficient to ensure the integrity of political competition and participation.[19]

What is so great about democracy? To what "problem" is democracy the "solution"? Possible competing answers include: (1) the form of power sharing among individuals in an institution or state that is most likely to achieve their common purposes; (2) the form of power sharing among individuals in an institution or state that is most likely to empower and dignify the members of the institution; (3) the form of power sharing among individuals in an institution or state that is most likely to preclude the exercise of arbitrary authority; and (4) the worst form of power sharing and government for the purposes listed above—except for all the others.

For which kinds of associations, if not all, is democracy the best (or least bad) solution? Is democracy suited to national groups, nation-states, the world? What about business firms, or universities, or think tanks, or even conferences? If it is the best system for some of these associations and not others, why so?

Why should the United States be interested in "promoting democracy"? Is the principal objective national self-determination, or freedom for individuals, or what? Is our objective primarily intended to benefit others, or us? Are there significant international implications of the spread of democracy (for example, what of Kant's assertion that democracies are inherently more peaceful than authoritarian states)?

Are there "preconditions" for the establishment and maintenance of democracy, or just correlates or dispositions? Is a market economy a necessary condition for sustainable democracy? (All current democracies have market economies, although not all market economies are democracies.) Is a bourgeois class a necessary condition for democracy, as Charles Lindblom would suggest? Most authors assert that a widespread belief in the legitimacy of democratic institutions is a necessary condition. (For example, Dahl asserts, "The greater the belief within a country of the legitimacy of the institutions of polyarchy, the greater the chances for polyarchy.") But Huntington questions whether "the development of a pro-democratic political culture has to *precede* the development of democratic institutions."[20]

What about the interaction of politics and economics? When countries develop economically, do they enter what Huntington calls a "zone of transition or choice" about democracy that was previously unavailable to them?[21] Is the high correlation between levels of economic development and democracy just a correlation? Is there some level of economic development measured in income per capita that signals a higher probability of democracy? If so, did the threshold shift in the late twentieth century to a level significantly higher than it had occupied in the prior century, as Huntington suggests? Which way do the causal connections run?

How does the process of democratization relate to the probability of a stable democracy? Is bloodshed required, as Barrington Moore theorizes? Or is Dahl closer to the mark when he argues that stable democracies "are more likely to result from rather slow evolutionary overthrow of existing hegemonies"?[22] Is the stability of democracy more likely in cases in which the expansion of political competition precedes the expansion of participation, or vice versa? Is stable democracy more likely to evolve from stable authoritarian rule, or from regimes that oscillate between despotism and democracy?

Is political democracy a "natural condition of mankind"? That is, is democracy more consistent with fundamental human needs, aspirations, and inclinations than are authoritarian, oligarchical, or other forms of government?

These questions are both complex and challenging, and they warrant careful consideration. At this juncture, however, we will return to the operational question: Is it possible for the United States government and society to promote democracy?

"Dos" and "Don'ts" for Promoting Democracy

When we began to do research for this assignment, we expected to find an "agenda of actions" for promoting democracy in the literature. We are still looking. Because we have been unable to find someone else's list, we will continue where qualified students of the subject have hesitated to tread.

In an earlier volume on avoiding nuclear war, *Hawks, Doves, and Owls*, we developed a simplistic format for stating an agenda of actions in the form of specific "dos" and "don'ts" for reducing the risks of nuclear war.[23] Thus, for example, one of our ten "principles for avoiding nuclear war" states, "Obtain a credible conventional deterrent." Under this heading, we suggest a number of actions to take and to avoid: "DO strengthen NATO and the Rapid Deployment Force to levels in which it would not be necessary to threaten escalation to nuclear use to deter Soviet aggression"; and "DON'T pretend that nuclear weapons deter only nuclear war"—a fiction that was gaining currency in the early 1980s when the book was written. Shorn of qualifications and footnotes, this agenda was better received by politicians and officials than by academic colleagues. In retrospect, however, for all its limitations, we judge it useful.

Here we attempt to formulate the first draft of an agenda of actions for a government and society determined to promote democracy abroad. Assuming the U.S. government were to give high priority to promoting democracy, what could it do? Each "do" or "don't" presupposes, of course, an unspecified ceteris paribus clause. In a scholarly paper, each would be subject to many qualifications. As is true in any policy arena, moreover, specific initiatives may conflict with each other and with other national objectives. Trade-offs and hard choices are therefore necessary. These principles and injunctions identify guidelines for action. They provide starting presumptions or inclinations that must, at the moment of choice, be balanced against other objectives.

Here we will attempt to organize initiatives for promoting democracy under thirteen principles. Each principle identifies a cluster of factors that U.S. policy (governmental and societal) could promote, the presence of which would make sustainable democracies more probable, the absence of which would make them less so. Such factors cover the spectrum from macroconsiderations that may appear so obvious as to not arise in general discussion, to microconsiderations so particular that they have generally been dismissed.

The first five principles identify initiatives that seek to create an *external environment* favoring democracy. The second five focus on what might be called the *infrastructure of democracy* within states. A final three target *strategies for democratizing* individual nations. Under each principle we group illustrative measures that the U.S. government or other actors in the society might take or avoid. A given action, such as the transfer of the technological infrastructure of democracy, might enhance the prospects for democracy while simultaneously increasing the prospects of chaos that could lead to an authoritarian resurgence. Whether a given action should be taken or avoided in a specific instance depends on situational assessment of the *net* effect on the prospects of democracy, as well as the trade-offs between promoting democracy and other objectives.

Readers may disagree not only with the judgment stated here, but also with the selection of actions to be considered. This agenda is far from complete and could be expanded with additional measures at the same level of generality. Greater specificity under each "do" or "don't" could lengthen the list still further. Each principle clearly deserves discussion at far greater length than it will receive here. Our principal objective is to demonstrate that there are a host of actions that can be taken to promote democracy and to stimulate others to formulate more satisfactory agendas.

Create an External Environment Favoring Democracy

Demonstrate the superior performance of democratic societies. The democratic revolution of 1989 in Eastern Europe was more clearly a vote *against* a Marxist-Leninist system that failed (relative to the competition) than a vote *for* a democratic market economy. Consider what the likelihood of such developments would have been had Marxist-Leninist systems performed better than Western democracies in providing the things—or even one of the things—that people most want: economic well-being, individual freedom, political participation, security, and an interesting life. It is a happy but unappreciated coincidence in this era of democratic expansion that the reasons for preferring political and economic democracies to the alternatives included the relative success of democracy in providing all of these things. The rejection of communist-imposed socialism in Eastern Europe was thus not only a vote against tyranny, but simultaneously (and inseparably) a vote for, for example, bananas. People were answering the question put so effectively by Ronald Reagan in the 1980 presidential campaign: whether they were better off than they had been, or could be under a plausible alternative.

• DO make American industrial democracy a "shining city on a hill."

The United States has been the demonstration case for modern democracy. Its role as exemplar and promoter of democracy in the recent era, and in the period immediately ahead, is difficult to exaggerate. Consider the alternative: What would the world be like if the United States had not been a democratic society during the last century. Indeed, consider what the likely history of post-World War II democracies would have been had the United States not been the leading society, economically, scientifically, technically, and culturally, as well as politically. Now, consider the worldwide prospects for democracy if American society fails in the future. As the Marxists would have said, "It is no accident" that two-thirds of today's modern democracies served substantial apprenticeships under Britain or the United States.

The domestic agenda of "dos" and "don'ts" for making not only American democracy, but all the dimensions of American society, into a "shining city on a hill" is a lengthy subject, worthy of another paper. It stretches from a sane energy policy, including a tax on oil that would require consumers to pay its full cost (including a security and environmental premium), to an elimination of the federal budget deficit, increased incentives for savings, strengthened

American economic competitiveness, an overhauled criminal justice system, a restructuring of the public school system away from monopolies and toward choice, a dampening of the demand side of the drug trade, powerful disincentives for teenagers having babies, prevention of domestic damage to children, and discouragement of the glorification of violence, of pornography, and of the vulgarity of popular culture.

- DO promote the success of the "commonwealth of industrial democracies."[24]

Almost as important as the success of American society for the prospects for democracies elsewhere is the demonstration effect of America's allies in the commonwealth of industrial democracies, specifically Europe and Japan. The successful reconstruction of defeated authoritarian regimes in Germany, Japan, and Italy, and the rebuilding of Western Europe into a set of industrial democracies that together exhibit the features of the most dynamic and successful societies in the world, reinforces confidence and success throughout the commonwealth. This community of shared values, institutions, and practices thus becomes a model for other societies aspiring to any of these dimensions of success. It is difficult to envision the alternative, but imagine that Germany or Japan had emerged from World War II as a successful economy under a more authoritarian guardianship, along the lines of, for example, Singapore. The ideological Cold War, between the "free world" on the one hand and the communist centralized states on the other, bundled together elements such as democracy, market economy, scientific and technological leadership, dynamic culture, and modernism, perhaps more tightly than they would otherwise have been. The collapse of the communist contenders thus leaves but one cluster of institutions and practices standing. (To add a mischievous editorial aside, it leaves unoccupied space for yet another "third way" ideology that would combine elements of socialism and authoritarianism.)

A lengthy agenda of specific actions for promoting the success of the commonwealth of democracies stretches from sustaining revised security organizations like the North Atlantic Treaty Organization (NATO) to creating new arrangements for responsibility and burden sharing that allow participants both to "pay and say," to strengthening a free trade system in which our stakes are more than purely economic. The Final Act of the November 1990 Conference on Security and Cooperation in Europe meeting (CSCE) represented a clear vote for such an international democratic order. In this document, thirty-four nations, including the Soviet Union and the countries of Eastern Europe, pledged their commitment to the ideals of democracy and human rights.

• DON'T neglect the failures of American society.

One of the better political cartoons of 1990 begins with a frame that says, "In a stunning victory for democracy, Violeta Chamorro has been elected president of Nicaragua"; it is followed by a second frame that says, "While in Lithuania voters have thrown out the Communists"; the narrative proceeds to a third frame that says, "Uncle Sam continues to take a beating in world trade and Japan says we have only ourselves to blame"; the cartoon concludes, "And studies show that most American kids don't know where any of these places are." The unchallenged number-one society in the world is also number one among developed countries in consumption of drugs (including 50 percent of the world's cocaine), crime, infant mortality (a higher rate in the nation's capital than in Jamaica), adult illiteracy, international debt, unwillingness to save, pornography, and growth of an underclass—among other things. As George Will recently observed, "Nothing in Bangladesh should be as interesting to Americans as the fact that a boy born in Harlem today has a lower life expectancy than the boy born in Bangladesh."[25] The domestic agenda for actions addressing each of these problems and others would take us far afield. The effort to find remedies to these problems, however, is not irrelevant to the standing of American democracy, and thus it is not immaterial to the prospects of democracy worldwide.

Communicate the facts about the superior performance of democratic societies. Facts about superior performance are not enough; such facts must be communicated credibly, particularly to citizens in societies whose governments seek to prevent dissemination of such truths. Western experts have generally assumed that the public in closed societies possesses levels of knowledge and understanding that the East European revolutions belied. No one who witnessed the shock and disgust of East Europeans discovering supposedly well-known facts about the hospitals, hunting lodges, and hotels of their "priviligentsia," or their amazement at the extent of their relative poverty, should miss this point again.

- DO act in confidence that it is ideas, not vested interests, which are dangerous for good or ill.

As Keynes explained:

> The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas.[26]

The ideas and ideals reflected in superior performance should, therefore, be communicated.

- DO provide leaders of nondemocratic countries with direct experience with the facts of life in democratic societies.

Words are an important form of communication, but direct experience is even more persuasive. Boris Yeltsin illustrates the point vividly in his autobiography when he recounts his shattering first visit to an American supermarket. He relates: "When I saw those shelves crammed with hundreds, thousands of cans, cartons, and goods of every possible sort, for the first time I felt quite frankly sick with despair for the Soviet people. That such a potentially super rich country as ours has been brought to a state of such poverty! It is terrible to think of it."[27]

- DO broadcast the facts of democratic and nondemocratic life through publications, radio, television, and audio and video cassettes to the populations of nondemocratic countries in their languages, and in terms and comparisons meaningful to them.

Radio Liberty, Radio Free Europe, Television Marti, the British Broadcasting Corporation World Service, the Cable News Network, and international comparative statistics produced by various organizations provide facts that undermine nondemocratic fictions.

- DO provide more extended, direct experience in democratic societies for the emerging leadership in nondemocratic countries, particularly through education.

Again, Keynes observed that "in the field of economic and political philosophy there are not many that are influenced by new theories after they are twenty-five or thirty years of age."[28] For the limited spaces available for foreign students in universities, democratic societies should focus on emerging leadership, paying special attention to both the most talented young people and to the children of the current elites. As the leader of a nondemocratic Asian society once explained about students from his country who came to the Kennedy School at Harvard, he was very pleased with the analytic and managerial skills they acquired, but disturbed that they fell victim so readily to "Western democratic presumptions."

- DO encourage analyses by scholars and governmental officials in democratic and nondemocratic countries of objective indicators of society's performance: gross national product (GNP) per capita, health status including mortality and morbidity, education, housing, food, telephones, automobiles, televisions, videocassette recorders, and the like.

- DON'T accept arguments about the moral or practical equivalence of political systems.
- DON'T discourage individuals from nondemocratic societies from visiting other nondemocratic societies for direct experience. Central Intelligence Agency fears that African students training in Moscow would be infected with Marxist-Leninist ideas would, we suspect, be found to have been exaggerated, when compared to the disillusioning impact of facts.
- DON'T bore others with lectures about democracy's superiority, but do not apologize for democratic values or the (relative) performance of democracies.

Build an international security order favorable to democracy. In the aftermath of World War II, the United States sought to shape a type of international order in which American values and institutions could survive and prosper. Although the focus of America's Cold War strategy was the containment of Soviet communist expansion, it also called for the reconstruction of geopolitical centers of value as democratic, market-oriented allies. This strategy went beyond a recovery aimed only at restoring a world of balance-of-power politics. It was based on a broader vision of what would be required to create a genuine community of nations, as well as a deeper and more optimistic faith in the responsibility-building characteristics of democratic institutions and procedures. What became an alliance of industrial democracies was founded on a particular concept of international order. There was more than hubris and moralism in American efforts to reconstruct Europe and Japan as democracies. Postwar leaders saw a connection between freedom, democracy, and stability. The preference for market-oriented economies was also not just parochial, for postwar statesmen understood the symbiosis between capitalism and freedom.

This basic strategy has proved successful in providing more than four decades of peace to a European continent on which war was as normal as peace in the prior four centuries. Properly understood, this success should be a source of confidence as the strategy is extended into the post–Cold War era.

War and the threat of war pose a danger to democracies, young and old. Responses to security threats require the centralization of power and encourage authoritarian tendencies, while simultaneously raising the visibility and influence of the military in society. Radical historical reinterpretations after the fact stagger our limited imaginations. If one tries to imagine the likely history of democracies in Western Europe over the past four decades in the absence of adequate security arrangements, however, the interaction between security and the prospects for democracy becomes clearer. What would the prospects for East European democracies have been if German unification had not occurred within the framework of stable security arrangements? Similarly, a withdrawal of the American "security blanket" in Asia, should it come, would likely lead to security conflicts that would pose substantial risks to emergent democracies in the region.

- DO build upon the alliance of industrial democracies in fashioning a strategy for security in the aftermath of the Cold War.

Substantial revisions in basic alliance relations, such as NATO, the Japanese Peace Treaty, and others will be necessary. That process should begin, however, with the recognition that, at least for Americans, West Europeans, and Japanese, in the words of the beer commercial, "It just doesn't get any better than this." These alliances have provided a longer peace, more sustained economic growth, and greater freedom than any of the parties enjoyed under any earlier arrangement. Alliances such as NATO have always had positive goals beyond defending against the Soviet threat; those goals should be explained and extended. The U.S. government should project a vision of a peaceful international order, starting with the foundation of the alliance of industrial democracies and extending, as Kant originally imagined, in successive stages to a "widening pacific union" among the democracies of the world.

- DO organize institutional arrangements to provide for the security of the newly independent nations in Eastern and central Europe. Weak as it is, the CSCE framework may be the best prospect for protecting current borders, while providing a process for adjudicating peaceful changes.
- DO seek to institutionalize open societies, including the full spectrum of confidence and security-building measures (CSBMs) to minimize paranoia and the possibility of a government's conjuring up imaginary enemies.
- DO "discreetly" capitalize on victory in the Cold War to build cooperative relations with the Soviet Union. Address specific regional security issues and global issues like the proliferation of atomic, biological, and chemical weapons and missiles in ways that contribute to a more secure environment for democracies.
- DON'T follow the advice of balance-of-power realists to be indifferent about the domestic structures of other societies.

Build an international economic order favorable to democracy.

- DO continue to build upon, extend, and strengthen the international economic order that has emerged over the past four decades.

America's postwar strategy aimed to create an international economic system that would provide stable monetary relations, stimulate investment and trade, reward market-oriented economies, and thus promote expansion of the U.S. and world economies. The Bretton Woods institutions were an attempt to prevent occurrences such as the Great Depression, which created the conditions under which Hitler came to power. The International Monetary Fund (IMF), the World Bank, and the General Agreement on Tariffs and Trade (GATT) together created the institutional structure of an international economic system that promoted growth in the world economy. The Marshall Plan transferred more than 1 percent of U.S. GNP per year to reconstruct the economies of Western Europe (specifically including the defeated economies) as market-oriented democratic members of a security alliance. Similar support helped rebuild Japan.

The performance record of this international economic system is impressive. It has permitted the most rapid and sustained expansion of the world economy in history. Since 1950, annual world product has quintupled, to more than $20 trillion. The American standard of living has tripled. Growth has been most impressive in the market-oriented, democratic societies, and in their allies. Economic growth and interactions with the industrial democracies continue to create pressures for democratization, as in the case of South Korea. While the successful economic performance of a society does not guarantee democracy, failing economic performance almost certainly guarantees a failure of democracy.

- DO welcome new democratic market economies into appropriate status in the major international economic organizations as they meet required prerequisites. Assist them in making the transitions required for most-favored-nation (MFN) trade status, for membership in the IMF, World Bank, and GATT, and for participation in other institutions.
- DO nurture the free trade system, resist backsliding, and press for the expansion of its realm in the GATT Uruguay Round. Provide open markets for exports from newly established democratic countries, especially in the realm of agricultural products.
- DO seek to organize a strategy for major Western financial assistance to Eastern Europe, and to hold out a "carrot" for equivalent Soviet transitions.

- DO recognize the political as well as economic stakes in the post–Cold War process of realigning responsibility for the maintenance of the international economic system.
- DON'T imagine, or allow leaders of newly democratic countries to imagine, that any viable "third way" exists. It is a powerful and profound fact of history that all viable democracies have market economies. This is no accident.
- DON'T insist on any single model of a market economy. The United States, the United Kingdom, Germany, and Sweden are successful, but different, examples of market economies.
- DON'T imagine that the international economic system is self-maintaining. Is a significant subsidy to free riders inherent in such a system?

Build an international political order favorable to democracy. The political strand of America's Cold War strategy emphasized promoting democratic institutions and values, not just by example, but by actively building democratic societies elsewhere. It concentrated on the countries that mattered most to the United States. The bedrock of these political institutions are democratic values, and the strategy sought to build a community based upon shared values. These values, which the Declaration of Independence asserts are universal, include the freedom of individual citizens to order their political, economic, and cultural life and the principle that governments should derive their powers from the consent of the governed, secured by regular, competitive, free elections. From the United Nations Charter and Declaration on Human Rights to the Helsinki Accords, the insistence upon the rights and freedom of individuals in democracies represents more than a preference. These values are essential ingredients in a commonwealth of industrial democracies that promise peace as well as freedom.

A noteworthy recent accomplishment is the Final Act of the November 1990 Vienna CSCE conference. Beyond the signatories' rhetorical affirmation of democracy and human rights, they agreed specifically to more operational criteria for assessing behavior consistent with these values. The signatories have established preliminary procedures for assessing the actions addressed in Vienna. The Final Act, in appendix A, affirms a commitment to (1) principles ("the protection and promotion of human rights and fundamental freedoms"); (2) criteria ("prohibit torture"); and (3) procedure ("invite observers from any other CSCE participating States . . . to observe the course of their national election").

- DO establish democracy, human rights, and individual freedom as norms for what the Soviet leadership now refers to as "civilized societies."

Explain the significance of human rights, including minority rights, and democratic institutions as essential elements in "civilized societies." Make these norms the standards for acceptability and membership in the community of civilized societies (as with the current effort to include free democratic elections among the criteria for membership in CSCE).

- DO insist on the performance of societies in meeting these standards.

Multiple monitoring and reporting mechanisms, including independent monitors, such as Amnesty International and Freedom House, as well as official multinational organizations, magnify the message.

- DO encourage advocates of victims whose rights are violated. Emphasize processes most appropriate to the specific society; for example, using the legal framework and independent judiciary in South Africa.
- DO establish and encourage both regional and international clubs of democratic societies.

The European Community has played a critical role in facilitating the transition to democracy in Spain, Portugal, and Greece (and will in the next phase, in Turkey and the newly independent nations of Eastern Europe).

- DO reward good behavior and penalize violators.

The interruption of international loans to China after Tiananmen Square spoke more credibly than any words of condemnation.

- DON'T impose a foolish consistency ("the hobgoblin of little minds").

For example, do not insist that the Muslim countries of the Persian Gulf make a rapid transition to democracy. And do not insist upon any single model of democratic governance. The American presidential system is preferable for some purposes. But it is a notable fact that when designing political systems for West Germany and Japan, the United States chose parliamentary systems.

- DON'T imagine an "end of history."

There is a large element of fashion in the current democratic revolutions, and fashions change.

It seems clear that there are scores, even hundreds, of initiatives that the U.S. government and society can take, and are taking, to promote democracy. Indeed, the puzzle is whether, or why, anyone really disagrees with this conclusion. Before closing with a speculation on our fundamental question, we summarize the "dos" and "don'ts" under the remaining principles.

Developing the Infrastructure of Democracy

Promote the pluralization of society.

- DO recognize that the private ownership of farms, housing, goods, and enterprises is among the most solid guarantees of pluralization. People with economic power have political power.

- DO aid and abet independent groups, voluntary associations, and civil society: independent trade unions, businesses, professional organizations, churches, political parties, and so on.
- DO encourage Western independent civilian groups to interact and stand in solidarity with their counterparts in newly democratic and nondemocratic societies.
- DO allow and promote independent communications media, enabling free dialogue and pluralism on a national scale.
- DO speed the transfer of the technological infrastructure of pluralism to newly democratic and nondemocratic societies: printing presses, photocopiers, personal computers, fax machines, satellite dishes, and modern telecommunications systems. (Don't hesitate to revise Coordinating Committee on Export Controls [COCOM] lists and procedures to free the transfer of most items, limiting only exports of militarily critical technologies—not personal computers, as the United States recently sought to do.)

Encourage the evolution of a political culture compatible with democracy.

- DO encourage the international culture that has emerged with modern telecommunications and travel, as well as the inclusion of people from political cultures hostile to democracy within that international culture.
- DO provide direct experiences for the leadership of nondemocratic societies (especially their emerging leaders) with democratic societies.
- DO encourage the emerging leadership of nondemocratic cultures to attend universities in democratic societies, with the expectation that individuals so educated will be the agents of change in nondemocratic cultures.
- DO encourage "global village" communication networks, such as the Cable News Network.

- DON'T be insensitive to, or imperialistic about, other cultures; but (as was advised above) don't accept the notion of a moral equivalence between authoritarianism and democracy.

Strengthen democratic institutions.

- DO provide information about and analyses of the strengths and weaknesses of various alternative models of democratic phenomena such as constitutions, legislatures, executive branches, civil services and public administration systems, relations between politicians and bureaucrats, civil-military relations, and independent judiciaries.
- DO provide assistance in conducting and monitoring free elections.
- DO provide assistance for newly emerging independent political parties (but don't teach them the bad habits and tricks of American political consultants).
- DO support the establishment of independent, functioning parliaments in new democracies.
- DO support the formation of independent judiciary systems.
- DO promote the development of democracy at the regional and local level.
- DO channel assistance through nongovernmental organizations, such as the National Endowment for Democracy, as well as through private foundations and nongovernmental organizations. This will limit the U.S. government's vulnerability to charges of imperialism.

Assist the development of market economies.

- DO provide help for developing the pillars of a market economy: private property, the rule of law, financial markets, a fiscal system, a banking system and a central bank, macroeconomic stabilization policies, antimonopoly regulations, privatization, and so on.
- DO work to assure access to world markets for the goods and services of newly democratized market economies, including the

extension of the General System of Preferences (GSP) treatment to agricultural products, Overseas Private Investment Corporation (OPIC) eligibility, Export-Import Bank credits, bilateral investment treaties, and special tax credits.

- DO encourage private-sector development through devices such as the Enterprise Fund, the European Bank for Reconstruction and Development (EBRD), and regional development banks.
- DO encourage foreign investment and joint ventures. For example, one demonstration project, the McDonald's restaurant in Moscow, uses imported strains of cattle and seeds for lettuce and tomatoes that are several times more productive than their Soviet equivalents. This and the restaurant's methods for delivering services mesmerize Muscovites.
- DO work actively with newly democratic market economies to establish a framework that will attract the type of international investments that transfer technology and know-how and thus encourage production.
- DO provide concrete economic support for decisions and policies that will promote economic growth. The IMF, the World Bank, the EBRD, and analogous international banks are the preferred instruments for such conditional assistance.

Socialize military and security forces to respect democratic norms and values.

- DO train the emerging military leadership with American and other Western military forces.
- DO make socialization to respect the norms and values of democracy an explicit part of such extended training programs.
- DO encourage the development of independent, civilian analysis of military issues in newly democratic and democratizing countries.
- DO support military-to-military exchanges between democratic and newly democratic and nondemocratic countries, including high-level contacts and visits to military training academies.

Strategies for Democratizing

Nurture and support leaders who are building democracy.

- DO recognize that key individuals make a substantial difference in the transition to and maintenance of democracies. Contrary to prevailing social science theories, social transformation is not all a matter of impersonal forces. We need to support those individuals who strongly favor democratic change.
- DO use "carrots" and "sticks" in a calculated manner to the advantage of leaders who are building democracy and to the disadvantage of their opponents.
- DO provide rewards for societies in which the leadership is making progress toward stable democracy, and penalize societies whose leadership is moving in the opposite direction.

Provide sustained advice and assistance to those making critical choices in the transition to democracy, market economies, and cooperative international relations.

- DON'T support flying carpets bearing wise men for a weekend.
- DO encourage relationships between expert groups in democratic societies and those in democratizing or nondemocratic societies (paying special attention to those in positions of political responsibility) to provide sustained advice and assistance drawn from Western experience with democracy, market economies, and international relations.
- DON'T require the leadership in previously closed societies to reinvent for themselves the institutions and practices of modern Western societies, from double-entry bookkeeping to the concept of an independent judiciary or an electoral system.
- DO seek to stimulate mirror-image institutions by encouraging communication between leaders of newly emerging democracies and those of established democracies in all sectors, including parliaments, judiciaries, civil services, the military, the law, the

press, and financial institutions. Such contacts should seek to promote a more effective transfer of the lessons of Western experience and to support key individuals in building democracies in their own societies.

- DO provide education and training, especially short courses, on the best practices in various areas of experience in political and economic democracies.
- DO encourage the development of independent universities and research institutions that can assume their responsibilities in a timely fashion.

Be sure to differentiate between various regions and countries.

- DO realize the inherent limitations of any "one size fits all" approach to promoting democracy.

Regions and countries differ in their histories, cultures, traditions, internal politics, values, and belief systems. These differences are likely to exert an important influence over the likelihood that any given society will become democratic.

Many of the major gains and setbacks in recent years have occurred throughout entire regions.[29] Between 1973 and 1989, Europe, Latin America, and Asia witnessed a considerable increase in the number of their democratic regimes, whereas Africa lost ground. A better understanding of these geographical disparities, including the factors that shape them, should provide useful clues regarding how democratic norms and institutions can best be promoted and transferred within a particular region or culture.

- DO watch for specific "windows of opportunity" in which, due to an unusual intersection of political and historical factors, a given country or region is uniquely open to democratic change.

Southern Europe entered such a period in the mid-1970s after the deaths of Iberian strongmen Francisco Franco and Antonio Salazar.

Latin America and Eastern Europe are in such a period today. Under these circumstances, external assistance—if provided in a timely, sensitive, and appropriate fashion—can prove particularly effective. Resulting success stories may then serve as inspiration for other countries in the same regions.

The notion of "windows of opportunity" applies to various stages of socioeconomic development, forms of government, and levels of economic development. Although scholars are still working to identify specific transition points and clear-cut patterns of causality, the process that leads from the growth and diffusion of economic power to demands for a similar diffusion of political is apparent. Promising candidates for democratization at a particular level of industrial development may therefore be identified and encouraged toward greater openness.

Conclusion

It may be useful to restate the central question posed in this paper, summarize our answer, and identify a number of important related questions whose consideration lies beyond the scope of this essay. The conference organizer posed a principal question: Is it possible for the United States to promote democracy? Our point of departure was the conference organizer's healthy skepticism about the government's capacity in general. This presumption was reinforced by the scholarly community's specific skepticism about promoting democracy. Since our analysis of the evidence leads us to a conclusion that contradicts such skepticism, we have stated it provocatively. Not only is it possible for the United States to promote democracy, we believe that the United States has promoted democracy, and is promoting democracy. We have identified sixty-nine specific actions the U.S. government can take or refrain from to promote democracy; we have no doubt that it would be possible to identify at least that many more.

For the academics in our readership, the more precise form of our argument goes as follows: under condition A, the transition to and consolidation of democracy in specific target countries is more probable; if the United States takes initiative B, then condition A is more probable; thus by taking initiative B, the United States can promote democracy.

According to this argument, the initiative (taken by the U.S. government and others) that produced CSCE agreement to establish democratic elections as the criterion for legitimate governments promotes democracy. Conversely, if failed U.S. policies should contribute to a worldwide recession and to protectionist measures to close markets to the exports of newly democratic countries, the overall economic performance of such countries would decline sharply, and with it their prospects for sustaining democracies.

If this limited proposition is accepted, then a number of further, related questions arise, questions that this essay has not addressed. Although they are beyond the scope of our assignment for the Rand conference, it may be appropriate nonetheless to state several of these questions and indicate what the analysis here suggests about possible answers.

First, is it possible to identify initiatives the U.S. government could take to establish conditions that are necessary for the establishment of democracy in any particular country, or sufficient to guarantee democracy in that country? On the evidence available, although certain conditions are highly correlated with democracy, none appears strictly to be necessary. Similarly, no one set of conditions appears to be sufficient to guarantee democracy. The best candidate to be considered a necessary condition is the presence of a market economy. Although there exist market economies with nondemocratic governments, there are no societies with democratic governments and nonmarket economies.

Second, if the United States (and its democratic allies) were to adopt a coherent program that included many of the items in our agenda (and others that could be added), would the consolidation of democracy in the newly democratic countries of Eastern Europe and Latin America, and transition to democracy elsewhere, be ensured? Certainly it would not; transitions to democracy are unsure in every case. Consolidation is never assured. On the historical record, there is no reason to believe that the transition to, or consolidation of, democracy is easy, quick, or ever guaranteed. What the record does suggest is that there are initiatives and conditions that make success more probable for democracies.

Third, recognizing that it is possible for the United States to promote democracy, how strongly does it want to do so? Has the promotion of democracy ever been the primary objective of American foreign policy, or should it be? Rhetoric aside, in fact, promotion of democracy has not been the primary objective of American foreign policy, is not now, and is not likely to be. When American policy makers have had to choose between promoting democracy and containing communism—or have perceived this to be their choice—security concerns have dominated the debate. In the aftermath of the Cold War, however, we believe that promoting democracy should become a more important objective. It should not be the overriding objective, but should be rather a priority objective that must compete for resources with other priority objectives.

The promotion of democracy has not attracted, now or ever, a large share of American foreign policy spending. Imagine that it were one-tenth as important as the defense of Western Europe from Soviet attack or intimidation has been for four decades of Cold War. The United States might then consider spending 10 percent of its annual allocation to NATO to consolidate democracy in Eastern Europe and encourage its development in the Soviet Union. At current spending levels that would mean $15 billion per year devoted to an agenda that could significantly improve the prospects for the development of democracy in the former Eastern bloc. The likelihood of an economic collapse there could be reduced by initiatives to ease debt burdens, to provide direct support for the development of new enterprises, and to encourage foreign investment and joint ventures; to offer sustained technical assistance and training; to build infrastructure; and so forth. If the United States were prepared to invest seriously in this effort, and were able to persuade its European allies to make equivalent investments, it would be possible to develop a program that markedly increased the probability of success in consolidating democracy in Eastern Europe and encouraging democracy in the Soviet Union.

How much assistance is the United States providing to Eastern Europe per person today? In 1990, U.S. aid amounted to approximately $4. In comparison, West Germany is investing $4,000 per person per year for the next decade in the former German Democratic Republic.

Fourth, does the United States have a coherent policy or program for promoting democracy? The answer is no. The agenda suggested here is an outline consisting of thirteen headings each followed by an illustrative "laundry list" of actions to be taken or avoided. The purpose stated in each of the thirteen headings could be developed into a strategy. Although some readers will boggle at the potential cost of sixty-nine initiatives (with prospects of more), if they compare such costs with those of initiatives taken in pursuit of U.S. objectives in Europe over the past four decades, the proposed strategies seem manageable.

Finally, we come again to the question of why there should be such a gap between our confidence that it is possible to promote democracy and the considered judgment of scholars who have studied the issue most and know best. Typically, policy prescriptions tend to outrun analysis. Authors seeking to suggest policy seem to feel that, having analyzed some empirical relationships, they thereby earn a scholar's equivalent of "poetic license" to prescribe policy while paying little heed to the practicality of their prescriptions. (Indeed, as one of us wrote two decades ago, most works of policy analysis are marked by a missing "chapter" that marries policy prescriptions to existing practices and institutions. That chapter is notably missing from this essay as well!)

Why then is there such a dearth of policy prescriptions from scholars about the promotion of democracy? First, prescription has not been the purpose or focus of most social scientists studying democracy. Their purpose was to define and analyze and, where possible, to identify correlations of causal significance. Second, respect for democratic values leads to a reluctance to suggest the external manipulation of other countries' politics and a desire to avoid undue interference in the internal affairs of other states. Third, there is the lingering influence of disappointing experiences in the past, whether the Alliance for Progress, or Woodrow Wilson's aspirations, or perhaps even U.S. efforts in Vietnam. Observers coming fresh to the literature sense almost a bad conscience or feeling of guilt about the American record. Perhaps many scholars agree with Hans Morgenthau's remarkable proposition:

> With unfailing consistency, we [the United States] have since the end of the Second World War intervened on behalf of conservative and fascist repression against revolutionary and radical reform. In an age when societies are in a revolutionary or pre-revolutionary stage, we have become the foremost counter-revolutionary status quo power on earth. Such a policy can only lead to moral and political disaster.[30]

We find Morgenthau's statement to be both inaccurate and dated.

A final factor contributing to scholarly reticence about prescription could be an appreciation for the fact that no identifiable set of conditions is sufficient to guarantee a sustainable democracy. In a world in which many nations are fraught with historical ethnic, racial, regional, and religious conflicts, and in which various subcultures and belief systems exist that are hostile to democratic values, hubris about the ability of the United States to export or impose democracy is certain to produce disappointing failures. Yet, if initiatives exist that will increase the probability that nondemocratic regimes will become democratic, the United States is justified in its continued effort to promote democracy.

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5 *James F. Brown*

Helping Eastern Europe: Thoughts, Suggestions, and Some Mild Obsessions

"From each according to his ability, to each according to his need." The Marxist creed still has a sort of relevance as Eastern Europe contemplates not the victory of communism but its disastrous legacy. Now it pertains not to millenarian fulfillment but to the West's role in picking up the pieces of failure. Communism's most famous slogan now becomes a rule of thumb for a capitalist salvage operation.

What the liberated nations of Eastern Europe want—and what the West wants for them—is the civil society, a comprehensive and secure democracy. This applies as much to southeastern Europe as to Eastern and central Europe, as much to Moscow's old "southern tier" as to its "northern tier." This is worth stressing, lest the West make the momentous mistake of writing off "the Balkans" as both irredeemable and irrelevant. True, Poland, Czechoslovakia, Hungary, and the Yugoslavian republic of Slovenia look set for political progress, while Bulgaria, Romania, Albania, and the southern parts of what is now Yugoslavia seem polarized politically and caught in a morass of ethnic divisiveness. But the difference between the two regions is relative, not basic; chronological, not chronic. The Byzantine and Ottoman legacy has indeed been retardative, but it is worth remembering that a half-century ago the Eastern and central European states were plagued by difficulties similar to those prevailing farther south; they handled their ethnic problems with a savagery unheard of in the Balkans. (Keep in mind, too, Western Europe's growing racial problems.) Furthermore, the severity of the problems of countries like Bulgaria and especially Romania is due not only to past history but to more recent communist oppression. In both these countries, communist rule came close to being totalitarian. Farther north, in Poland and Hungary for example, it was authoritarian. That accounts for much of the difference today. Take Poland and Romania between the two world wars; there was not much difference in political climate between them. But Ceausescu changed all that. Even under communism, Poland and Hungary could retain or develop practices and institutions that smacked of the civil society and could be carried over into the democratic system. Romania and Bulgaria could not.

The Decisive Economic Base

Spain is the Western country whose recent experience is considered the most relevant to postcommunist Eastern Europe. Poland, in particular, is often paired and compared to Spain. The rapid and relatively painless progress of Spain from authoritarianism to democratic constitutionalism is seen as a more realistic model than the long-established democracies of Western Europe and North America.

Whatever political relevance Spain may have, however, is more than neutralized by the economic difference. In latter-day Franco's Spain the market was in operation, was institutionalized, and was working tolerably well. Private property was widespread and protected by law. Spain, therefore, had the necessary economic foundation on which Franco's successors could develop democratic institutions. No East European country has that necessary economic basis—not Czechoslovakia, sound by the standards of the Council for Mutual Economic Assistance (Comecon) but pitiful by West European criteria, and not Hungary, despite a quarter-century of sometimes meaningful socialist economic reform.

Without a viable economic base, therefore, no political progress can be secure. This, then, must be the priority target—exclusively so if necessary—for postcommunist Eastern Europe. Western aid should be single-mindedly directed at achieving it. "Pluralism," "competitive politics," "checks and balances," and the like must wait. This need in no way detracts from the longer-term importance of political and constitutional institutions and procedures. They are, after all, the essence of civil society. But at present they are subsidiary, almost marginal.

In fact, the premature introduction of competitive, pluralist politics in Eastern Europe could jeopardize the entire prospect of civil society. It would delay, dilute, even destroy meaningful economic reform by turning it into a political issue easily manipulated by the self-serving and the demagogic. Effective economic reforms need a democratic consensus cushioning them against the social disruptions they must inevitably produce. It is on this account that the prospects for Eastern Europe look less favorable now than they did immediately following the collapse of communist rule. At the beginning of 1990, Poland seemed to have the two ingredients essential for success: "shock therapy" economic reform and political consensus. If the Poles could make it, others might follow. If the Poles could not make it, others would have little chance. The collapse of the Polish political consensus in 1990 changed all that. After having been largely instrumental in breaking the Polish consensus, Lech Walesa is now trying to create a new one. It will be difficult. The penalty of failure could be serious for Poland.

The Political Trend

Accepting, then, that economic performance should be paramount and all-pervasive until a minimum acceptable level is established, what are the "dos" and "don'ts" of other aspects of the West's relations with the region?

First, two don'ts—two widespread misconceptions that need dispelling. One confuses democracy's material infrastructure with its essence, identifies the civil society with its logistics. This misconception is found in both Eastern Europe and the West. A decent telephone system and the whole panoply of scientific gadgetry that has transformed the West are now seen, not as a means to an end in Eastern Europe, but as the end itself. *Technik macht frei?* Nearly, but not quite.

The second misconception goes to the opposite pole: pessimistic, even fatalistic, and sometimes—consciously or unconsciously—racist. The East European peoples, the argument goes (the Czechs are usually excepted here) are not yet ready (and might never be) for democracy at home and genuine international cooperation. The southeast Europeans, especially, are victims of this prejudice; to some Westerners they seem only marginally better equipped than the Arabs for modern statehood. Many Westerners, however triumphant (or triumphalist) over the international eclipse of communism, still somehow regret the passing of *Pax Sovietica* in Eastern Europe. Some looked forward to *Pax Germanica* taking its place, to the salvation of the East Europeans from their worst enemy: themselves. By the middle of 1991, however, the prospect of *Pax Germanica* looks far off and forlorn.

Of these two misconceptions, obviously the first is the less harmful. Unfortunately, however, if not corrected, or modified, it could lead to serious disillusionment for those harboring it and might eventually put them on the same positions as the "Asia begins at the Landstrasse" brigade. Failing to realize that technology was supportive, not salvational, they could explain Eastern Europe's continuing—perhaps mounting—difficulties by the limitations not of technology, but of the East Europeans themselves. This technological neurosis could, in addition, have another, equally catastrophic, consequence. It could become an excuse (conscious or unconscious) for not giving Eastern Europe the kind of comprehensive economic assistance that the building of democracy there really requires. There are already signs that it might be becoming this. In short, *Pax Americana*, although it has a role to play, should be kept in its place.

The second misconception is not only pernicious but could result in an even more comprehensive disaster. It would condemn the East Europeans to a marchland existence. The resulting desperation and destabilization would spill over in both easterly and westerly directions. It would further disrupt what are now the western parts of the Soviet Union. It would also cause tremors in Western Europe. The new Germany, struggling to stabilize its unity and to find a role for itself in Europe, would be faced with yet another difficulty it does not need. Those loose ends of history that were always present, but harmless in the old *Bundesrepublik*, could be dangerous in reunited Germany.

Crafting Democracy

While this second misconception is rightly condemned, the question of how soon and how successfully viable democracies can develop in postcommunist Eastern Europe—even given the right economic conditions—remains a worrying one for Western well-wishers. In the West, democracies and democratic attitudes have grown organically and over a long period (although democratic attitudes are still often conspicuous by their absence). Must the task be as long and Sisyphean in the East?

The answer is that it need not. Both democratic structures and a degree of democratic practice can be *crafted*—imperfectly but passably, provided the economic conditions are right. Giuseppe DiPalma, writing about the possibilities for democracy in both southern and Eastern Europe, argues strongly that if the necessary political and legal framework is established, progress toward democracy can indeed be made, however slowly and unevenly.[1]

DiPalma makes the following points:

- Genuine democrats, *pace* the "organicists," need not precede democracy.
- The lack of easy familiarity with the workings of democratic rules and institutions need not be an incapacitating hindrance.
- Former communist incumbents (one need not inquire too deeply into their motives) can change their habits. They may not move readily toward democracy, but they may "back into it."
- As a society inches toward democracy, a "bandwagon" effect might be created. Apart from anything else, this would make the danger of a communist backlash all the more remote.

DiPalma's arguments are worth noting, especially by condescending Westerners. He tends, though, to underestimate two things: the understandable vengefulness of society against former communist incumbents, and the dangers to democracy of economic failure. As long as economic conditions remain precarious, this underestimation is probably justified. But if they were to become disastrous, then attempts to forge democracy could give way to the acceptance of populist, authoritarian rule. There is a real danger of this in some countries—not just Romania, but Hungary, Bulgaria, and Poland. This would negate both internal freedoms and external peace.

Once again, therefore, the primacy of economics is emphasized, and also the importance of sufficient, judiciously applied, Western economic help.

What Is to Be Done?

Recommendations can easily degenerate into laundry lists. No such list will be attempted here, but rather a few general remarks, ending with suggestions about the kind of assistance on which the United States is uniquely well equipped to concentrate.

First, though, another warning—this time against underestimating the East Europeans and overestimating ourselves. In many subjects, the East Europeans need little or no teaching—just the tools to do the job or to enable them to bring their talents fully into play.

Take journalism, for example. Communism, by definition, depressed journalistic integrity and standards. But in Poland, Hungary, and Czechoslovakia there are many journalists every bit as talented and professional as their Western colleagues. Even before the fall of communism there was also much good journalism: in Poland, both before and during martial law, in Janos Kadar's Hungary, and in the Prague Spring. A bit less Western condescension and a bit more knowledge might be in order here. (East European journalism will not benefit much from certain types of exposure to the West, as paladins like Rupert Murdoch, Robert Maxwell, and Axel Springer descend in search of easy pickings.)

There are two areas, though, in which Western help is desperately needed. One—the environment—has often been mentioned. Help here is much more crucial than most people in the West realize. Unless something is done very soon to slow, halt, and reverse the slide in many parts of Eastern Europe toward ecological disaster, then all the economic, political, and logistic help that might be contemplated will become irrelevant. The East European environmental disaster has already gone beyond being a question of the quality of life. It is now a question of life itself.

Almost as urgent as environmental help, but much less discussed, is help in the sphere of psychology and psychiatry. Many East Europeans—often those the least aware of the fact—are afflicted with psychological disorders. It is not just the "pollution of the mind" to which Vaclav Havel and others have referred—the effects of forty years of doublespeak or of living for decades in a communist barracks, no matter how lax the regulations were in some countries. The disorders are also the effect of crowded living conditions, of an antiwork ethic, and of daily frustration with an inefficient, brutalized, or helpless bureaucracy, with endless shopping queues, and so on. (Having necessarily wasted so much time in the past, how will many East Europeans learn how to spend their time in the future?) Even worse, for many there is the impact of living with the guilt of having cooperated with the communist regimes or—worst of all—with the security apparatuses in some way or other. There is a whole range of problems here needing expert, sympathetic, and patient help. The situation is obviously beyond the capacities of the East Europeans themselves to remedy. The answer, of course, is not an invasion by budding young American Freudians, but a carefully thought out campaign of assistance, primarily involving the training of local mental health staff.

Finally, there is a field in which the United States can help Eastern Europe and help itself. American prestige is far higher in Eastern Europe today than anywhere else in the world. This can be exploited for the benefit of both parties. Eastern Europe wants a strong American presence, and America needs a strong presence in Eastern Europe. What kind of presence is *possible*? A military presence seems excluded. An economic presence is necessary as a pledge of American seriousness, but it will never compare with that of Europe, in general, and Germany, in particular.

Where the United States can sweep the board is in its cultural influence, and from this will seep political influence. Culture here is by no means confined to "high" culture, but is used in the broadest possible sense. There is a receptiveness to American culture (and to subcultures and countercultures), particularly on the part of younger East Europeans, far greater than that to any other Western culture. This must be imaginatively and constructively exploited by both government and private institutions. How? Three means are worth considering:

- Educational exchanges at every level.
- A beefed-up role for the United States Information Agency (USIA), particularly through cultural missions and the more extended use

of institutions such as America House. (Such types of cultural activity are all the more necessary so as to complement, and counter, the impact of the waves of American commercial culture already flooding the region.) Every East European city of any size should have its America House. (They have been a huge success in West Germany for so many years.) They will have to compete with the *Goethe-Institute*, the *Maisons françaises*, and the British Councils, but given the receptive climate, USIA's missions should be able to compete effectively and without much trouble, provided they are well funded and the whole program is well led.

- Refurbishing and redesigning, but by all means continuing, Radio Free Europe (RFE). In this institution, the United States has a powerful and successful political and cultural instrument already in place, enjoying support, respect, and even affection in Eastern Europe. It could now become (in a way the Voice of America never could) the voice of Atlanticism in Europe, both a symbol and an assurance of America's commitment to Eastern Europe and to its place in the international mainstream. Conversely, to dismantle RFE would be a signal to East Europeans of America's lack of interest in them, now that communism has been defeated there. If RFE were disbanded, some of the enthusiasm for America would change to bewilderment.

These are just three ways of maintaining and bolstering the American presence in Eastern Europe. There are more. All should be used so as not to waste an opportunity that rarely comes in history—and will never be repeated.

6

Alex Alexiev

Aid to the Southern Tier

The spectacular collapse of communism in Eastern Europe largely obviated the question "Why help Eastern Europe?" for the West and replaced it with the more urgent "*How* to help Eastern Europe?" That Eastern Europe does need help is taken for granted, as is generally the belief that the direction in which the region is moving is entirely congenial to fundamental Western interests, to say nothing of those of local folk, trampled as they were under the heavy foot of totalitarianism for some five decades. The inherent virtues of democracy and free markets quite apart, the current tide sweeping over the eastern part of the continent is already overcoming the division of Europe that was the main cause of the intractable East-West conflict.

It is perhaps worthwhile to remind ourselves just how momentous this shift has been, by remembering that, until very recently, learned experts, arms control advocates, and even former secretaries of state argued strenuously that neither the reunification of Germany nor the disintegration of the Soviet empire was in the best interest of the United States. It is worthwhile to remind ourselves of this because a new bevy of naysayers is already lamenting assorted real and imagined Eastern European ills and conjuring up dark visions of economic failure and social strife, as if longing for the "stability" of yesteryear. I am far from being inclined to gloss over the serious problems that Eastern Europe, particularly that its southeastern part, is facing in its march to a better future. Still, it needs to be said again that the pain awaiting Eastern Europe, traumatic though it may be at times, is, to paraphrase the Chinese proverb, the intense but sweet pain of being born and not the prolonged agony of dying.

It is because of this that the West must and will be involved in helping to alleviate the "birth pains" of the new Eastern Europe, knowing in advance that they cannot be avoided. Yet, to pursue this obstetrical analogy further, one should not forget that the ultimate objective of birth is not to avoid pain but to deliver a healthy baby and that, though the midwife can help, most of the work must be done by the patient.

If it is a foregone conclusion that aid will be given, then the question of what, how much, and how to give becomes an important one. The history of Western developmental aid, but for a few exceptions, is one full of noble intentions and indifferent results—or worse.

The Political Setting

I have chosen to focus my remarks on the southern tier of Eastern Europe. While the inexorable trend to democracy affects the entire region, there are significant differences in the nature and pace of the process in the southeastern, compared to the central, part of Eastern Europe that warrant a separate examination. Although this fact is often recognized in the West, its implications for aid policies are not infrequently neglected.

Less than a year after the beginning of the upheaval that marked the end of the old regimes, Eastern Europe split into two distinct groups, each marching to a different drummer, albeit in the same general direction. The German Democratic Republic, Poland, Hungary, and Czechoslovakia seem to have already embarked firmly on the road to pluralistic democracy and free enterprise. The political structures of the totalitarian system there have largely been destroyed, and the crucial tasks at hand now are the consolidation of the still fragile democratic order and the daunting challenge of transforming the ossified structures of the command economy.

To these four countries I would also add Croatia and Slovenia. Although they still live in a very rough and potentially violent neighborhood, the processes taking place in the two Yugoslavian republics exhibit remarkable similarity with their cousins to the north. In both Slovenia and Croatia, the erstwhile communist establishments have been decisively defeated in free elections, and a consensus exists that there is no alternative to capitalism and integration with the West.

A much different picture obtains to the southeast, where Romania, Bulgaria, and Serbia form what, for lack of a better term, I would call the "Byzantine faction." This term is intended primarily to convey the extent to which history and culture continue to be oppressively relevant there, rather than to imply any commonality of interest among these age-old adversaries. The anticommunist revolutions in Romania and Bulgaria had a manipulated, staged character (despite the outbreak of large-scale violence in the Romanian case), and resulted in outcomes considerably short of a genuine political catharsis. As a result, the political structures of the old regime have remained largely intact, if shaken, as have the internal security apparatuses and the communist-dominated militaries. Though reform-oriented (some would say warmed-over) communists/socialists preside, the conservative party *nomenklatura*, both in the administrative sector and in the economy, is still very much in control below the top, and it remains a most formidable obstacle to any attempt to introduce genuine reform.

Thus, despite the holding of free, if hardly fair, elections, democratic institutions have yet to take firm root, and economic reform is still in its infancy. Against the background of a rapidly collapsing economy and a mounting popular perception of having been cheated again, this situation is becoming dangerously volatile and may be turning explosive.

Yet another factor that seriously clouds the prospects for rapid progress in southeastern Europe is the pernicious influence of rising nationalism and ethnic strife. Most of the present conflicts have long historical antecedents, but this should not obscure the fact that their renewed acuteness is to a large degree part of the bitter legacy of communism. Brutal campaigns against ethnic minorities by the regimes of Todor Zhivkov and Nicolae Ceausescu have left open wounds and bitterness in the body politic that may take many years to overcome. Worse still, there is considerable evidence that powerfully entrenched remnants of the old order are still bent on using chauvinism and ethnic conflict for their purposes. Extreme nationalist organizations, Vatra Romaneasca in Romania and the Committee for Defense of National Rights in Bulgaria, for instance, are both linked to the old security organs and hard-line elements in the present ruling parties. The situation is perhaps even more dangerous in Serbia, where party boss Slobodan Milosevic has made Great Serbian chauvinism and a jingoistic anti-Albanian policy the cornerstone of his effort to preserve the Communist party in power. This policy has already brought Yugoslavia to the brink of disintegration and into the abyss of violence and civil war. It is very disturbing, in this respect, to register the remarkable equanimity with which the West observed the unprecedented and wholesale abuse of the human and political rights of the Albanians in the Kosovo region.

If the foregoing analysis is correct, it would follow that conditions in the "southern tier" are far from ideal for a successful aid program from the West. It is clear, for instance, that few of the requisite political preconditions exist for the successful application of a large economic aid package, especially of the government-to-government type. Nor should one entertain the illusion that outsiders could dramatically influence the political dynamics of the place. Let me hasten to add that there are things that could and should be done. The neocommunist regimes still in power are desperately trying to cling to it, but their options are limited by the new realities in Eastern Europe and the world and by the ironic fact that they find themselves increasingly dependent on the West. Beyond that, there is little doubt that communism can no more be reformed in southeastern Europe than elsewhere, which means that it is only a matter of time, and not a long time at that, before it too succumbs to history. The objective of Western aid thus should be to try to smooth over this immediate transition period and prepare the ground for the next stage of genuine democratization. As with all aid, one should always keep in mind the Hippocratic tenet: Do no harm!

The Political Dimension of Aid

The objectives of assistance in the political sphere are straightforward and simple, though far from easy to achieve. They include reinforcing and speeding up the democratic process, building up democratic parties and institutions, and assisting in the development and consolidation of free and independent media, among others. There are a number of specific small-scale training programs that could be very effective in achieving these objectives, along with the provision of technical assistance, equipment, and important commodities such as newsprint. A word of caution is warranted here about longer-term educational programs. Sending large numbers of students to the United States, for instance, may be a good idea in the future, but at present it makes little sense, given scarce U.S. funding and the better than even chance that most of the students would not want to return to their home countries.

In a similar vein, better screening appears to be needed for shorter-term academic and professional training programs. I was told by a distinguished professor at Sofia State University, for instance, that virtually every recipient of a Fulbright or International Research and Exchanges Board grant to the United States in the past ten years has been a member of the party or academic *nomenklatura*. "They consider it a party perk," he said. I have made similar observations even with respect to people selected by the United States Information Agency (USIA).

It is important for governments providing aid to speak out forcefully against nondemocratic tendencies and abuses of human rights that continue to take place. Speaking out in defense of universal principles is not interference in internal affairs and should not be shied away from. This is not always practiced. For example, the outrageous conduct of Ion Iliescu's Romanian regime in recruiting mobs of coal miners for the bloody suppression of demonstrations was roundly condemned, but less glaring abuses—such as the removal of local freely elected officials—have passed unnoticed. The Bulgarian regime, despite pious protestations of democratic beliefs, still refuses to dismantle the feared state security organs, a fact that for most Bulgarians means one thing—the process could still be reversed.

It is also essential for Western policies not to legitimize or give the impression of legitimizing regimes that are not perceived as legitimate by their own people. Unfortunately, mistakes in this area still seem to be the rule rather than the exception.

Two other political issues should be given close attention: policies in the ethnic-relations field and the depoliticization of the military. Specific aid policies could be tied to improvement of a regime's record in regard to ethnic relations, and other cultural and economic programs could be designed specifically to assist ethnic minorities. Depoliticization of the military is, of course, a key precondition to the establishment of a democratic system as well as a guarantee against its subversion. Western experts could be recruited either individually, for instance under the auspices of the USIA American Participant Abroad program, or in a group to conduct seminars on the subject. RAND has recently conducted several such seminars in Eastern Europe with considerable success.

The Economic Dimension

As I do not possess the specialized knowledge it takes to make an intelligent argument on specific programs, I will limit my remarks to some commonsense propositions.

First, it must be stated clearly to the East Europeans, and indeed to ourselves, that Western economic aid cannot be a panacea for their problems, even under the best of circumstances. It has been estimated that it would cost some $500 billion to bring eastern Germany to West German economic standards. To give an idea of what may actually be forthcoming, in 1989 total Western investment in Eastern Europe amounted to some $2 billion. The large-scale resources some East Europeans seem to fantasize about are simply not available. Even if they were, under the conditions prevailing in southeastern Europe, and in fact throughout Eastern Europe, any large amount of aid is likely to be wasted or stolen by corrupt bureaucracies. Worse still, more aid may come to be expected and so breed the pernicious dependency on Western largesse that has nearly destroyed Africa. Perhaps the West needs to tell the East Europeans that sometimes one *does* need to bite the hand that feeds him so it will let him feed himself.

No loans or credits should therefore be given before creating the proper market structures. Even after that, economic aid should be tied to specific projects and tightly supervised. This, of course, applies only to government or government-guaranteed money. Private investors should be free to take their chances.

There may be, however, a need for humanitarian aid fairly soon, as the countries under discussion hit economic bottom and hunger becomes a problem. This is not idle speculation. The possibility of famine has been openly acknowledged by the Bulgarian regime, and the situation is no better in Romania. And this at the end of the twentieth century in Europe! It boggles the mind.

At the lower level, it is possible and desirable to render technical assistance to budding entrepreneurs and private farmers as well as to larger private institutions now beginning to sprout. Courses in basic management, accounting, inventory control, and even the most basic precepts of private enterprise could provide considerable payoffs in a system where people have been taught for decades that there is, for instance, a major difference between "personal" and "private" property.

Higher-level management training for senior executives could also be organized with relatively small investment. Such training could very effectively be combined with short-term on-the-job training in the United States. The director of an Estonian business school that operates on this model told me that the true measure of the success of his school lies in the fact that nine out of ten of his students, who are mostly senior managers and factory directors, immediately leave their state sector jobs upon graduation and go into private business.

In southeastern Europe as elsewhere, the worst assistance is the kind the recipient comes to expect and become dependent on: such a state of affairs must be avoided at all costs.

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A. Ross Johnson

Comment

The question addressed by the conference—how can the United States support the development and consolidation of democratic polities and free-market economies in postcommunist Eastern Europe—is a matter of strategic importance. Communist power in, and Soviet domination over, Eastern Europe must not return. A modicum of stability is essential, both for Eastern Europe and for Europe as a whole. The European Community may not be able to "afford" new East European members in the near future. Neither, however, can it afford economic collapse, environmental catastrophe, political chaos, or ethnic conflict on its eastern borders. Relative success in Eastern Europe can have a positive impact on the development of the USSR—or (more likely) its successor states. American involvement in this process is important, as part and parcel of the involvement of a nonisolationist America in the post–Cold War Europe.

The context of this challenge should be kept in view. Eastern Europe has the dubious honor of attempting for the first time in history to recover from the political and economic shambles of communism. It lacks the concentrated shock of defeat and massive destruction in wartime—the "Zero Hour"—that resulted in changed outlooks and self-sacrifice in postwar Germany and Japan. There is, nonetheless, remarkable consensus in Eastern Europe, and in the West, on present objectives. Central Europe wants to be part of Europe. "Third way" thinking has been largely discredited throughout the region (although traces of it survive in Romania and elsewhere). The goal of developing free-market economies is accepted by all parties. Pluralist democracy is the political aim—albeit with varying modalities and content. Eastern Europe aims for closer security ties with the West, including the West European Union and the North Atlantic Treaty Organization (NATO).

There is a difference in these and other respects between central Europe (Poland, Czechoslovakia, Hungary, Slovenia, Croatia) on the one hand, and southeastern Europe (Romania, Bulgaria, Serbia) on the other hand. Alex Alexiev and James Brown have discussed these regional distinctions. Their papers are complementary; Alexiev traces the differences, while Brown notes the limits. Bulgaria, Romania, and Serbia emerged from the Ottoman Empire in the late nineteenth and early twentieth centuries, and they lacked some of the civic institutions and traditions developed in areas that were dominated by the Austro-Hungarian Empire. Yet their peoples share the aspirations of states to the north to be "Europeans" (with free-market economies and pluralist polities). Even if they did not, Europe (as the United States) could not today accept the existence of second-class or "Balkan" standards for human rights, minority rights, or other issues in the southeast European states. Hence the conditionality of recent Western policy toward Romania.

Western policy can indeed, as Graham Allison and Robert Beschel suggest, help promote democratic developments in Eastern Europe. The poor record of such efforts in the third world, and the conditions that prevailed in pre–World War II Eastern Europe, do not negate this proposition. In isolating Eastern Europe from the West for most of a half-century, the Soviet Union caused the region to see itself increasingly as European and not as something in between, whether as "Mittel-Europa" or as "the Balkans." Budapest is much closer to Brussels today (in terms of how political and economic issues are defined) than it was to Vienna in 1900 or 1930.

There are many instruments by which the United States can help promote democracy and free markets in Eastern Europe. Allison and Beschel have listed many of them in their paper; it is important that these be placed in order of priority and that the United States and Western Europe not approach Eastern Europe in a patronizing way. That would be all too reminiscent of Soviet behavior in postwar Eastern Europe. For the West as a whole, the principal challenge is to assist East European free-market economic development with a "Marshall Plan for Eastern Europe" under present circumstances. The United States, while contributing to economic programs, also has much to contribute in the realm of ideas. Rising East European decision and opinion makers without prior American experience should be invited to the United States. American information programs—Radio Free Europe, United States Information Agency activities, the Voice of America, private-sector informational activities—should continue. Radio Free Europe/Radio Liberty audience and opinion research and listener feedback document the East European demand for American as well as West European information on democratic institutions and practices, entrepreneurship, objective journalism, and much more. Imparting American ideas to East European leaders and peoples should remain a major component of Support for East European Democracy (SEED) initiatives.

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Jan Nowak

Comment

The United States has no strategic or economic interest in Eastern and central Europe other than an ideological commitment to promote democracy. Historically, great power interest in this area was associated with either a German or a Soviet threat. From the American perspective, Eastern and central Europe should be viewed not in isolation but in the context of developments in the Soviet Union and Europe west of the Oder-Neisse border. Bipartisan U.S. policy, pursued by a variety of economic and political measures, contributed greatly to the nonviolent movement from a communist totalitarian system toward democracy.

Strategic Objectives

The end of the Cold War created an entirely new strategic situation. The old world order has collapsed; the new one has not yet emerged. It is uncertain who will be in control of Soviet military potential and nuclear arsenal two or three years from now. Will the Soviet Union disintegrate into independent national states, or will it be a federation or confederation of fifteen republics? Will another empire emerge, dominated by the national ambitions of Great Russia? No scenario—good or bad—can be ruled out.

Since the birth of the Solidarity independent labor union ten years ago, the developments in Poland, and more recently in the rest of Eastern and central Europe, have led to the collapse of the Soviet system in the USSR. In turn, the feedback from changes in the USSR made possible the formation of the first noncommunist government in Poland, removal of the Berlin Wall, and eventually the emancipation of six nations, with a total population of 122 million.

The fate of nascent democracy in Eastern and central Europe may in the future have a decisive influence on the direction of political and economic reconstruction in the Soviet Union. The failure of economic reform could plunge the area into conditions similar to those besetting the Weimar Republic before the advent of the Third Reich: galloping inflation, massive unemployment, and general frustration among the population. Deteriorating economic conditions and disenchantment with democracy may easily bring to power militant, nationalistic dictatorships. On the other hand, the visible success of a free-market economy and democracy in Eastern Europe would strengthen the pressure for similar reforms in the Soviet Union. It is therefore in the vital interest of the United States and other industrial powers that the experiment in democracy in former communist satellites of the Soviet Union should end not in failure but in visible success. The awareness of what is at stake should give a sense of purpose to U.S. economic aid policy.

The Crash Program of Economic Reform in Poland

For understandable reasons, Poland has a place of high priority in the U.S. policy of promoting economic transformation from command to free-market economies. As of January 1, 1990, the new noncommunist Polish government embarked on an unprecedented crash economic program. Within six months, Deputy Prime Minister Leszek Balcerowicz, following strictly the prescription of the International Monetary Fund (IMF), undertook several drastic measures to restore stability and lay the legal and economic foundations for a competitive, free-enterprise system. Most subsidies and tax exemptions were eliminated. Fiscal discipline was restored. The astronomic budget deficit was reduced from approximately 8 percent of gross national product (GNP) to only 1 percent. Inflation, which was raging at 960 percent in January, was brought down to 21.6 percent in August. Ninety percent of prices were decontrolled. The exchange rate of the zloty, established in January at 9,500 per U.S. dollar, has remained stable without intervention from the central bank. The currency was made convertible, and the central bank was separated from the treasury. Most of the import and export restrictions were removed, and customs tariffs were lowered. Hard-currency imports declined by 22 percent, while exports increased by 23.5 percent. As a result, the trade imbalance brought in a surplus of $2.7 billion.

In July, legislation allowing privatization of state-owned enterprises was passed by the parliament, and a pilot project affecting twelve large state concerns was introduced. It is expected that all smaller state enterprises employing fewer than 300 workers will be privately owned by the end of 1991.

Social and Economic Costs of Transition

The social and economic costs of the reform are staggering. Sold production in the state sector dropped by about 28.7 percent, while production in the private sector increased by only 2 percent. GNP as a whole declined by more than 15 percent. Real wages fell 35 percent in the first seven months of 1990. Unemployment rose from 56,000 in January to 820,000 (6.1 percent of the labor force) in June, and will probably reach 1.5 million by the end of the year. Few democratic governments could survive such drastic deterioration in their nation's standards of living in less than one year. The Polish people, furthermore, will have to wait another two or three years before substantial improvement is seen.

Existing Threats

The Polish experiment in democracy and a free-market economy is now facing external as well as internal dangers. The first threat comes from the collapse of the Soviet economy. As of January 1, 1991, the delivery of gas by the USSR was reduced from eight million cubic meters to only five million cubic meters. Soviet gas is delivered by pipeline; there are no corresponding facilities that would allow the import of gas from other countries. At the same time, imports of Soviet crude oil—currently thirteen million barrels a year—may be reduced to zero. Limited unloading facilities at Polish ports allow for only one-third of total Soviet imports to be replaced by imports from other countries. Imports of other goods from the Soviet Union also are declining sharply, and the Polish surplus in trade with the USSR has been increasing. Any restrictions of Polish exports to the USSR would raise unemployment in Poland to unacceptable levels.

The economies of Hungary, Czechoslovakia, and particularly Bulgaria are even more vulnerable to a possible collapse of Soviet production and foreign trade. The Council for Mutual Economic Assistance (Comecon) once provided markets for industrial goods produced by Eastern bloc states in what amounted to barter trade. Industrial production of the former communist states cannot compete in the hard-currency markets of the free world.

Poland's oil crisis has been compounded by the country's participation in the blockade of Iraq that began in late summer 1990. Iraq was repaying its debts to Poland by providing one-third of Poland's oil imports. Buying oil for dollars at much higher prices will have a severely adverse impact on Poland's balance of payments.

The reunification of Germany will deprive Poland of its second-most-important trade partner: East Germany. The German Democratic Republic and the USSR together accounted for more than half of Polish trade. Negotiations on mutual economic commitments between East Germany and Poland have made no progress.

The third danger to Poland's still fragile democracy is of a political nature. Until now, the difficult task of democratic and economic reconstruction has been based on a general consensus. The Polish people have displayed unexpectedly high levels of toleration for the considerable hardships brought about by reform. The situation changed on May 9, 1990, when Lech Walesa proclaimed "permanent political warfare" against the government of Tadeusz Mazowiecki, which he himself had created only eight months earlier. In the name of pluralism and the necessity to accelerate dismantling of remaining elements of the communist regime, the Solidarity movement was split into two hostile camps headed by Walesa and Mazowiecki. The alliance of workers, intelligentsia, and farmers that played such a crucial role in the success of democracy was brought to an end. The ensuing public criticism of Mazowiecki's government with populist slogans has eroded popular support and created a climate for social protest.

The campaign in Poland's first fully free and democratic presidential and parliamentary elections exposed the weakening of the present ruling team in the middle of its conduct of the risky and difficult process of political and economic transformation. Walesa accused Mazowiecki of proceeding too slowly in dismantling the communist *nomenklatura* and of an excessively restrictive wage policy. Walesa's critics, on the other hand, were concerned by his authoritarian tendencies and his announced plans to "rule by using an ax and decrees." The chairman of Solidarity still enjoys the broad support of workers and people in the countryside, who consider him a symbol of success and place their trust in his instinctive wisdom. Even Walesa's most outspoken critics still entertain hopes that this charismatic leader may restore his cooperation with the new elite that emerged in the ten years of Solidarity's struggle for freedom and democracy.

Foreign Aid

The assistance offered to Poland by the European Community, the International Monetary Fund, the World Bank, and twenty-four industrialized nations amounts to a little less than $9 billion. The United

States contributed $753 million—about 8 percent of the total. The United States, however, played a leading role as an international fund-raiser. Without the U.S. administration's initiatives, leadership, and prodding, there would be no international assistance of such dimensions. For instance, the American grant of $200 million to the stabilization fund was offered on condition that other leading industrial powers would contribute the balance of $1 billion. The fund made possible the stabilization and convertibility of the Polish currency.

Recommendations

Reduction of the Polish foreign debt is considered to be the first priority. The growing burden of Poland's external debt, which has reached $46 billion, undermines confidence in the stability of the Polish economy and its balance of payments. Private foreign investment is discouraged by uncertainty and the risks involved. Full participation of private creditors and investors in the Polish recovery will not be possible until the debt problem is finally and permanently solved. Poland cannot continue to sustain repayments of more than 2 percent of the principal per annum. The present market value of Poland's debt is approximately twelve cents on the dollar. Thus, substantial if not complete debt reduction is essential. Precedents were established when both West Germany and the Soviet Union were granted debt relief in the postwar years.

Establish priorities to ensure better coordination of various projects giving assistance to Poland. The existing programs were improvised in haste in order to provide prompt response to fast-moving changes. After one year, it is possible to establish priorities and better coordinate the various projects. Polish beneficiaries complain that they receive too much unsolicited advice, that too much money is being spent by aid donors on travel, experts, salaries, and overhead, and that too great a share of the grants is spent in the United States. It is time to create a clear mechanism that would permit aid recipients to present their views and needs.

A contingency plan of assistance to the Polish government *should be prepared.* It may be necessary to soften the social impact of growing unemployment through a major increase in public works projects.

In the present transitional phase, such instruments of American influence as Radio Free Europe and Radio Liberty should be maintained. They can assist in the consolidation of the emerging but still fragile democracies in Eastern Europe. Both radio services still have very large audiences and enjoy considerable credibility. As in the past, broadcasting may play an important role in any future crisis.

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PART IV

FREE-MARKET SYSTEMS

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7

Leif H. Olsen

The Intellectual and Political Barriers to Free Markets

> It must be pointed out that in Marxian terminology two stages of communism are distinguished. The first (called by Marx the lower phase), or "Socialism," is a transitional stage during which some elements of capitalism are retained. . . . The second stage (Marx's higher phase), or "Communism," is to be marked by an age of plenty, distribution according to needs (not work), the absence of money and the market mechanism, the disappearance of the last vestiges of capitalism and the ultimate withering away of the State. The USSR, socially the most advanced Socialist country at present, is vaguely scheduled to start entering the second stage about 1980.
>
> Jozef Wilczynski
> *The Economics of Socialism*

The decay of the communist command economies in Eastern Europe and the Soviet Union has been under way for many decades; while in process, this process offered little drama to those outside these countries except for the comparatively few professional observers. For everyone else the drama came in November 1989, when the Berlin Wall came down. In terms of the social sciences, these events offer extraordinary opportunities for study and the advancement of knowledge in both the political and economic sciences. It is for that reason, among others, that this paper contains a number of references to how some scholars in both these disciplines expected the socialist communist economic systems to evolve.

The other reason this paper contains some theoretical and philosophical views is that I expect that a number of papers presented at this conference will more than adequately cover proposals for financial aid and the content of assistance programs.

How people think about economic systems will reveal their receptivity to change and their ability to manage change. Thus I have endeavored to introduce some points of view which may be different from the mainstream of the discussion.

The Invisible Problems of Economics

The task of successfully implementing market economies in Eastern Europe and the Soviet Union and allowing them to flourish will be encumbered by a series of unfortunate characteristics of centralized economies managed by individuals in a political and legal setting. The hazards are multiplied by the exhilaration of the speed of events, which dictates quick action, shortcuts, and the immediate adoption of what appear to be the most attractive parts of free-market economies and the expectation that they will very shortly deliver "the goods," literally and figuratively. It is sobering to recognize that free-market economies have evolved over a very long span of time and that certain essential pieces came into being only through experience, trials, and adaptations.

From time to time I will elaborate on the shortcomings of centrally planned socialist economies. This is done as a reminder that when faced with the unprecedented problems of unscrambling the egg of capitalism, the peoples of Eastern Europe must remind themselves of the bankruptcy of the former systems. Before discussing some of the specifics of these economies, it is useful to examine a number of the challenges facing individuals in Eastern Europe as they create a framework of more successful economic principles.

I would like to begin with a proposition. We find in society and academe a conventional view that the physical sciences, such as physics and chemistry, are difficult for the human mind to grasp and use in practical applications, while social sciences, such as economics and political science, are easy to comprehend. In fact just the opposite is true. Personal value judgments and political views are much less likely to bias research and conclusions in the physical sciences than in the social sciences. The presence of value judgments dilutes rigorous analysis in the social sciences and provides wide latitude for incorrect or illogical conclusions, and this impedes the advancement of knowledge. In the social sciences, we still see many examples of fourteenth-century technology. In contrast, the physical sciences have made giant strides in this century in the areas of transportation, communications, and data processing, to name but a few.

Economics is difficult because, as a social science, it is not susceptible to precise measurements, and it is plagued by the political judgments of its practitioners, which include not only trained economists, but politicians, businessmen, and other social scientists. Economics is even more exasperating to the business and political communities because although its language is math, it is a math that offers only approximations. Furthermore, economics is widely interpreted by a line of deductive reasoning that impedes the advancement of knowledge, namely, "Whatever is plausible and self-evident must be true and requires no further analysis." There is empirical evidence supporting economic theories that should be used in drawing conclusions; yet such evidence is often at the center of disputes driven by differences in political and other related value judgments. To all this we must add the pervasive intellectual arrogance of economists (with some notable exceptions) who cannot or will not communicate ideas in simple prose. Physicists do not have any essential need to communicate broadly with the public, politicians, and the media. But economists cannot avoid it if they wish to advance their ideas and fulfill a major role for their discipline.

Whether economics is a science is in the eye of the beholder. A physical scientist comparing economics to the rigor required in his field would argue that economics is not a science. An economist comparing the measurements in his field with those of sociology, for example, would insist that economics is a science. The obvious answer is that we must treat economics as a science by demanding thorough analysis and conclusions as value-free as possible. One result of such an approach is that its body of conclusions is likely to displease people on both ends of a political spectrum.

An economist cannot objectively use economic principles to achieve "fairness" in society. Economics is not a discipline that conveys compassion. Yet many economists endeavor to manipulate economic theory in ways that seek to achieve what they believe to be fair. In doing so they generally seek objectives that are inherently contradictory, such as high wages but low prices, or rent controls together with an ample supply of housing. Proposals for economic change in Eastern Europe will not be free from such distortions and the unfortunate consequences.

In a democratic society, value-free conclusions in economics are not easily achieved. When economics becomes subject to law, it is interpreted by lawyers, by judges, and directly or indirectly by the writings of economists. These interpretations seldom reflect a rational set of economic principles. For example, free markets are extolled in U.S. political speeches. Most Americans rejoiced over the collapse of the Berlin Wall as a symbol of the victory of our free-market system over the centrally planned socialist economies of Eastern Europe. Most people would unhesitatingly characterize the U.S. economy as free-market oriented, which for the most part it is, in spite of the fact that free markets in the United States are often resisted by businessmen, consumers, or government. Even private owners of capital are frequently required to justify their legitimacy in defensive interplay, as adversaries of government.

For some reason, economics does not excite much interest among highly educated people working in other fields. This should not be taken to mean that economists have broader interests; to the contrary, some are so narrowly focused that they can scarcely make any contribution to the discipline. There are notable exceptions to this generalization, and where they exist, significant improvements in the practical application of economics takes place. For example, RAND seeks continuously to achieve a cross-fertilization of disciplines, as does the Law and Economics Center at George Mason University School of Law. Nevertheless, economics, along with political science, needs a close interaction with and critical interpretation by all major groups in society, particularly government.

A political scientist's explanation for the recent events in Eastern Europe and the Soviet Union would provide many important elements that an economist would omit. The political explanation, however, would also omit many essential details about a seriously flawed economic system. These two disciplines must join together to structure a free-market economy in that part of the world.

In the union of these two disciplines in actual practice, economics always becomes the handmaiden of politics, to the detriment of general welfare. Jozef Wilczynski, in 1970, wrote in *The Economics of Socialism*:

> It is not without significance that between 1928 and 1954 no textbook of economics was written and published in the Soviet Union. The majority of writers were preoccupied with interpreting Marx, in order—as was concluded at the Conference of Polish Economists in 1967—"to provide apologetic justification of current economic policies." Yet neither Marx, nor Engels, nor Lenin ever presented a systematic and complete treatment of economic theory, particularly in respect of the allocation of resources, demand analysis, consumer equilibrium and foreign trade.[1]

Free Markets

The creation of free-market economies in Eastern Europe is an overwhelming task. The discussion of economic programs within the confines of a brief paper can only hope to stimulate a discussion. The value of this paper and of the discussions embraced in this conference will be found in drawing attention to the less obvious needs and to such potential pitfalls as the separation in time of privatization from the decontrol of prices and wages. In such cases, if government still owns enterprises, managers are not likely to allocate resources to maximize the advantages of market prices. Another example would be delays in the establishment of service-industry infrastructures, such as competition in distribution, the availability of liability insurance, and the creation of media information systems in business, industry, and labor. Apart from the difficulties of a systematic and rapid introduction of economic and business elements, there are pitfalls in assuming that everyone agrees on or understands what is meant by "free-market economies." As I will note again later, even in the United States there is no clear agreement on free markets—and there is even subliminal hostility to them.

Charles Wolf asked me to discuss how the free-market system will be promoted by undertaking or avoiding actions, programs, and policies in the areas of monetary and fiscal measures, price and wage deregulation, capital market development, legal frameworks for property rights and dispute resolution, privatization, social security and unemployment insurance, currency convertibility, and so on. These elements are, of course, among the institutional structures of free markets. They are the essential components of the blueprints for those who undertake to construct free markets. Many of these elements already exist in various forms, in some cases designed to serve a centrally planned economy. Some progress has also been made, certainly in Poland and Hungary, in the establishment of free markets. Here is how David Lipton and Jeffrey Sachs, economic advisers to Solidarity, describe recent accomplishments:

> As of April 1990, several initial goals of the stabilization phase of Poland's program appear to be within reach. The corrective inflation has subsided, and aggregate demand has been sharply reduced. With tight demand and currency devaluation, Poland has been able to introduce a convertible currency, a liberal trade regime, the free determination of most goods prices, and a reasonable set of relative prices including those for energy and food.[2]

What is actually described here is a very limited start: the initial burst of individual initiative in small businesses once economic freedoms are granted. As Lipton and Sachs discuss in some detail, "Poland faces enormous challenges in the months ahead."[3] The guiding principles and structure of a centrally planned economy still remain in such areas as wages, resource allocation, investment, and government ownership of capital.

It is far beyond the scope of this paper to catalogue the existence or stage of development of free-market economic elements in Eastern Europe. Thus I assume, purely for the purposes of this discussion, that they do not yet exist, while acknowledging that in actuality they do exist.

Legal Framework

The first and most basic element in the creation of a free-market economy is the creation of a legal framework. The establishment of this framework may provide an immediate test of the extent to which political freedom has been gained. In *Capitalism and Freedom*, Milton Friedman notes that:

> Economic arrangements are important because of their effect on the concentration or dispersion of power. The kind of economic organization that provides economic freedom directly, namely, competitive capitalism, also promotes political freedom because it separates economic power from political power and in this way enables the one to offset the other. Historical evidence speaks with a single voice on the relation between political freedom and a free market. I know of no example in time or place of a society that has been marked by a large measure of political freedom, and that has not also used something comparable to a free market to organize the bulk of economic activity.[4]

Law must secure the rights of private ownership of capital, the transfer of such ownership, the right to sue, and the settlement of disputes. This should cover not simply rights to own real capital, but also intellectual and other forms of intangible property. In the Soviet

Union, time and events have probably obliterated the rightful claims of the primary owners of property confiscated by government when the communists came to power. This is not true in Poland, however; as privatization moves forward, laws must be established to provide for the settlement of such claims. In the former East Germany, such claimants are being indemnified by the now-combined Germany. Some may argue that claims of prior owners should not extend to the governments that succeed the communists. Unquestionably it is a moral issue. The costs of moral wrongs are ethereal. They live for a long time and undermine the integrity of successor governments and thus the confidence they inspire.

Government must be made subject to laws establishing economic freedoms. This is particularly important in order to prevent special-interest groups from achieving favored treatment, as has happened in the United States. The legal codification of market economies in Eastern Europe will be aided by the fact that many of these countries had such laws before World War II. In addition, they may well select from the legal codes of other European countries. Americans should share with them their own experiences, both good and bad. The U.S. government has evolved over time and now contains many limitations on economic freedoms that the Founding Fathers did not intend.

The legal principles underpinning such law in the United States begin with the Constitution, but over time the interpretation of the Constitution has created a body of law that has become more restrictive with respect to property rights. As James A. Dorn has noted:

> The demise of economic due process began in earnest in the late 1930s, as the Supreme Court decided not to give property rights and economic liberties the same fundamental rights and civil liberties. With this judicially created distinction in hand . . . "legislatures have great difficulty in restraining freedom of speech or press, and almost none in curtailing freedom of enterprise."[5]

The creation of a body of law to support market economies underlies most discussions about the reformed economic structure. Legislation will provide for privatization, liberalization of prices and wages, and the creation of specific financial market institutions. As we know from the experience of the United States, however, there must be a basic body of political principles establishing the ethos for an economic system that will initiate a systematic code of law. Incomplete, piecemeal legislation will only create future problems. The objective in East European countries should be to benefit from the historical mistakes of mature free-market economies in seeking to create as complete a body of law as possible, to be adopted at the time public and political zeal is at its peak. If this is not done, undesirable legal features will develop in the future to fill voids. If there is one thing that is certain, it is that these countries' free-market zeal will greatly diminish at some point.

We know from experience that there will naturally be conflict between the legislative and the judicial branches of a democratic government. The judiciary often "legislates" with the encouragement or the acquiescence of the legislature because interest groups perceive that in the course of a political debate the legislature will fail to adopt a law which is sought. Peter H. Aranson writes of this tendency:

> The notion of judges as economists seems philosophically objectionable, because it eviscerates any notion of the judiciary as a protector of rights. . . . If judges acted as legislators, their actions would incorporate in the judiciary all of the failures of legislatures, threaten judges' independence, and obliterate any reasonable control that judges now exercise.
>
> The judiciary, and particularly the Supreme Court, should not follow the mistaken path of trying to substitute its own educated economic judgments for the legislature's political ones. There is scant evidence that the Court enjoys a comparative advantage in such a contest.[6]

If the creation of new laws for an economic system is dictated simply by an arbitrary, or worse, a political decision that the next piece of economic structure requires it, the process could be a lengthy one. There is then the risk that an incomplete body of laws will be enacted and that the judiciary will be led to engage in the kind of mischief set forth by Aranson.

Privatization

The sale or transfer of state-owned firms to private citizens must be discussed while bearing in mind several potential problems. First, the removal of price and wage controls should precede privatization. This step will initiate the reallocation of resources through market mechanisms, and it will help to determine the true value of existing firms under conditions in which prices and wages are determined by the market. Without this step, privately owned firms will be operating with the same debilitating controls that produced problems in the first place. This step is necessary to eliminate opportunity costs that permeate economies where asset allocation is determined by a central planning authority making arbitrary political decisions.

As an example of the distortions of such centralized allocation, we have the spectacle, in the Soviet Union, of insufficient labor and machinery to harvest a bumper crop. In the past, labor shortages in an emergency were dealt with by instructing state enterprises to send workers into the fields. This resulted in losses at factories. Such losses used to be forgiven, but recent accounting changes directed toward making enterprises more self-financing have left such forgiveness uncertain. Hence the response to calls for help in the harvest was muted.

The Soviet Union is also beset by shortages of combine parts, railroad cars, and storage facilities. These shortages are all characteristic of an economy that is driven by controls, rather than by free prices. Freeing prices and wages will not only allocate resources more efficiently among existing industries, it will spawn new firms, particularly in services, to fill large gaps that now exist in a command economy.

The second problem of centralized resource allocation is that there is no organized market for the purchase and sale of government enterprises. Contentious bidding for government-owned firms has already emerged in Eastern European countries. Workers assume that they are the natural owners of the business. Governmentappointed managers believe that they are simply the "inheritors" of the firm from a defunct government. Lipton and Sachs have said, "It seems clear to us that any transfer program that will win widespread political assent must indeed involve at least partial transfer to stakeholders, . . . such as workers, state banks, and the local government in the region where the enterprise resides . . . rather than simply a transfer of ownership directly to households."[7]

I believe there is merit in employee ownership—but how is it to be achieved? Lech Walesa and Solidarity would like to see ownership distributed as follows: 40 percent to the government, 20 percent to the workers, and 40 percent to private owners. It is a mistake, however, to retain any ownership by government or government-owned banks. Among the serious deficiencies of centrally planned socialist economies is the absence of competition among firms in the same industry. In Poland, for example, the pharmaceutical industry functions through one company, called Polfa, with thirteen noncompetitive subsidiary companies. Any retention of ownership by government, which will undoubtedly retain powers to regulate, will inhibit competition from newly created nongovernment-owned entities. Since such entities are likely to be created by joint ventures with foreign companies, the continuation of government ownership in industry will stop any significant foreign capital inflow to Poland.

Ownership in government firms should be sold entirely to private owners. That does not rule out purchases by workers' groups through Employee Stock Ownership Plans (ESOPs) or through stock option plans by managements. "Selling" shares will force the creation of a market structure, no matter how primitive it may be at the outset, and it will establish the principle of capital creation. Capital is created when current consumption is forgone and the savings are used through direct lending or through the purchase of securities to enable someone to use it to create real capital, for example, machinery, equipment, and buildings.

Once it is determined that equity shares should be sold, the next question is how such a sale should be managed. Any political intrusion will defeat the most desirable outcome, which is for all of society to receive the benefits of more efficient allocation of resources and higher standards of living. One possible approach to selling ownership in government firms is through a national lottery. This would eliminate the personal administrative element that would make such sales susceptible to deep resentment because of perceptions of a lack of fairness. The holders of winning lottery tickets would have the right to buy shares. They could also sell their tickets to others if they prefer not to undertake the purchase of stock or the interest cost of financing such purchases. It may take several lotteries to accomplish privatization. However, laws should be created to prevent government from retaining any ownership beyond a fixed date.

The changes in Poland have been wrought in part by Solidarity. It wants each company to retain a "works council" with the power to discharge the chief executive and to review annual profits with an eye to determining how much should be paid to workers as bonuses and to shareholders as dividends. This reveals, not too surprisingly, that market economies are not entirely understood or that they are not entirely appealing to significant interest groups in Poland. Establishment of a works council would mean that the effective management of a company would reside with the workers. If they are also owners, it might be successful. In any case it would require extraordinary leadership in the works council for the hiring and firing process to function as it must in a free economic environment and to pay the market price for capital. Obviously the retention of such a vestige of the socialist system would, over time, severely damage the ability of the company to attract capital.

Ownership should be conveyed in such a way as to ensure effective management. This can be done through stock options tied to performance. Stock options can also be allotted to worker groups on the same basis.

Valuation techniques should be used to ascertain the total value of firms, although share prices should be low enough, and financing should be available enough, to encourage participation that is as broad as possible. Due diligence should be a shared responsibility between the borrower and the lender: in other words, credit terms should be written in such a way that the borrower is not solely responsible for determining the likely success of a firm.

The objective in selling shares is not to maximize the value of a firm to the government, but instead to convey ownership to the private sector. The government will realize the benefits of privatization from the development of a strong, well-balanced tax base and the security stemming from the well-being of its citizens.

These benefits of private ownership will flourish more rapidly and with greater certainty if there is no effort to retain what some might regard as the "better features of socialism." Autocratic management, whether it occurs in a business or in government, destroys the collective initiative of the governed, and it undermines any organization's ability to match the achievements of an organization in which individual initiative is allowed and encouraged. "Psychic income" provides effective incentives for many people to excel in their endeavors, but such rewards are not perfect substitutes for material rewards related to performance, since psychic rewards cannot provide food, shelter, and clothing.

The destruction of individual initiative in an entire nation and the muting of material rewards for performance is deadly to human welfare. Privatization provides exactly the opposite effect.

Price and Wage Deregulation

Before discussing the necessity of allowing market forces to determine prices and wages, we might gain some perspective by recalling, as described in the pages of Robert L. Heilbroner's *Between Capitalism and Socialism*, a famous debate over the ability of a socialist economy to survive.

> The most intellectually respectable criticism of socialism in the mid-1930s was the effort of Ludwig von Mises and Friedrich Hayek to destroy the credibility of socialism as a desirable social order, not by inveighing against its ideals or its excesses, but by demonstrating that the economic system on which it was based would not work.

> In brief, their criticism was based on the contention that socialism was intrinsically unable to achieve a rational economic order—that is, a system in which all the factors of production were employed as efficiently as possible—because it lacked one critical mechanism: a market in which capital could be valued by the free offers of owners of capital and by the free bids of would-be hirers of capital. Since by definition there could be no private ownership of capital, no free market price for it could ever be ascertained. As a result, the only way of deciding which enterprises were to have capital, and which were not, was perforce the essentially arbitrary decision of some Central Planning Board. Such a system, it was presumed, could not long endure.
>
> This line of attack against socialism did not fare very well. In the mid-1930s it was effectively demolished by Oscar Lange, the brilliant Polish economist then at Harvard. Lange demonstrated in two incisive articles that Mises had failed to see that a Central Planning Board could indeed plan rationally for the simple reason that it would receive exactly the same information from a socialized economic system as did entrepreneurs under a market system. The only difference was that the Board would not learn about the condition of relative scarcity or plenty of capital goods or other commodities by price changes, as under capitalism, but by the building-up or running-down of inventories. That is, when a good was underpriced, instead of its price going up, as in a free market, the planners would discover that supplies of the good were being depleted faster than they were being replaced. All the Board would then have to do was to raise the price until the level of inventories was again constant. As a result, it could allocate its resources quite as efficiently as any capitalist system.[8]

Hayek and von Mises have been proved right, but they failed to consider the capacity of an authoritarian, nonpluralistic society to long endure the economic hardship of a system that would not work. Although their discussion centers primarily on the price of capital, it effectively deals with the price of all economic factors. I quote it here because price theory, which is one of the least disputed, most agreed-on theories in economic literature, seems to be the least understood by the public—even if it is the beneficiary of market economies. Prices are essential to convey information. They are not intended to extract income from buyers.

When Lange argued that a central planning board could simply move prices in response to inventory changes, he avoided any reference to kinds of inventories. He assumed, as did other socialists, that prices did not function to provide information about what kind of goods people wanted. As every visitor from Western nations knows, the range of goods offered to consumers in centrally planned economies is very narrow. It is so narrow, in fact, that despite comparatively high employment and the availability of income, the quality of life is much poorer than in free-market economies. The price of a good or a service is not expressed solely in the money price tag, but also in terms of quality. Thus even low money prices may be high if the quality of the goods is poor. A noncompetitive, centrally controlled market results in a comparatively narrow selection of goods that are high in price because of poor quality.

Prices and wages (the price of labor) that are freely determined by the market will result in the efficient allocation of resources.

Credit Markets

I will not dwell at length on credit markets. Banks must be among the government firms to be privatized. While there are libertarians who oppose central banks and money issued by government, I am not one of these. In any event, I prefer to propose what it may be possible to achieve. I doubt there will be any serious obstacles to the creation of central banks in Eastern Europe. There will undoubtedly be disputes about whether they should be subservient to treasuries. While many Americans consider the independence of the Federal Reserve to be sacred, I prefer to hold it accountable. That accountability may be much more direct and clear if a central bank is responsible to the executive branch of government. Moreover, monetary policy should not be carried out by a large committee. A committee of three is a logical number and will make accountability less obscure.

Consumer credit, including amortized mortgages, although it came along somewhat late in the development of credit markets in the United States, should not be delayed in Eastern Europe. While development of assembly-line production is well-known, the vital role of consumer credit is unfamiliar. Consumer credit enables households to acquire durable goods that are essential to increases in standards of living.

Insurance and Futures Markets

Life insurance is an essential financial services product that needs no great explanation. Liability insurance is also essential to encourage risk taking. It provides guidelines and knowledge of the costs of risk necessary to the rational conduct of any business.

Risk taking is also encouraged and spread through the development of futures markets for commodities and financial instruments. It has obvious benefits for agriculture.

Distribution Systems

In Poland there is a single government-owned agency that handles the distribution of goods and services within the country. It collects a fee of 8 percent for its services. This system must give way to privately owned, multiple systems for different industries that will reflect marketing skills. Distribution systems assume considerable risk in the success of businesses, and if they do not compete they will not become efficient. This is equally true in the field of exporting and importing.

Under the existing arrangements, the government collects and provides foreign exchange. Individual firms are not permitted to earn foreign exchange directly. This policy should be changed to provide an incentive to exporting and to provide for the rational flow of foreign capital needed for specific kinds of exporting industries.

Foreign Capital and Joint Ventures

Capital flows to where it is well treated, and it bestows commensurate benefits to those who provide a hospitable environment. The process begins with the treatment accorded capital owned by residents of a country. Nonresidents will not be encouraged to risk their investments in a country afflicted with "capital flight." This is a hard lesson for societies to learn. It has yet to be learned in Central and South America.

Foreign joint venture partners will seek sovereign risk protection, that is, risk against confiscation and exchange restrictions. These foreign partners will seek access to domestic markets in a given country, or export advantages arising from proprietary technology or low costs.

In most of the East European countries, low labor costs will be the initial best source of foreign exchange earnings. Tourism, which requires accommodations, transportation, and communications, is an industry that typically earns foreign exchange in developing countries. Another source of foreign exchange can be developed rapidly through joint ventures with foreign companies that have superior, but labor-intensive, technologies. The history of the development of Asian and Pacific countries offers an excellent guide to this procedure. These countries began as low-labor-cost producers, but they simultaneously raised the value of human capital through education. It is noteworthy that the largest single group of foreign graduate students in the United States today is Asian in origin. Many of these countries, from Korea to Malaysia, are now striving to develop their own indigenous high-technology industries. One thing countries along the Pacific Basin have in common is comparatively free market economies.

Poland's export markets, together with the other East European countries, have been formed within the communist bloc and, importantly, with the Soviet Union. These markets are no longer certain, however. All these countries have a desperate need to import technology and consumer goods from other nations. To do this they must earn hard, convertible currency. This places greater importance and urgency on joint ventures, which tap the advantages of the emerging economies of Eastern Europe and the overseas market access offered by foreign companies.

Social Security and Unemployment Insurance

I would oppose the introduction of social security to Eastern Europe. It has become a fiscal disaster in the United States. The same amount of money that has been taxed to support social security would have earned far greater returns had it been invested privately. Legal provisions encouraging private pension systems should be instituted in Eastern Europe instead. The savings in such pools would be used far more efficiently in private investment, and that in turn will enhance the tax base rather than weaken it, as has been the case with social security in the United States. Provisions should be made for early vesting and mobility of pensions.

Unemployment insurance will provide an important safety net during the transition and later. However, East European countries might benefit from looking at the Japanese experience. Paternalistic arrangements between labor and management provide wide latitude in determining wages and workplace arrangements. In return, workers are given comparatively greater job security than exists in other industrialized countries.

Under unemployment insurance arrangements, labor is apt to take the attitude that it has no responsibility for the competitive cost of jobs. Labor unions in the United States and Western Europe are inclined to hold to their demands even when doing so means that employees must be laid off to maintain the competitive position of the firm. The logic of such a position is that government will take care of the unemployed. Unemployment insurance, as in the case of all insurance, raises risk-taking levels, even when those risks involve unemployment.

Perhaps one way to describe the economic events unfolding in Eastern Europe, and now in the Soviet Union, is to liken those economies to an industry that has been regulated, subsidized, and otherwise protected from competition, and is now emerging into a free market. We know from the U.S. experience with deregulation that marginal firms will fail, incompetence and fraud will mark part of the transition, benefits will not be readily apparent to everyone, and nostalgia for the prior autocratic system of communist command economies will exclude from memory its harsh deficiencies.

The Support for East European Democracy (SEED) Act of 1989 provided $200 million to support, along with funds from other countries and the International Monetary Fund, structural adjustments in Poland and Hungary. These funds seek to establish the necessary structures for a free-market economy and a pluralistic society. There is still reluctance to move to complete privatization and market-determined prices and wages, however. We must recognize that what has happened in all these countries is the bankruptcy of central planning and socialism; the winning ways of capitalism and free markets have not replaced them. Those ways have appeal, but even in the United States, with its years of benefits from them, there are those who would introduce restraints usually associated with centrally planned economies.

The greatest risk faced by all of the countries emerging from socialist command economies is that they might not go far enough toward freedom. Some interest groups will seek to gain advantages over others, failing to recognize that the advantages they gain will still fall far short of those they would realize from pervasive acceptance of all the essential principles of market economies.

Three years ago at a RAND conference called to discuss unanticipated "future shocks," no one in the room even hinted at events of the past year in Eastern Europe and the Soviet Union. And even if someone, through remarkable foresight, had predicted the collapse of communism throughout the world, that person would not have been believed. Likewise, there is no reason to assume that our contemporary projections of future events in Eastern Europe and the Soviet Union will turn out to be true, however believable they may be. If someone with perfect foreknowledge told conference participants what would happen in that part of the world during the next five to ten years, that person would, again, probably not be believed. That is simply the nature of most accurate predictions. One possible way to start thinking about this, however, would be to quote from Heilbroner's essay, "A Look at the Future of Capitalism":

> However mistakenly, some form of planned socialist economy has been widely seen as the direction in which economic organization has been drifting, more rapidly in the underdeveloped areas, more gradually in the developed ones, but with ineluctable tread in all. The virtual collapse of centrally planned socialism has cleared away all such anticipations. The shape of things to come will be determined by the dynamics of world capitalism alone—an awareness that conjures up in some minds Pogo's famous statement that we have met the enemy and they are us.[9]

Heilbroner goes on to discuss his discomfort with, and others' criticisms of, capitalism. The point is that centrally planned socialist economies simply did not work. However, what kind of capitalist or free-market economies emerge in what is, to a certain degree, a vacuum, remains to be seen.

Twenty years ago, in his *Between Capitalism and Socialism*, Heilbroner said:

> Taking socialism seriously means more than acknowledging its difficulties as a political movement. It means understanding as well that socialism is the expression of a collective hope for mankind, its idealization of what it conceives itself to be capable of. When the fires of socialism no longer burn, it will mean that mankind has extinguished that hope and abandoned that ideal.[10]

Free markets and private ownership of capital have demonstrated economic logic, but in a democracy there is a drift toward egalitarianism. We may continue to find ourselves somewhere between capitalism and socialism.

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8 *Steven W. Popper*

Aid from Western Governments: The First Steps

The old order in Eastern Europe is gone. The degree of disarray in the former institutions of power is profound; these seem unlikely to play a significant part in reshaping the region. The success of the successor regimes and the stability of individual nations are not assured, however. To a great extent, domestic political consensus and institution building, national security, and even regional stability will depend upon resolving the economic crisis facing each nation in the region. If for no other reason, this makes the successful resolution of economic crisis an object of policy interest for the West.[1] The question of what the West might do actively to aid the process naturally arises.

This paper considers the question of the West's role in normative terms. After providing a context for discussing the general phenomenon of Western economic assistance, it provides a view of what governments, in particular, can and ought to do during the earliest stages of transforming the economic realities of Eastern Europe.

There should be serious consideration as well of what the limits to the potential role of Western governments might be.

The paper presents a single strategic framework, neither authoritative nor comprehensive, for discussion and assessment. The central thesis is that while most effort will have to come from the East Europeans themselves, there is a Western role for supporting local efforts. Stabilization and direct investment should largely be carried out by players other than Western governments. Individual initiatives from private commercial and noncommercial interests could be decisive in several areas. Yet, there remains a need for institution building; Western governments are best poised to contribute to this aspect of political and economic transformation.

The Economic Crisis of Eastern Europe

The countries of Eastern Europe would not naturally be counted in the ranks of the impoverished or underdeveloped. They are, in fact, medium-income countries, relatively well-endowed with human, material, and capital resources, that have traditionally exhibited high levels of saving and investment. The origin of the region's general economic crisis lies not in a lack of domestic resources per se, but in the inability of the economic systems as they existed in the past, and still largely continue to exist, to make efficient use of those resources. The solution to the crisis faced in each country must lie not simply in reform of existing systems—a process already under way, at least nominally, for more than twenty years in some countries—but in their thorough transformation.

This systemic, or "flow," aspect to the general economic crisis is the root of the general economic malaise and must be addressed. The crisis is also aggravated by problems of a "stock" character, however. Forty years of Soviet-style socialism have left a number of debts as a legacy. Most obvious, if not the most preponderant, is the debt owed to foreigners. While tractable in most countries, the accumulation of this debt was the first significant intrusion of reality into the economics of illusion holding sway throughout the region. East European leaders were surprised by their inability to translate borrowed funds into assets able to yield productivity gains and subsequently to earn payback. Though foreign debt is a major issue only in Poland, Hungary, and Bulgaria, it provides a paradigm for visualizing several forms of debt acting as greater burdens for the future.

Only a handful of these legacies, or stock problems, can be mentioned here. Among these are the debts owed to the environment, the debt owed to the capital stock,[2] and the debt owed to the civilian population of each country as manifested in goods shortages and the proliferation of monetary imbalances—the debt whose falling due played the largest role in bringing the communist regimes down, one after the other, in 1989.

Clearly, these latter, stock problems may be alleviated by money; the former, flow problems may not. The bifurcation of the general economic crisis and the dynamic connections between its two aspects frame the environment within which Western assistance must occur. Early on, the East Europeans turned to the West for help, and the West demonstrated its willingness to provide the means, if in more limited measure than some in the East hoped. The more thoughtful among the East Europeans will point out that what they wish from the West is not aid, but assistance. Aid, in the form of block grants and resource transfers, it is recognized, could be misused. It runs the danger of carrying in its wake a new bureaucratic structure that would absorb a good share of any resources. The biggest danger, however, is the potential for large aid grants to mitigate some of the stock problems, which are primarily the symptoms of crisis, and to thereby delay solutions to the systemic, flow problems, which are the cause of crisis. The greater need is for assistance to put in motion a fundamental transformation of systems.

Inherent Problems with Western Economic Assistance

Aid to Eastern Europe from the West is made problematic by the unique character, as well as the sheer range (and scale), of tasks being tackled. Drawing upon previous models of economic assistance to provide governing principles for today's effort without consciously incorporating the modifications necessary to adapt them to the particular circumstances of Eastern Europe may not only lead to squandering aid, but could, despite all good intentions to the contrary, result in a deterioration of the economic situation of the recipients.

This assertion is based upon several assumptions. Principal among these is the need for as quick an implementation schedule as possible to maximize the likelihood for successful transformation of the existing economic systems. Current discussion of economic policy in the region centers not on whether transformation is required but whether it should be rapid or more "moderate." Domestic politics will always require the time course for such a thorough transformation to be drawn out. This works to the detriment of reform. The operational essence of the process is to arrive at some point[3] where the momentum of transformation begins to overbalance the inertia of the past system. The period of transition must be reduced to as short a time as possible. Drawing out reform reduces the short-term pain, often because the actual elements of reform become attenuated, while running the risk that the cumulative inconvenience and suffering sustained by the population will be, in the end, as great or even greater than it would have been otherwise—with no ultimate payoff. A quick transition implies greater dislocation to the economy in the politically relevant near term and will appear as a considerable threat to rents originating from within the prevailing structure of informal property rights—stakes the population has in the current system even if only in the form of accommodations they have become comfortable with over time.

Several factors reduce the efficiency of more measured reform. To be successful, a program for the radical transformation of a Soviet-type economy must be able to draw upon a series of wasting assets. Foremost is the climate arising from the initial optimism, hopefulness, and goodwill of the civil population. This asset is required for buying the time necessary for the reform to work. If it is absent, the time available to reformers becomes ever shorter, and the ability and willingness of the population to accept change from the current regime grows less and less. In this analysis, the worst thing one can do is to waste time, frittering away such assets with simplistic, ill-thought-out policies, labeled as "fundamental reform," which do little more than probe at underlying problems and gradually enhance the view that something more major is required.

A second asset is the belief that the responsible authorities are serious and committed to the course they have charted. This particularly affects the process of transforming economic institutions and existing systems of relations, especially between enterprises and central authorities. If this proceeds slowly or indecisively, there will be internal pressure for the system as a whole to return to the "wild type" it was cultured from. People and organizations will watch to gauge the degree of serious commitment by reformist regimes before modifying their own behavior; they may as easily become genuinely confused by successive rounds of short-lived "reform" designs. Individuals will then tend to react to uncertainty and apparent crises by drawing upon their experience and training. A gradual reform process does not support a psychological or institutional break with the past and would permit the emerging systems to attempt "reform" rather than transformation by erecting administrative and legislative solutions in preference to market-oriented ones.[4] In the meantime, the population might become skittish, even panicked, the authority of the regime would dwindle, and the very word "reform" would acquire a highly pejorative connotation. Although dissatisfaction might build, serious economic transformation would then only be achievable after a process of political relegitimization.

The Soviet Union finds itself precisely in this unfavorable position. The central government is currently reaping domestic political penalties after gathering the fullest possible measure of ill will by, first, announcing successive "reforms" and, then, backing away from the announced implementation schedule once the deleterious effects became obvious to all.

Western assistance to Eastern Europe will do little more than assuage the consciences of the donor governments if it is provided in a form permitting current disequilibria to persist and allowing East European governments to postpone transformation. Removal of disequilibria and their systemic progenitors, not their preservation, will require the more active act of will. The latter condition would occur by default. Even if a new government sets out on a reform course, institutional drag will serve to frustrate its design. The tendency toward "leveling" in industry by formal or informal policies of taxation and subsidization, resulting in resource transfers from apparent profit generators to losers, has a bureaucratic persistence that is difficult to eradicate, especially in a period of concurrent political transformation.[5] The tendency will most often be to try to cushion the blow through operation of this paternalistic system, no matter how attenuated it becomes. Western assistance must be structured so as not to perpetuate, however unintentionally, this strong behavioral predisposition. The continuing importance of the central budget in all aspects of economic life, combined with the relative underdevelopment of market-type institutions, means that any infusion of resources into the East European systems will, without appropriate cautions, prove highly fungible. Before a true economic transformation is enacted, it would be almost impossible to ensure that resources of Western origin, intended for improving some aspect of infrastructure or for investment in some branch of the economy, would not ultimately have the effect of buying a bit more time for sectors contributing nothing, or less than nothing, to national income.

On the other hand, Western assistance could be a useful asset in lengthening the period of time available to a committed, well-articulated reform process by providing the means to help the transformation over the initial period of implementation. The trick, then, will be to find the means of doing this without entailing the risk of triggering efforts to preserve disequilibria. To reduce the possibility of unintentional negative consequences resulting from Western assistance, such economic aid should be designed to accord with certain underlying principles. Above all else, such efforts must be both *prudent* and *contingent*.

Prudence, in this instance, requires recognition that while money per se can alleviate certain of Eastern Europe's debts, it will not necessarily help, and in some instances could even hurt, the overall process of transformation to more functional economic systems. To the extent that such assistance provides the equivalent of balance-of-payments finance (which may then be used to avoid the harder measures of reform), or that it pumps greater liquidity into systems already burdened by the consequences of insufficient monetary control, it is a detriment. Precisely because of the underdevelopment or nonexistence of major market-type economic institutions, this lurks as a major concern. Large-scale assistance should be targeted to meet specific purposes in furthering the ultimate goal of successful transformation to an economic system that makes more efficient use of domestic resources.

The ideal of contingency suggests that aid of any significant size needs to be predicated upon a demonstrated commitment to fundamental reform in each potential recipient country. This is contentious. In many ears it sounds peremptory, as if the West were putting itself in position to force its system upon the former socialist states of Eastern Europe. It sounds ungenerous and so runs counter to the initial proclivities of many in the developed West. Yet it is based upon the recognition that the economic systems operating in the past, and to a large extent continuing into the present, have the capacity for absorbing large quantities of assistance without any long-lasting effect other than to increase levels of indebtedness. Contingency also is a requirement for assuring that primary attention is given to the flow dimension of the economic crisis and not to the ensuing stocks of debt.

This is not to suggest that assistance should be made contingent upon demonstration of successful economic transformation. Assistance is required earlier, as an important contribution to achieving success. The contingency should be upon the establishment of and primary reliance upon a new set of institutions and legal relations. The point is not for East Europeans to demonstrate their worthiness of assistance from the West; rather, it is to make certain there are means in place for treating the causes of malaise, not just the symptoms. Not coincidentally, this is also a requirement for successful application of assistance. The actual events ensuing from a transformation process are difficult to predict *a priori*; they are certain to be surprising. There needs to exist a mechanism, if only a rudimentary one, that will be responsive to the midcourse corrections and patches almost certain to be required by a program to modify as complex a system as a nation's economy.

De Facto Coordination through Division of Effort

The requirements of prudence and contingency imply a need for coordination among donors. This is a daunting prospect. The potential donors are numerous, the requirements of each potential recipient are not well specified and are open to argument and differing perceptions, and the time available seems short. Any coordination attempts, it would seem, are almost certain to fail because of the limited time and information available and because of differences in the agendas of the various players.

The barriers to coordination do not stem solely from Western shortcomings. Some are attributable to the East Europeans, although a good deal of this is owing to the suddenness of change and to confusion on the part of the new governments. In Hungary, the country perhaps farthest along the road to developing Western-style political and governmental institutions, there are new leaders in a new governmental system, and even two of the ministries most relevant to economic transformation are "new."[6] There is considerable infighting, uncertainty over turf, and an inability or unwillingness to come together over assistance issues. The government is not in a position to put out strong signals to Western partners. Government programs issued to date and in prospect for the immediate future are too general. This is partly because those with technical expertise within the government are not eager to make recommendations or to take strong stands. For example, the simple decision over which should have primacy in environmental cleanup efforts—clean air or clean water—is not solely technical; it is also in large part political. There is still great uncertainty over political direction and over the personnel needs of greatly restructured government entities. Experts are waiting for vastly overburdened, newly formed governments to give the signals for a new schedule of priorities.

East Europeans often single out the European Community's PHARE program (Pologne-Hongrie: Assistance á la Restructuration Economique) as the most coordinated Western assistance effort. This is partly because it has a well-defined structure for determining areas for assistance, which thus helps focus thinking and bureaucratic agendas. Its projects are categorized under the five headings of restructuring, trade, environment, agriculture, and education. Better definition permits better targeting.

The problem of coordination among donors seems to be made even more intractable by the speed with which events are occurring. Although a coordinated approach would seem desirable, to delay assistance while awaiting appropriate coordination would be to lose the opportunities of the moment and to fail to meet the pressing needs of Eastern Europe.

The answer to the coordination conundrum would seem to lie in somehow obviating the need for specific assignment of actual tasks to potential donors, a design almost certain to be unattainable, unenforceable, and doomed by its inherent rigidity. Coordination might follow more naturally if the general functions of the Western players were made clear and agreement on broad roles were reached. Further, if potential projects are themselves categorized by type, falling into two groups primarily, but not exclusively, distinguished by the magnitude of the resources involved, the situation seems less hopeless. Indeed, this division, although its line of demarcation is difficult to pinpoint, seems to be a natural one, based upon the variety of needs of the region.

The Sources

There are three classes of potential resource contributors: international institutions (for example, the International Monetary Fund

[IMF], the World Bank, and the new European Bank for Reconstruction and Development), Western governments either singly or in concert, and private business and philanthropic interests in the West. Each has a role to play.

The international institutions, principally the IMF, are best poised to take the lead in coordinating assistance to achieve the macroeconomic stabilization required in each reforming country. Substantial financial assistance from these or other sources must be predicated upon an agreement to a sound program of macroeconomic stabilization to be pursued in tandem with any aid program. Any assistance must follow a pattern of well-defined steps whose release will be predicated on maintaining a course of fiscal and monetary stabilization. The IMF is best suited to play this role, not because of any special expertise with Soviet-type economies, but because of the well-understood and limited character of its charter and the fact that it has no larger political agenda. It is the latter point that makes Western governments so ill suited to play a positive role in the stabilization process. They cannot be effective as an external force pressing other governments to maintain an austerity course. It is in the long-term interest of all that they remain uninvolved with the initial implementation of stabilization measures.

Western private capital also has an unprecedentedly crucial role to play. This source has the potential of providing a substantial amount of financial inputs, of aiding in the privatization of industry, and of providing considerable technical assistance. Direct foreign investment will, by its nature, be targeted to improving performance of specific sectors and could prove an important means for transferring technologies (both embodied and disembodied), for fostering managerial expertise and infrastructure, and for helping to indicate where existing productive assets could be put to best use to enable participation in the world marketplace.

Direct foreign investment will be opportunistic; that is its nature and its strength. Any infusion of resources from this source will be carefully targeted. It will prove to be most effective, and make the largest contribution, in those countries where Western business interests have most reason to believe the transformation process will prove successful. That is to say, the more reason there is to believe in the eventual success of the transition to a functioning market economy, the greater will be the tendency to think of activities as long-term investments rather than as attempts to gain short-term advantage from existing economic disequilibria. The less there is confidence in eventual success, the greater the "carpetbagging" problem—and the greater the potential for foreign investment proving a net decrement to a nation's resources. This harks back to the need for a credible program of reform to be tied to contingent stabilization assistance that is provided by international economic institutions. Therefore, though not coordinated in a formal way with the stabilization process, direct foreign investment by Western business will, by following its own best interests, be tied to the successful emplacement of well-crafted reform packages.

Two Types of Government Assistance

The balance of this paper will discuss a strategy governing the assistance efforts of Western governments.[7] Aid from this source could be channeled through international agencies, in which case the prescription sketched above will hold, or it could be administered directly by agencies of the donor government. This last role is in many respects the most problematic. Whereas the interests of international agencies and private investors are easily defined and rather straightforward, the behavior of Western governments has the potential for being influenced rather more by domestic and foreign political interests and pressures than by purely economic considerations. This, coupled with the magnitude of the resources they wield, makes governments most susceptible to aiding the implementation of assistance strategies with potentially deleterious consequences for the recipients.[8] Many of these pitfalls may be obviated if Western governments consent to be bound by an additional set of rules in their assistance efforts.

Western governments should view potential initiatives as falling into one of two classes: those to be pursued initially and at the earliest opportunity, and those to be implemented later during the course of the reform process.[9] The two types are also distinguished by the nature of the ends they are designed to achieve. The first class, the projects and programs set in motion immediately, should be directed toward improving human capital endowments and to rebuilding and reformulating the institutional infrastructure of East European economies. These will be relatively small scale: any given initiative will have minimal budgetary impact on either donor or recipient. The effect of such programs will come through the leverage of their influence, not from the amounts of money at stake. Finally, their defining hallmark will be speed of implementation.

Many of these early initiatives may be put in place even before the stabilization plan and the main package of reform measures are formally enacted. These initiatives will help develop domestic constituencies for and consensus on the direction of reforms, as well as building the institutional infrastructure necessary for successfully carrying the reforms out. Western interests and those of Eastern Europe would benefit if these initiatives were engaged in extensively wherever opportunity offered, that is, wherever the local governments were to permit. Because of the minimal impact of any given effort, the need for policy coordination decreases. Indeed, such endeavors might even be aided by a multiplicity of responses from different donors. The problem imposed by the press of events is solved: each donor could and should do as much as it can in this vein at the earliest opportunity to meet perceived needs. Some specific initiatives will be suggested in the following section.

The second class of initiatives comprises programs directed to improving the physical infrastructure of Eastern Europe and helping clear several of the region's debts. These will likely be larger-scale efforts disposing of significant resources. Environmental cleanup, the meeting of transportation and communication needs, and the revamping of health care systems are but a few examples that come readily to mind. Significant efforts in these areas should be implemented in a rigorous manner, consistent with the principle of contingency in that they should be intimately bound with achieving specific indicators of success in the reform process.

There are several problems inherent in larger-scale lending. So much is at stake that no one can afford, politically or economically, for individual efforts to go wrong. The required caution will lead to delay in implementation and an excess of administration. By late June 1990, East Europeans felt they had seen little or no money for such large-scale projects from the leading industrialized democracies. What they had seen were three or four fact-finding delegations a week. Politicians and the East European bureaucracies were overburdened by them, as were enterprise personnel. New governmental systems find it difficult to cope with these junkets, and East Europeans have become doubly annoyed because of their perception that such missions come at the expense of the funding for actual programs.

There are other dangers inherent in large assistance ventures. If employed at an early date, they may be misdirected to addressing the wrong needs. For example, agricultural commodity assistance programs to redress what are perceived as chronic shortages of basic foods may well be inappropriate. Shortage may well exist because of chronic excess demand stemming from unrealistic pricing, or because of shortcomings in distribution systems. Commodity assistance would address neither of these problems, and could even delay their recognition and solution while destroying the incentives of newly privatized domestic agriculture.

In general, large assistance ventures run the risk of providing resource transfers sufficiently large to tempt the delay of fundamental transformation of the economy. The ideal for large-ticket assistance programs is to incorporate ideas of conditionality. Whereas the hallmark of small-scale initiatives is speed of implementation, here the defining hallmark should be contingency. These efforts can, and should, come later in the course of economic transformation. They should be structured in successive steps, or tranches, and the stages should be triggered by meeting certain targets. The conditions need not be tied solely to the sectors in which the assistance system is to lend aid. As an example, successive tranches of a large program to assist the rebuilding of rural telephone service or electrification might be tied to milestones of privatization and the breaking up of concentrated industries. At first blush, this linkage appears beside the point, the two themes unrelated. Yet such conditionality addresses the heart of the problem of large-scale Western assistance: how to effect the positive transformation of these economies without allowing underdeveloped systems of fiscal control to be overcome by pressures to engage in resource transfers that will only shore up existing structures. Major shifts of resources should take only this form.

This effort might be easier to control and bring to fruition than it may first appear. Few potential sovereign donors will be in a position to fund large-scale projects by themselves.[10] Coordination and consultation will need to occur as a matter of course. The emphasis on contingency will ensure some level of interaction with the international agencies. While the need is pressing, the time necessary to plan and coordinate such efforts will be available, because the first type of Western governmental assistance will reduce pressure on Western governments to be seen to be "doing something" to aid Eastern Europe.

Suggestions for Action

This section considers more specifically possible U.S. and other Western initiatives of the first type—those to be put into action at the earliest stage of transformation. The balance of the paper will concentrate attention on these measures inasmuch as, by definition, they will be the initial steps of a comprehensive assistance package.

Immediate Western assistance should be targeted to the core concern in preparing the way of successful economic and political transformation: making it clear to the populations of Eastern Europe that democracy will better serve their long-run interests than even the most enlightened of dictatorships. The best supports for emerging democratic systems are productive, wealth-generating local economies.

The emphasis of the small-ticket assistance constituting the bulk of early Western efforts should be on education in its various forms. The Peace Corps program to teach English, a target of initial ridicule in the West, is a model for this type of action. It has been well received in Eastern Europe, where it is seen as providing a key to helping open many other doors.

Even the programs of the first type, although freer and more flexible than the second type of initiative that requires major allocations, will need to follow certain rules if they are to be effective. First, creation of new bureaucratic structures should be avoided wherever possible. Programs should work through existing systems on the part of both the recipients and the donors. New structures cost time and money and erect barriers of intermediation, preventing the true needs of ultimate recipients from being heard and addressed.

Second, in general the theme of all such programs should be to "train the trainers." Programs should be targeted as much as possible to institutions of education, instruction, and training. This is the best way to leverage whatever aid is forthcoming, as well as to consummate as quickly as possible a transformation of basic systems.

A third rule should be that a strong institutional predisposition should exist that favors long-term relationships rather than short-term consultancies. The latter are more likely to be a waste of money (as Groucho Marx so eloquently put it, "Hello, I must be going"), are less likely to have lasting effects or contribute to synergy, and, most important, are more likely to bring in personnel with an interest in, a predisposition for, and a lack of practical alternatives to, their own off-the-shelf programs. Longer-term initiatives are more likely to be molded to serve actual needs based upon analyses of the local situation. The predisposition to longer-term engagement needs to be "hard-wired" into the program structure from the beginning, or else the exigencies of the moment and the desire of agencies to be seen to be doing *something* in the short term will make it more likely for the more superficial forms of engagement to be funded.

How are the needs of the region to be identified? Naturally, there must be extensive contact with governments at all levels and with informal or nongovernmental groups. Another way to determine needs is to set up an information service to poll businesses eager to enter the markets of the region. Legislation should enable U.S. government agencies,[11] or the joint U.S.-East European enterprise funds established by the Support for East European Democracy (SEED) Act of 1989, to act as clearinghouses to collect information on what potential investors would wish to build in the region and to identify the personnel and skill barriers in the way of these plans. If some service or production arrangement appears to be favored by local conditions, but is impracticable because of the underdeveloped state of training or institutional support in some area, programs could be developed that would combine government and private resources to provide the training. This would make for further coordination between governments and the actions of private business.

In shaping programs, decisions will need to be made about whether it is more efficient to train East Europeans at home or abroad. On the one hand, costs would be greater, and the number of trainees subsequently fewer, if training occurred in the donor country. It might even be counterproductive in some training areas, where information could be imparted more easily on-site, or where unmodified international practice would not suffice to meet needs and would have to be shaped to local interests, practices, and concerns (for example, in the training of local law enforcement personnel). Further, some thought would need to be given to constructing such programs so as to guarantee the return of trainees to their countries of origin. Perhaps most seriously, training East Europeans abroad would require developing mechanisms for selection not required by on-site programs. These mechanisms would tend to become almost irresistible objects for politicking, patronage, and local power plays.

On the other hand, a training program based abroad has one tremendous advantage over *in situ* training. One of the major problems faced by Eastern Europe is the "dead weight" imposed by highly structured approaches to every aspect of daily life. These shibboleths are so pervasive and so common as to be rarely perceived; they are virtually invisible to those most affected. The dead hand of what East Europeans know to be "true," to be the accepted way to do things, is in some ways the greatest handicap the region bears. An expert coming from the West to Eastern Europe will impart what he knows, but it will often be placed by East European trainees within their own familiar frames of reference. This effect could undercut the purpose of the whole exercise, causing undetected miscommunication. In some areas, it would be valuable to impart an entirely new frame of reference or at least convey the insight that there may be ways to achieve a given end other than those in the trainees' familiar tradition. Such insights are not readily transferable in an overt process and need to be perceived by the trainee as a systematic totality. Scholarship programs for trainees are a means for providing this type of information transfer. While the number of such trainees may be few within an overall program, each has the potential of becoming a benign "virus" to vitalize existing systems in the home country. A few such trainees could greatly magnify the potential effect of *in situ* programs by providing them the tools they would require, in the form of their home-trained compatriots, to implement new approaches.

Specific Initiatives

There are some specific programs and program elements that both would be purposeful and would meet the most pressing needs of East European aid recipients. My intention in listing them is to illustrate the wide range of possibilities for projects of this type, as well as explicitly to identify some of Eastern Europe's most pressing needs.

Local government. A phenomenon common to the region, indeed, the essence of the political transformation of 1989, is the decentralization of political authority. As part of the process, local governments are gaining control of, and responsibility for, maintenance and provision of local services. No longer will these things be sustained by formal subsidies from the center or by informal subsidies shunted through the alternative mechanism of the local party structure. Small governments must now guarantee local finances, find solutions to local problems, deal with environmental and public health issues on the local level, and engage in a wide range of public works projects. The expertise and tools, both analytical and administrative, to deal with these issues are profoundly lacking.

In the wake of these systemic changes and the removal of the former integument of the local party networks, breakdowns of local government structures would have a poor effect on popular perceptions of the democratization process. Such breakdowns would also compromise the political system's ability to absorb and sustain economic transformation. In particular, they would complicate efforts to make certain that Western direct investment does not accrue exclusively to the capital cities.

Aid to local governments presents itself as a potentially fruitful avenue for assistance. An institution already existing that might serve as a bridge in promoting this development is Sister Cities International. Funds provided by donor governments could be used to establish programs to send experts, set up general-systems approaches to a standard package of problems, and transport East European local government officials to observe the operation of local government in the United States.

Education. In line with the general recommendation to "train the trainers," professional exchanges could play a big role. A particularly important mechanism to support both emerging democracy and economic transformation would be to provide the services of experts in areas such as banking, journalism, accounting, and law. The existing Fulbright or International Research and Exchanges Board programs could quite adequately be directed toward this end. In some instances, these would be "green field" ventures, putting in place educational assets never before existing. As an example, universities throughout the region are reassessing their need for large departments of scientific socialism, while there exist virtually no means for instruction in political science in the Western sense. Such efforts need not necessarily be confined to the university setting. The Fulbright auspices could be used as a platform for organizing professional seminars and training programs.

Banking. One vital ingredient for any successful economic transformation is the establishment of independent and viable central and commercial banks. In some countries there already exists a degree of banking expertise, while in others such institutions operate only at rudimentary levels. Instruction and advice in the basic tenets of banking practice will provide economic systems with experts in such vitally needed functions as credit evaluation, risk analysis, monetary policy, and the art of maximizing financial resources consistent with sound banking practices.

Journalism. New journals, newspapers, and other media sources are springing up daily throughout the region. Enthusiasm and interest are high, while the level of professionalism and journalistic responsibility is often distressingly low. It would be of great value in assuring the existence and influence of a viable free press to train journalists and publishers in the ethical and financial aspects of journalism.

Law. Although many unsatisfactory laws have been taken off the books in postrevolutionary Eastern Europe, a problem remains because few new laws have been put forth to replace them. Thus, the shattering of the former system of censorship has not been accompanied by any law governing libel or conferring other forms of press discipline. Magazines offering pornography of the most graphic and brutal nature are sold out of the same kiosks where children buy their comic books. The restrictive and repressive socialist laws on small business have been discarded without being replaced by a new code of business law to cover such areas as reporting and auditing requirements, contracting, and bankruptcy. There is great need for contact with Western legal experts to assist in the massive task of framing new legislation. Beyond purely technical advice, expertise will be needed to gain some insight into what the consequences of specific legislation might be, given the realities of each country's situation.

Small business. It would be useful to have a program bringing experts from Western small business administrations to help in establishing chambers of commerce and other counterpart institutions in Eastern Europe. Even where these already exist, they are either discredited or in need of serious revision. Privatization pressure would be strengthened by establishing lobbying groups of small business owners.

Equity markets. An exchange program could be developed, in concert with the New York Stock Exchange, the American Stock Exchange, the National Association of Securities Dealers, and the Chicago Board of Trade, to send over employees who can aid in the reestablishment of local exchanges in Eastern Europe by working in them for a time. Functioning exchanges will be crucial tools in aiding the privatization of state industry on a local basis. Well-established bourses will ease some political worries tending to slow privatization by ensuring, as far as is possible, that shares in former state enterprise will continue to be traded on domestic exchanges and not on those of the West.

Parliamentary support. A characteristic of the political transformation of the region has been the transfer of power from communist parties to parliaments. Whereas, almost without exception, the former communist parliaments met for a maximum of only a few weeks of the year to rubber-stamp government decrees, they now have primary responsibility for legislation and governance. Parliamentarians in Eastern Europe as yet have no professional staffs to assist them with research, drafting of legislation, or constituent outreach. Exchange programs with congressional staffers, or perhaps even better, with the staffs of various state legislatures, would considerably strengthen staff work in East European parliaments by providing models as well as practical advice. This is the single most useful type of assistance the U.S. government could render in consolidating the democracies of the region, by helping to ensure parliamentary control. Once such programs were in place and both sides had a better sense of the needs and the likely scale of the effort, follow-on programs for assistance could be focused on providing such tools as computers, related equipment, data bases, and other aspects of infrastructure.

Environment. Throughout the region, environmental degradation has been disastrous. This has troubling long-term implications for public health, as well as short-term economic consequences as large point-source polluters are identified and shut down under public pressure, often engendering serious supply implications for economies characterized by high levels of concentration in most industrial sectors. There is a great need for libraries, data bases, and contact with Western environmental control experts.

Educational materials. There is a common need, felt throughout the region and in all sectors: for books, books, subscriptions to Western journals, and more books. These are vitally needed in all fields, are quite scarce, and are terribly expensive to countries trying desperately to achieve some measure of fiscal control by reducing subsidies. Books are needed and wanted, will be heavily used, and thus will be highly influential. In this connection, some thought might be given to the fate of the libraries attached to the U.S. forces based in Western Europe, likely to be drawn down soon to some as-yet-unspecified degree.

Student support. Scholarships need to be provided to enable East European students to attend U.S. universities. Many schools are prepared to grant tuition waivers but are not capable of covering housing or transportation costs. U.S. government funds could be used to make up the shortfall.

Accounting and enterprise organization. Much has been made of the need to teach management skills to enterprise personnel. East

Europeans find themselves overburdened with offers to establish management training centers. Much of this attention has been misplaced and is based upon misassessment of the problems ailing East European managers. It is not the skill of the management that is wanting change, but rather the environment in which the managers operate. There is room here for massive Western assistance. As with many laws identified with past regimes, the official accounting practices of the past are now no longer mandatory. As with many other laws, however, nothing has been placed in its stead. Therefore, practice reverts to the methods most familiar to enterprise personnel. For lack of an alternative, the accounting methods of the past, and former systems of enterprise management and organization, continue. Designed to shape the enterprise as an instrument within a system of hierarchical command, these systems now fail to provide the information needed by independent, competitive firms intended to play a part in a transformed economic system. Considerable assistance is required in framing and diffusing awareness of accounting practices and enterprise organizations appropriate for the new requirements of enterprises. Such assistance is by no means sufficient to guarantee appropriate incentives; other changes in the economic sphere will be required. When instituted, these changes will render enterprises more responsive to the opportunities presented by modifications of the economic system. This is crucial to the economic well-being of the region as a whole.

Retraining. Some thought should be devoted to the potential for retraining intellectual workers. Perhaps the biggest barrier to political and economic reform is the requirement for agents to behave in ways that are new and unfamiliar, if not "unnatural." When placed under stress, their inclination, if choice exists, is to rely on past training for solutions. Thus the tendency of the system as a whole, when stressed, is to revert to earlier patterns. There will be many potentially useful members of society made redundant by the profound changes in Eastern Europe. They threaten to form a class of disaffected, formerly important persons who have little obvious place in the new circumstances (military political officers, officials of planning agencies and price offices, and the like). Even perceptive critics of the former economic system, the providers of the intellectual antecedents to the revolutions of 1989, may also find themselves at a loss when the objects of their years of study and mobilization efforts no longer exist. They are too valuable a resource to be lost. Provision should be made for some form of counseling to help them find their place in the new system they helped bring into being. The degree to which they can conform to evolving circumstances will in itself be a measure of how much systemic evolution occurs. Their readjustment can be furthered by teaching them to employ strategies to identify and place an appropriate "spin" on skills they already possess, to help them ease their entry into new circumstances.

Scientific exchanges. All East European countries possess large scientific research and development (R&D) establishments. In some fields, several such institutions are distinguished by the quality of their personnel. By and large, however, they have contributed a disproportionately small amount to the international pool of knowledge and invention. Again, a good deal of the blame can be laid to the bureaucratic system within which they operated, both domestically and multilaterally with Soviet-bloc colleagues. Throughout the world there is today a current of international cooperation running through many areas of science and technology. The major avenue for such cooperation in the East—the Council for Mutual Economic Assistance (Comecon) and in particular its large-scale Comprehensive Program for Science and Technology to the Year 2000—seems likely to become defunct. Further, many aspects of R&D administration and national science policy formulation taken for granted in the West (for example, merit panels, decentralization of effort, and peer review) are not innate in the existing systems of Eastern Europe. There is a need to draw the East European scientific establishments into the current of international discourse.

This suggests a need for more resources and emphasis to be placed on exchanges among scientists, East and West. The benefit the

East Europeans would reap from coming to the West seem obvious. Less obvious would be the quid pro quo the Eastern visitors would provide. Some sources suggest that these scientists and technicians, as a result of being forced to work with antiquated equipment and relatively fewer resources, are often better at experimental design than their Western counterparts. In this area the commerce in benefits stemming from Western assistance may well flow two ways. Visa requirements should be eased and fellowships provided for East European scientific workers, along with an increase in the resources to maintain Westerners working with their colleagues in the East.

Conclusion

There remains a substantial need for financial assistance to Eastern Europe. Each nation of the region labors to a greater or lesser degree under several forms of debt. The first assistance to come from Western governments should be channeled through international organizations best suited to impel the new governments of Eastern Europe to stay the course of reform while implementing feasible policies of macroeconomic stabilization. Later, after the structure for transformation has been firmly established, Western governments may consider more massive infusions of material assistance, although the importance of private commercial efforts could be great. Donors of such aid must, however, always maintain their primary objective firmly in view. Assistance should be tied to ensuring the successful transition to economic systems better suited than those of the past to utilizing domestic resources. To do otherwise, in spite of all good intentions to the contrary, would be to prolong the existence of current systems by providing means of avoiding the painful necessity for change.

Enacted in some haste by a U.S. Congress eager to assist the great changes in Eastern Europe, the SEED Act has and should continue to serve as a model for immediate action by the governments of the West. The press of events affected the form the act took, but it is the thesis of this paper that the SEED legislation is an appropriate and vital part of a coordinated approach, however inadvertent this outcome. It is appropriate to meet Eastern Europe's present needs. Western governments should now be stimulating private initiatives, facilitating contacts between their citizens and those of Eastern Europe, providing expertise on the construction and rehabilitation of institutions, and helping build the skills necessary for a successful transformation to market systems. Now that time is more of a luxury than it was in the autumn of 1989, there is danger of enacting initiatives that will prove too challenging to the institutions of East European countries still struggling with problems of stabilization. The challenge is to make certain that the legislative successors to the SEED Act carry forward purposefully and by design what was put in place in the original by good intentions and default.

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9 *Lawrence H. Summers*

Reform in Eastern Europe: What Must Be Done? What Can Outsiders Do?

A good rule about social phenomena is that they take longer to happen than anyone expects, and when they do happen, they move more rapidly than anyone could predict. That was certainly the case with the decline of communist economies, and one suspects that it will be the case with the economic renaissance we hope will occur in Eastern Europe at some point.

My comments cover four questions: (1) What exactly are the economic problems that the East European countries face? (2) What must be done about it? (3) What are the limitations on what outside aid can accomplish? and (4) How can aid be used as a lever for growth? (I use the term "aid" in the broad sense of what the U.S. government can do, rather than the narrow sense of what U.S. aid can do.)

What Are the Economic Problems?

The problems in Eastern Europe—and in the Soviet Union—are broadly of three kinds. The first is the "flow problem": They have the wrong system—one that does not work. Inflation is pervasive; repressed inflation is much more costly, and gives rise to queues and black markets. Macroeconomic imbalances result in price distortions. The lack of incentives for enterprises to be efficient constitutes the most significant problem facing these countries.

The second class of problem concerns socialist debts: the hard-currency obligations to Western creditors, an environment that has been squandered and plundered and surely requires more spending to be restored, and debt in the form of deferred maintenance and lack of investment.

The third category of problem is that after decades of socialism, people do not have a work ethic. As someone put it, "Well, it's all very well to talk about privatizing agriculture and selling people their farms in the Soviet Union. There are just three problems. One is that the farmer isn't really a farmer, he's a guy who lives in a twelve-story building and is bused out to the fields. The second is that his grandfather is still alive, but his friend's grandfather who owned land was shot. And the third problem is that he knows he can't get any gasoline for the tractor and the collective farm can, and they don't come by it honestly; he doesn't know how they get the gasoline and he doesn't particularly want to know, but the moment it becomes his plot that will become his problem as well."

On the other hand, one can overemphasize those attitudinal problems too much. Soviet Prime Minister Nikolai Ryzhkov was asked what would happen if the black market suddenly went on strike, and he said the economy would collapse. The success with which the black markets operate suggests that if incentives existed, people, being people, would respond to them. If there has been no permanent poisoning of attitudes, that would allow a viable market economy to function in these countries.

It is also true that socialist debts are of a magnitude that a well-functioning economy could rapidly outgrow. In 1980, South Korea's debt problem was much more serious than Brazil's or Argentina's; when South Korea grew rapidly, the debt problem was resolved.

Systemic problems are, in a sense, a sign of opportunity. You can ask yourself why your child is doing badly and whether there is anything that can be done. It is probably better news to learn that your child is an underachiever who is not studying than to learn that he is not very smart. In exactly the same sense, the fact that poor performance is a consequence of the system rather than a consequence of lack of human capital, the fact that people cannot work properly, the fact that there are not enough machines, means there is opportunity for rapid growth.

What Must Reform Accomplish?

What, then, must be accomplished? Three things that are essential: the macroeconomy must be stabilized; the institutions of capitalism must be created; and, what is often neglected but is most important, the rules and laws of capitalism must be established. Even Milton Friedman recognized that there was a role for an "iron hand" supporting the invisible hand. Spontaneous privatization is a major problem in Eastern Europe. What does that mean? It means the existence of a kind of corruption that does not appear even in *Barbarians at the Gate*. It is one thing to say, "I own an enterprise, I am the manager of an enterprise, we have legislated enterprise free of centralization." That is good, but if my enterprise proceeds to make my brother-in-law's company, in which I have a strong personal interest, into its major supplier, then laws and regulations are needed. What stops this behavior in the United States is not that the decentralized shareholders of General Motors are watching and monitoring the corporation carefully. What stops it are laws, laws that then establish certain cultural norms.

It is easier to draw up a list of what is different between Western economies and socialist economies, and to say that socialist economies must take on the features of Western economies, than it is to say something useful about questions of staging. How fast should it be done, and what should be done first? There is a certain amount of naivete about the possibility of making an excessively rapid transformation. Even a careful study of the German economic miracle shows that significant numbers of prices were controlled for several years. There were precious few convertible currencies in Western Europe in the 1950s, and the postwar problem of privatization in particular is one that is greatly oversimplified in some discussions.

I'm inclined to agree with a view strongly advocated by my colleague Janos Kornai: it is tremendously important (and also not very hard) to get out of the way of the people in Eastern Europe who are going to be entrepreneurs and who are going to start businesses. That is the easy part. Two-thirds of Eastern Europe's people work for the thousand largest enterprises, however, and you have to think about what will happen to them.

Some people have the image that what the British did when privatizing British Air can be done in Eastern Europe. You roll in Goldman, Sachs, you have an underwriting, you sell a firm outright or auction it off, and the people who pay the most get it. Britain worked pretty hard at privatization. They had a determined leader. They already had the City, and they accomplished twenty privatizations in eight years! There are 7,800 major enterprises in Poland. It is just not easy to do quickly. And if it is done quickly, the process may run into what might be referred to as the "privatization traps." You have an enterprise; you sell it in today's Czechoslovakia. The price is wrong, there is some question as to what the government is going to hold: people pay twelve-times-earnings for companies in the United States, they are not going to pay twelve-times-earnings for companies in Czechoslovakia; suppose they pay three-times-earnings. Then there are two possibilities. One is that the reform works brilliantly, in which case the people who say that the companies were "stolen" at a small fraction of their true value turn out to be right ten years later. The result is a buildup of incredible popular pressure—pressure to get at the speculators, to tax them heavily, to expropriate, to take the enterprises back. The other possibility is that the people who say that the price was too low turn out to be wrong; if they turn out to be wrong, then the reform was not successful anyway.

So the specter of selling off all the enterprises quickly is just not realistic. Another reason for reaching this conclusion, aside from the logistics and the fact that a fair price or a happy solution is impossible when privatization is attempted too quickly, is that the wrong people have all the money. There is a story about a former governor of Arkansas, who filed a statement showing a personal net worth of $12,000 when he first took office. In eight years, he left office with a net worth of $750,000. As the governor's salary was only $14,000 a year, he was asked how he accomplished this. He looked the interviewer in the eye and said, "Thrift!"

In just the same way, in the Soviet Union, roughly half the money is held by people who have 50,000 rubles or more. A very generous annual income in the USSR is 6,000 rubles, and so one suspects that a large fraction of the people who have the most money did not come by it honestly. The politics of selling to the people who have half the money—and presumably most of the money that would be available for large purchases—raises very serious questions.

In seeking to transform formerly socialist economies one must first think about macroeconomic stabilization and price reform, to create a sense of what really is valuable and what is not. Privatization should come second. It should come through some form of gradual strategy, perhaps involving the divestiture of large numbers of companies to competing mutual funds, perhaps through setting up a workers' pension scheme, or competing pension schemes, that invest assets. What is surely not viable is to immediately create a big stock market, with everyone trading on a large scale. The German stock market, even today, represents only 20 percent of Germany's gross national product (GNP); four companies represent 60 percent of the value of the Italian stock market. It is just wrong to suppose that "people's capitalism," with everybody trading on the stock market, is necessary for capitalism to work, or is viable in the short run for what is going to happen in Eastern Europe.

What Are the Limitations of Foreign Aid?

What about the role of aid? I suggest there are three problems. First, aid to governments strengthens governments, but the objective, of course, is to go in the opposite direction. Of course, that is not completely true. Aid to governments that helps them to enforce insider trading laws, that helps them to figure out how to sell enterprises, that helps them set up a safety net, is desirable. It is claimed, although I do not know whether the claim is true, that state enterprises in Poland that want to be restructured and want to learn how to export are told they cannot get financing to pay for Western consultants because they are not yet in the private sector. This claim is made often enough so that I believe it. If true, it reflects a real obstacle to effective reform. Nevertheless, in general, the main effort of aid has to be to reduce the role of government.

I refer, with some irony, to the discussion of federalism in the socialist world. Particularly in the Soviet context, there is a case for decentralization, and there is a case for strategies that promote breakup rather than unification. Such strategies are obviously difficult to design when one is talking about government-to-government federal aid. The case for supporting decentralization rests on three arguments. The first is that new blood would be more likely to succeed than would old blood. For example, one wonders whether a government in Moscow with the old ministries in charge would have the same chance of accomplishing reform that a new and—one would hope—democratic government of, say, the Ukraine would have.

The second argument for decentralization is the "competing jurisdictions" argument. U.S. corporate law helps corporations because there is a race to the bottom, as corporations try to locate in whatever state is maximally advantageous. In an atmosphere of deregulation, the Soviet republic that has the most generous foreign investment code will get the foreign investment. The republic that moves first to raise prices will get the goods and lose the rubles. The republic that has the most ambitious reform program is likely to get the most Western assistance. The dynamic of competition will tend to force everyone to move more dramatically than they otherwise would. When Estonia raised the price of liquor and Leningrad did not, everyone with a pickup truck appeared in Leningrad to transport the liquor back to Estonia. That produced pressure to raise prices in Leningrad. It also, it must be said, produced pressure for passport controls in Leningrad, and that is obviously much less advantageous.

The third argument for decentralization is that no one knows what the right answer is; trying multiple strategies, seeing which ones work, and then having the ones that work be emulated has something to recommend it. By avoiding a focus only on central governments, problems can be limited.

Besides the limitation that relates to the government-to-government character of aid, there is the "fungibility" issue. If one looks carefully at U.S. assistance to Latin America in recent years, a significant fraction of it has been recycled back to U.S. banks. U.S. banks have been indirect but significant beneficiaries of that assistance, and there is a question as to whether that is a desirable way to spend money. If more of the assistance had been in the form of education in villages and less in the form of cash grants to central governments, this outcome would have been less likely.

Finally, aid as investment can accomplish very little because of the inevitably limited scale of resources.

Aid as a Lever for Growth

Consider the money stock of the Soviet Union, not the so-called ruble overhang. The entire money stock of the Soviet Union, which is approximately equal to the total retail sales of the Soviet Union, is about 500 billion rubles. The black market exchange rate, in the fall of 1990, which is an extreme number in this calculation, was about twenty rubles to the dollar. That means the entire money stock of the Soviet Union was only worth $25 billion. If one believes the ruble overhang is half of that—a figure that is probably on the high side—that makes the overhang $12.5 billion. If large amounts of hard currency were made available, that exchange rate would, of course, change. Using the tourist exchange rate, or six rubles to the dollar, the money stock of the Soviet Union—retail sales in the Soviet Union—would be about $80 billion.

The point is that, given the scarcity of goods and the scarcity of hard currency, small amounts of hard currency, though quite large relative to people's incomes, could have substantial effects if used appropriately. That does not say whether those effects will deter or encourage reform. There were large amounts of hard currency flowing into the Soviet Union, in the form of borrowing, throughout the 1970s, without any substantial effect. In a country of 300 million people, $4 billion or so could, however, make a difference. Given how important imported goods are to the Soviets, small amounts of aid money could make a very large difference.

I would like to highlight two other points about aid as a lever for growth. Stabilization loans clearly are a good idea in countries that are truly stabilizing, especially in the context of leading them to get rid of repressed inflation. Our conference discussion has emphasized what is probably the single most important thing we can do, namely, to keep markets open. This will reward initiative, encourage foreign investment in these countries, and lead to their acquiring the right price structure, namely, that available in the West. It is appropriate to think of money spent to buy political acceptability of open markets—whether it is assistance to displaced workers in Spain or inducements of some other kind to relevant constituencies—as spending to help Eastern Europe. It may well be that spending money to buy political acceptability of open markets is one of the most important things we can do.

The other point we have neglected in our discussion of aid in the form of technical and managerial assistance is debt relief. My impression is that discussions of loans to these countries typically make the mistake of supposing that debt will be repaid. I think this is probably not a valid assumption. Yet, I am a little bit skeptical of just how much is accomplished when debt that is probably not going to be paid is forgiven. Not much may be lost, but I believe it is a mistake to think that debt which countries are not repaying is in fact likely to stifle their growth to a very substantial extent. I think, furthermore, that there is great danger that programs directed at debt relief, unless they are carefully designed, will not in fact flow down to average citizens in the countries on whose behalf they are crafted.

At the end of the day, the role of aid has to be relatively marginal. I think the most important things we can do are to keep markets open, provide managerial assistance in creating an appropriate infrastructure, and provide relief if things go badly wrong.

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Paul Marer

Comment

I would like to address three sets of questions. First, what do we mean by successful, capitalist, free-market systems, toward which many central and East European countries seem to be striving? Second, what can be said about the strategy for introducing such a system? And third, what role is there for the West in effectively promoting the transition?

Basic Features of Successful Market Economies

In spite of many notable systemic differences between successful market economies in North America, Western Europe, and Asia, they share certain basic common features. These are:

Predominantly private ownership of the means of production. State-owned companies generally cannot be efficient if they are not operating in a predominantly private, market economy setting. In centrally planned and transition economies, most means of production are not private. That is why privatization is essential.

Reasonable macroeconomic balance, which means the absence of a high rate of open or repressed inflation. Macroeconomic imbalance is bad because it channels too much of enterprise and household activities into economically unproductive pursuits. All open and transition economies have varying degrees of repressed or open inflation. This is difficult to eliminate because, in the absence of real owners and a viable banking system, traditional instruments of monetary control are not highly effective.

Competition. In certain countries (for example, Japan), domestic competition is fierce; in small economies, import competition is pervasive; in still others, both are strong. Competition is the dynamic force that causes the weak to retrench, thereby freeing resources to be employed in more productive uses. Competition also forces producers to control costs and to innovate, both essential to economic progress. Centrally planned economies (CPEs) and transition economies face little domestic or import competition. The former is absent not only for systemic reasons but also because production is highly concentrated. This is why a program of deconcentration is essential. Import competition is also weak or absent, for systemic reasons and, in the case of some countries, because of the precarious status of their balance of payments.

An adequate-to-high level of private savings and efficient financial intermediation. CPEs and transition economics have neither; much of savings has been forced upon firms and households by the government, which is also in charge of financial intermediation. In the absence of market signals, much of investment is misdirected, even if the authorities attempt to use economic rather than political, social, or bureaucratic criteria to allocate it.

A convertible currency. This is essential because it greatly expands enterprise and household choices and weakens bureaucratic resource allocation. A country cannot have a convertible currency until it allows market forces sufficient play.

A social safety net to help the unemployed and the physically or mentally infirm. CPEs operate such safety nets within enterprises, in effect forcing them to act uneconomically, in the social interest.

Safety nets have to be erected and maintained outside the enterprise sector.

In sum, during the early stages of transition, the former CPEs have none of the basic features that make market economies perform well.

The Strategy of Building a Market Economy

Because an economy is a complex and highly interdependent mechanism, all the missing elements have to be created more or less simultaneously, even though different time periods will be needed to finish constructing the components. The best way to proceed is to introduce packages of reform and to signal a timetable for their implementation. Sequencing is really a question more of emphasis than of fundamental choice.

In the initial package, high priority should be given to weaving a social safety net (its main elements should be unemployment compensation and minimum guaranteed annual family income), together with privatizing much of small business, including much of trade. It is important that an approximate timetable be established for the reduction of subsidies and for gradually exposing producers to import and domestic competition.

What Role for the West?

The transformation sketched here is an extraordinarily difficult undertaking. It can be likened to demolishing a house and rebuilding it differently while its residents continue to live in it. The main difficulty is not intellectual design but political manageability in the face of:

- Having to service the kinds of huge inherited domestic and foreign debts mentioned in Steven Popper's paper.
- Having to disturb a large array of vested economic and political interests.

- Having to tell the population that the costs of transition are immediate or near-term, while most of its benefits will be realized in the future.
- Having to put up with expectations that throwing out the communists will improve the economic situation quickly.

I agree with Leif Olsen, Steven Popper, and Lawrence Summers that the transition should proceed with all deliberate speed. The role of the West to promote this should be twofold. First, it should assist the new governments in gaining breathing space (three to four years) by helping the central and East European countries manage the huge adverse impact on them of the collapse of the Soviet economy and the ending of the old institutional arrangements of the Council for Mutual Economic Assistance (Comecon). The most heavily indebted countries should have a temporary easing of their debt service burdens. All this aid should be provided under strict conditionality, requiring that each country have a comprehensive transformation program of, say, as long as five years; Western aid should be tied to progress on its implementation. Both the aid itself, and the conditionality in particular, would help governments manage the domestic politics of a difficult transition program. Second, the West should provide all kinds of technical assistance and training, along the lines discussed in the papers and comments by Kenneth Juster, Carol Adelman, and John Van Oudenaren.

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C. Richard Neu

Comment

In listening to the conference discussions, I have been struck by the depth of the thinking that has been reflected here. One speaker after another has pointed to the fundamental issues that have to be resolved in designing development strategies for Eastern Europe: How fast can or should privatization proceed? Is microeconomic reform possible before macroeconomic stabilization has been accomplished? Which among the many needs of the East European economies should be given priority in aid programs? Should aid be seen as a necessary precursor to economic reform, providing East European governments with enough slack to institute potentially painful reforms, or should it be seen as a reward, provided only after recipient governments have demonstrated their willingness to make hard choices?

These are important questions, and it is useful for the academic and policy communities represented here to debate them. We have not resolved them, but I think we have made some progress. At the very least, we have a clearer idea of the lines of research and deliberation that will form the basis for the continuing inquiry these questions deserve. In this respect, I think that this conference has been a success.

I cannot escape the feeling, though, that we have left part of our agenda uncompleted. These fundamental questions will not be resolved soon. This, of course, should not deter us from pursuing them. In the meantime, though, there are real needs to be met in Eastern Europe. The U.S. government and the governments of other potential donor countries have to plan today for aid programs that will be implemented tomorrow. This planning cannot and should not wait until we have thoroughly studied the pros and cons of a variety of aid strategies. One of our purposes in this conference, as I understand it, is to offer advice to the United States Agency for International Development (USAID) about how to manage aid programs for Eastern Europe in the very near term. I fear that we may not have provided as much useful advice on this score as we might.

To try to fill this gap, I will propose some interim operational guidelines for planning U.S. aid to Eastern Europe. I do not suggest that these guidelines are in any sense complete or final. I do not even suggest that they are completely correct. It is clear that encouraging the rise of market economies is a very complex business, and no simple set of "dos" and "don'ts" will be sufficient for all contingencies.

Nonetheless, I think a few simple rules may carry us a long way. As several speakers have pointed out, the needs of Eastern Europe are enormous and the resources that the United States or any other donor country can provide are small by comparison. This suggests to me that no donor is going to have to make subtle choices about how best to allocate available aid resources. For the foreseeable future, there will be many more obviously worthwhile projects to undertake than there will be resources available. Some projects will certainly provide higher rates of return than others. But since we have the resources to meet only the most pressing needs, it seems to me that there is little to be gained from attempts to fine-tune our aid programs.

It is not the job of Western donor nations to reform and develop the economies of Eastern Europe. This, necessarily, is the job of the East European governments themselves. Our role is to assist in this process to the degree that we can. Thus, our aid programs do not need to be in any way balanced or comprehensive. As long as we are doing good and are seen to be doing good, we should probably not worry overly much whether some alternative strategy might do marginally more good. Rough guidelines will probably be all we need in the near term.

In this spirit, I propose the following four rules of thumb for planning aid to Eastern Europe.

Except for humanitarian purposes, do not support consumption. The need for new investment in Eastern Europe is very large. This investment will take place only if local and foreign entrepreneurs see opportunities to earn rates of return sufficient to outweigh the considerable risks that investors in Eastern Europe will face for the next few years. Fortunately, unmet demand is high in Eastern Europe, and the marginal product of additional capital will also be generally high. Almost by definition, foreign aid that subsidizes consumption will contribute nothing in the form of additions to the capital stock. Worse, though, subsidies for consumption will reduce the prices of final outputs, depress expected rates of return on new and existing capital, and discourage investment.

The political consequences of subsidizing consumption are also problematic. The process of economic reform will be painful throughout Eastern Europe, and governments will need strong incentives to continue to pursue painful policies. The principal motivating force for the reform that has been accomplished to date has been consumer dissatisfaction over living standards. For foreign donors to ease the plight of consumers would be to weaken the principal force driving governments toward reform, and would therefore be counterproductive.

Perhaps the most important practical implication of this rule of thumb is that food aid to Eastern Europe should be given with deep reluctance. The most likely consequences of such assistance will be reduced investment in food production and distribution and reduced pressure on governments to get on with the task of reform. Food aid in the event of a serious crisis, of course, is easily justified on humanitarian and political grounds. But aid intended simply to hold down the cost of food in Eastern Europe is likely to do more harm than good.

Choose aid projects that are both safe and visible. Aid should be aimed at providing material assistance to the people of Eastern Europe. It should also, though, serve to demonstrate both the goodwill of Western donor nations and the advantages to be gained from adopting Western practices and techniques. Thus, it is important that Western aid should generate clear and visible benefits.

To be sure, much of what needs to be accomplished in Eastern Europe will require risky undertakings. Much of the social, financial, and economic infrastructure that has to be built will produce little immediately visible benefit. But as we have noted above, the goal of Western aid is not and cannot be to undertake every project necessary to rebuild the East European economies; most of what needs to be done will have to be done by the East Europeans themselves. Inasmuch as foreign donors will be supporting only a few of the many necessary projects, there seems little need for them to support projects with invisible or highly uncertain benefits. The number of worthwhile, safe, and visible projects will far exceed what foreign donors can support; why, then, support any other kind?

As a practical matter, this means that foreign donors should concentrate on relatively simple, small-scale efforts where the need is clear and where immediate benefits for the population are likely. Examples of such projects might be the construction of sewage treatment facilities or road building. To be avoided are very large-scale projects that depend for success on the completion of other large-scale projects, or on the enactment of economic or political reforms beyond the control of project managers. Among the kind of projects to be avoided, perhaps, are such things as trying to rebuild an entire national telephone system and large-scale civil engineering works such as dams, bridges, or tunnels.

Do not intensify already functioning competition. A major aim of economic reform will be to foster competition among domestic suppliers in most sectors of the economy. In the early phases of reform, this competition may be rather fragile. New firms—some locally owned and some owned by foreigners—will be setting up where previously there had been only state monopolies. If foreign governments intervene, through their aid programs, in markets where even a rudimentary level of indigenous competition has grown up or appears likely to, they run the risk of driving new and vulnerable firms out of business, leaving nothing but the still-monopolistic remnant of the old state monopoly when the aid program ends. Starting new businesses in Eastern Europe will be difficult enough without having to compete—even indirectly—with the aid agency of some foreign government.

A much better course, it would seem, is to concentrate aid efforts in activities where internal competition is unlikely or undesirable. This suggests a concentration on public service- and public utility-like functions such as water and sewage systems, power distribution systems, payments and check-clearing systems, health clinics, education, and so on. If aid projects succeed in establishing commercially viable operations, these can eventually be turned over to either public or private entities to be operated as regulated monopolies. If these services are natural monopolies, few opportunities for fruitful competition will have been lost. Also attractive for these reasons are aid projects aimed at assisting municipal or regional governments in providing public services.

This line of reasoning leads me to question some kinds of proposed aid projects that are widely seen as attractive. We are often told, for example, that there is a huge unmet demand in Eastern Europe for Western books. The idea of supplying a commodity as wholesome, inspiring, and flattering to the West as the best of our cultural and technical writings at first seems very appealing. But publishing is not a technically demanding endeavor. Surely there are or could be a number of firms in Eastern Europe capable of publishing or distributing Western-style books. By supplying much-demanded books as part of an aid program, we may discourage the establishment of local publishers and distributors, thereby perpetuating the problem our aid is aimed at overcoming.

For some products, though, there may be little prospect that a meaningfully competitive local industry will ever be established. Private East European pharmaceutical firms, for example, will undoubtedly appear, but it seems extremely unlikely that these firms can ever become efficient producers of more than a limited range of products. Economies of scale are extremely important in the pharmaceutical industry, and the efficient production of many drugs can be managed only on a continental scale. Aid programs to supply selected drugs to East European physicians and hospitals, therefore, might prove to be highly effective. Considerable benefits may accrue to local populations, with little adverse affect on any local pharmaceutical industry that develops.

Remove physical and institutional barriers to competition. The logical counterpart to the previous rule of thumb is that aid should be aimed at removing existing barriers to competition. If, for example, inadequate transportation systems make it difficult to ship fresh produce, agricultural markets may become a series of local monopolies. Road building, railroad upgrading, and provision of refrigerated trucks or rail cars might all help to foster competition on a regional or national scale. Similarly, an inadequate network of financial services—banking, insurance, accountancy, and so on—may discourage the creation of new businesses. Training and technical assistance programs to modernize financial services and perhaps aid in purchasing data processing equipment could remove some of these barriers to entry and encourage the more rapid growth of competition. Particularly valuable may be business training and consulting services, which may facilitate the creation of new enterprises and thus increased competition.

Adherence to these guidelines, I think, will increase the odds that Western aid to Eastern Europe will achieve at least a Hippocratic standard; that is, aid will do no harm. This, in itself, would be something of an achievement. I think, though, that we might hope for more than this. Aid planned in accordance with these guidelines is likely to generate important benefits for the people of Eastern Europe. By contributing visibly to the development of stable, market-oriented economies in Eastern Europe, such aid will also serve to advance the longer-term interests of the United States.

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Part V

Ongoing U.S. Government Assistance

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Kenneth I. Juster

U.S. Government Assistance to Central and Eastern Europe

During the past year, we have witnessed the most dramatic changes on the European continent since the end of World War II.

The turn away from communism and the emergence of democracies in Eastern Europe represent nothing less than a vindication of U.S. foreign policy during the postwar era. We also must appreciate the fact, however, that the communists drove the countries of Eastern Europe and their economies to the brink of ruin. They have left behind in these countries an obsolescent industrial base, massive debt, and environmental decay. Perhaps the most damaging legacy, however, is psychological: populations grown accustomed to risk avoidance, a degeneration of entrepreneurial skills, and a dependence on government largess (including price subsidies, guaranteed jobs, and rent control). Thus, the new governments of central and Eastern Europe have their work cut out for them. So, too, does the West—because it is in our interest that the East Europeans succeed.

For the United States, a successful transition to democracy and free markets in Eastern Europe would mean at least two important things. First, it would mean that the turn away from communism has become irreversible. Second, it would help ensure that the region will attain some stability and not again become a power vacuum or an unstable theater of tension and rivalries. Americans therefore have every incentive to assist the central and East European nations in their time of need—and we are doing just that.

A General Framework for U.S. Assistance

I have found in my discussions with those outside the government that the U.S. administration's approach to central and Eastern Europe is often insufficiently understood or appreciated. The fact of the matter is that the administration does have a philosophy and a strategy for promoting reform throughout that region. However, it does not—and, I would submit, it cannot—have a finely tuned blueprint to anticipate specific developments in each particular country. The era of blueprints is behind us; its graveyard was Eastern Europe in 1989. Anyone who had a blueprint for the region over the past year would have had to change it numerous times by now. What is needed, instead, is a clear sense of what our destination ought to be, and a good road map for getting there. This, I believe, we have. Beyond that, we must be flexible—and sufficiently skillful—to respond to events as they occur.

So what is the U.S. assistance policy in central and Eastern Europe? It is based on the concept of a "new democratic differentiation." This term was chosen to contrast with the United States' longstanding policy of expanding contact with communist governments in Eastern Europe, to the extent that their foreign policies differed from that of the Soviet Union. The administration now has adopted a new policy standard—that is, the United States will tailor its assistance to the specific needs of each East European country as it moves positively toward four objectives.

- Progress toward political pluralism, based on free and fair elections and an end to the monopoly of the Communist party.

- Progress toward economic reform, based on the emergence of a market-oriented economy with a substantial private sector.
- Enhanced respect for internationally recognized human rights, including the right to emigrate and to speak and travel freely.
- A willingness on the part of each of these countries to build a friendly relationship with the United States.

In practice, the "new democratic differentiation" distinguishes three levels of assistance to central and East European countries. I will briefly describe these three levels of assistance and provide some examples of the types of programs the administration is supporting.

At the most basic level, some countries need *short-term humanitarian aid* to cope with severe shortages of necessities, such as food and medicine. The United States has made humanitarian assistance available to all countries of the region. For example, we have provided medical supplies to the Romanians, and food relief totaling approximately $200 million to both Poland and Romania in their time of urgent need. During this fiscal year, the Department of Defense, through its humanitarian assistance program, has provided surplus equipment to Hungary, Romania, Poland, and Bulgaria.

Over the *medium term*, there are a number of steps that the United States is taking to create an institutional framework to support political reform and the move toward market economies. Again, most of this assistance is open to all countries of the region, but in proportion to their commitment to reform. There are four general categories of medium-term assistance, and different priorities within each for each country.

One of our priorities is to assist in *developing democratic institutions and the rule of law*. That assistance from the outside can help to establish democracy is proved by the examples of West Germany and Japan. For both historical and policy reasons, the United States enjoys a comparative advantage over other Western countries as the predominant source of government-supported assistance to build democratic institutions. Moreover, the administration views our support for democratic initiatives as advancing U.S.

interests in the region. Our initiatives in this area are concentrated in four areas.

- Rule of law and human rights. The United States will assist democratic governments of central and Eastern Europe to establish laws and legal systems based on the rule of the majority and protection of the rights of individuals and minorities.
- Political process. The United States will help new legislatures, political parties, and civic organizations to develop into effective, stable democratic institutions.
- Social process and cultural pluralism. Through, among other things, support for educational curriculum reform, training of teachers, and support for trade unions and other nongovernmental organizations, the United States will assist in strengthening the principles and practices of democratic pluralism within the societies of central and Eastern Europe.
- Support for independent media. The United States will assist in establishing independent radio and television stations, publishing independent newspapers, and training journalists. Indeed, we have already launched an Independent Media Fund designed to advance these programs on a regional basis.

A second medium-term priority is *technical training and assistance in support of economic reform*. Our priorities here include, for example:

- Assistance in designing comprehensive economic reform policies, both in the macroeconomic and microeconomic areas. We have had extensive consultations with several of the East European governments on monetary policy, budget policy, and exchange rate convertibility, as well as on price reform, privatization, and competition policy.
- Assistance in restructuring state-owned enterprises and preparing them for privatization.
- Assistance aimed at developing an institutional infrastructure

conducive to a market-based economy, with emphasis on banking and financial services, a securities exchange, new tax codes, and generally accepted accounting practices.

- Assistance to develop legal frameworks for private, market-based economies.
- Training of managers, accountants, and others in the basic workings of a market economy.
- English language training, which will facilitate the exchange of scientific and technical information.

Based on the suggestions that the United States has received from the various East European governments, as well as from our embassies in the region, the administration is focusing this assistance most heavily in the areas of agriculture, banking, energy, health care, housing, small business, and public administration.

I have left aside the environment, because that is a separate medium-term assistance priority in and of itself. The primary goal of U.S. environmental assistance programs in Eastern Europe is to strengthen the region's capacity for (1) mitigation of critical environmental problems, and (2) remediation and prevention of pollution through the setting of new environmental standards and regulations, perhaps on a regional basis, that are compatible with economic growth. The administration also seeks to maximize the rapid introduction of cost-effective energy conservation technologies in central and Eastern Europe—to bring about environmental improvements while lowering the cost and capital requirements for fossil fuel consumption.

Finally, although doing so does not strictly fall within the assistance framework, the U.S. government seeks to increase market access by ***normalizing bilateral trade and investment relations with countries that meet the requirements of U.S. law.*** Our efforts in this area include:

- The signing of bilateral investment treaties.
  — We have already concluded a comprehensive business and economic agreement with Poland.

- We are in the final stages of concluding a bilateral investment treaty with Czechoslovakia.
- We are in the midst of negotiations with Yugoslavia on a bilateral investment treaty.
- We are in the process of opening negotiations for such agreements with Hungary and Bulgaria.

• The signing of trade agreements and the granting of most-favored-nation (MFN) status.

- We have already granted MFN status to Poland, Hungary, and Yugoslavia.
- We have signed a trade agreement with Czechoslovakia, which will confer MFN once approved by the Congress.
- We are beginning the process of negotiating the trade agreement necessary for granting MFN status to Bulgaria.

• This category of assistance also includes the programs of the Export-Import Bank (now operating in Poland, Hungary, Yugoslavia, and Czechoslovakia), the Overseas Private Investment Corporation (currently operating in Poland, Hungary, and Yugoslavia, and opening in Czechoslovakia in the near future), and the Trade and Development Program (operating in Poland, Hungary, and Czechoslovakia), all of which provide U.S. government money to foreign governments for feasibility studies by U.S. firms.

• Increased access of the East European countries to high technology from the West. Indeed, in response to developments in central and Eastern Europe, the Coordinating Committee on Export Controls (COCOM) recently liberalized controls on the export of technology to that region.

All of these agreements and activities are designed to stimulate the economies of Eastern Europe and, as such, to improve the quality of life there.

The third and final level of assistance is *bilateral and multilateral economic support and other measures designed to permit the* *integration of the countries of central and Eastern Europe into the world economic community.* This is by far the largest category of funding and is available, generally with a good deal of conditionality, for those countries that have decided to take the leap to a market-based economy by implementing major economic reform programs. Poland is most clearly in this category, followed by Yugoslavia, with Hungary and Czechoslovakia not far behind them. U.S. economic support here takes several forms.

On the *multilateral front*, the United States is the major contributor (almost 20 percent) to the International Monetary Fund (IMF) stabilization programs and World Bank structural adjustment programs in these countries. Again, these two institutions are most active in Poland, but have programs in Hungary and Yugoslavia as well. Czechoslovakia has just become a member of the IMF and the World Bank, and Bulgaria is currently in the process of seeking membership in these institutions. The United States is also one of the founding members of, and will be the largest contributor (supplying 10 percent of the budget) to, the new European Bank for Reconstruction and Development (EBRD). At least 60 percent of the EBRD's loans are to be devoted to private-sector projects—to set up new enterprises or fund the privatization of state-owned enterprises. No more than 40 percent of the EBRD's loans will go to infrastructure improvements to those state-owned enterprises that should help nurture free enterprises—such as improved telephone systems and railways.

The United States has also taken the lead in establishing the new Organization for Economic Cooperation and Development (OECD) Center for Cooperation with European Economies in Transition, and has proposed, in addition, that the OECD offer a new affiliate member status at this time to Poland, Hungary, and Czechoslovakia. (Yugoslavia has long been an associate member of the OECD.)

In terms of *bilateral economic support*, the United States has led the way, with a $200 million grant, in establishing a $1 billion stabilization fund to support the convertibility of the Polish currency. In addition, one of our most significant initiatives has been the establishment of the Polish-American and Hungarian-American enterprise funds.

The enterprise funds are a bold experiment, a new way of delivering economic assistance. Rather than have the U.S. government provide a one-time grant to Poland or Hungary, the administration has developed instead the enterprise funds as a means for tapping into private-sector expertise to manage U.S. government grants. The president, in consultation with the Congress, has asked a group of prominent private citizens from the United States, and from Poland and Hungary, respectively, for each of the two funds, to form a corporation to use U.S. government money to make loans, grants, equity investments, and other forms of financial transactions designed to promote private-sector development in Poland and Hungary. The hope is that these enterprise funds will be able to manage U.S. government grants in the way that an investment banker might—unencumbered by the bureaucratic constraints normally associated with government activities—and that they will be able to multiply many times over the financial impact of the initial grants.

Guiding Principles

Before turning to a brief discussion of the Support for East European Democracy (SEED) Act of 1989 and some of the programs the United States is administering in Eastern Europe, I would like to note some of the general principles that we have developed to guide our activities.

- Use assistance to advance the process of economic reform, not substitute for it.
- Emphasize projects that can start up quickly and have an immediate impact, to meet urgent needs.
- Concentrate assistance in each country in a limited number of areas where the United States has a comparative advantage over other Western donors and where the United States can have an impact.

- Concentrate on practical, nuts-and-bolts programs, rather than abstract theory or study.
- Encourage demonstration projects in key sectors of the economy, especially projects designed to improve the environment and the quality of life.
- Establish, where practical, generic programs that can then be tailored to the needs of each country.
- Put experts in the field for periods of up to one year; stay away from sponsoring short visits or one-day programs.
- Emphasize training in the recipient countries rather than in the United States, for reasons both of cost-effectiveness and of avoidance of a brain drain of valuable but limited talent.
- Emphasize educating the educators and training the trainers.
- Work with existing institutions, if possible. Generally avoid creating new institutions, because the overall costs and the time lag involved are too great.
- Establish sustainable relationships between U.S. institutions and organizations in central and Eastern Europe, so as to strengthen the American presence (and influence) in the region.
- Support programs that respond to the needs of the central and East Europeans, rather than those that are designed to suit the desires of U.S. organizations.
- Develop a streamlined funding mechanism to gain maximum flexibility while maintaining accountability.
- Take into account, before starting any new project, the activities of other Western countries and of the international financial institutions. Coordinate efforts where possible.

U.S. Assistance Programs

How do the framework and the principles that I have mentioned apply, in terms of U.S. government assistance programs in central and Eastern Europe? I think it is fair to say that four countries qualify now for special attention because of their readiness to implement democratic reforms and their decision to make the transition to a market-based economy. These are Poland, Hungary, Czechoslovakia, and Yugoslavia. Of these four, we believe that Poland deserves top priority for several reasons.

- Its economic problems are the most severe.
- Its economic reforms are the most far-reaching.
- Its economy is the largest in the region.
- Poland is viewed by most observers as the test case in Eastern Europe. Success or failure of the Polish effort, therefore, is extremely important politically.

Yugoslavia, under Prime Minister Ante Markovic, has also embarked on an ambitious program of economic reform, and two of the republics—Slovenia and Croatia—have recently held free elections. The United States has provided substantial technical assistance to Yugoslavia, but we are concerned about the rising internal tensions in the country and the detrimental effect these tensions could have on further political and economic reform.

Hungary and Czechoslovakia both elected new democratic governments in 1990, and although each country is moving toward a market-oriented economy, each also has yet to define clearly a comprehensive economic reform program.

With respect to Bulgaria, the U.S. government has expressed its concern about the fairness of the elections in June 1990, but is cautiously optimistic about the new government just formed. Assuming continued democratization, the United States is prepared to offer assistance.

Finally, regarding Romania; the United States continues to have reservations about government's commitment to democratic reform and basic human rights. We have informed the regime of President Ion Iliescu of the sort of democratic reforms we would like to see, and we are prepared to assist the Romanians in building democratic institutions.

As to specific programs in the region, the focus has been primarily on Poland and Hungary because those are the countries for whom the Congress has appropriated money. The initial legislation in this area—the SEED Act—was written prior to the revolutions in Bulgaria, Czechoslovakia, Romania, and East Germany. The SEED Act, therefore, was designed to promote reform in the two most liberalized countries in the region at the time—Poland and Hungary. Moreover, because at the time of the drafting of the act we were not yet dealing with popularly elected governments in those two countries, the legislation designated virtually all of the funds appropriated to be used for specific programs.

Listed below is a quick review of the programs provided by the SEED Act and the amounts appropriated for fiscal year 1990.

- Humanitarian assistance:
  - Food assistance for Poland (over $130 million)
  - Medical supplies for Poland ($2 million)
- Democratic initiatives for Poland and Hungary ($4 million)
- Developing human resources for Poland and Hungary:
  - Technical training ($3 million)
  - Labor market transition ($1.5 million)
  - Peace Corps ($2 million)
  - Educational and cultural exchanges ($3 million)
  - Scholarship programs ($2 million)
  - Science and technology exchanges ($1.5 million)
- Environmental initiatives:
  - Clean fossil fuels (Poland) ($10 million)
  - Krakow environmental activities ($2.3 million)
  - Regional Environmental Center ($1 million)

- Trade and investment:
  - — Overseas Private Investment Corporation (OPIC) authority to operate in Poland and Hungary, with $40 million of OPIC's Investment Guarantee Authority earmarked for Poland
  - — Export-Import Bank authority to guarantee, insure, finance, extend credit, and participate in extension of credit in Poland and Hungary
  - — Trade Credit Insurance Program: $200 million in secondary guarantees of short-term Ex-Im trade credits for exports for the private sector in Poland
  - — Trade and Development Program: $2 million for financing planning services of the U.S. private sector for important development projects
- Stabilization Fund for Poland ($200 million grant)
- Enterprise Funds:
  - — Poland ($35 million)
  - — Hungary ($5 million)

While the SEED Act provided authority for the expenditure of funds only in Poland and Hungary, there has been to date some limited authority for expenditures in the other East European countries. First, when the Congress passed the Urgent Assistance for Democracy in Panama Act of 1990 to provide emergency assistance to the new government in that country, it added authority for the expenditure of $10 million for democratic initiatives in central and Eastern Europe. These funds have been used for pre-election assistance, development of an independent media fund, and the launching of rule-of-law programs, among other things.

Second, various government agencies—such as the Commerce Department, the United States Agency for International Development, the United States Information Agency, and the Peace Corps—have utilized existing budgetary authority or presidential waivers for additional programs in central and Eastern Europe.

The administration also introduced new legislation on March 7, 1990, entitled the Eastern European Democracy and Free Market Act, to respond to the dramatic events in that region. The president's initiative, in effect, seeks to enact the general framework for assistance that I have described above. It makes all the countries of central and Eastern Europe, as well as Yugoslavia, eligible for assistance at a level corresponding to their positive movement toward U.S. objectives for the region. It requests $300 million in fiscal year 1991 for the funding of assistance programs. It contains no specific earmarks, so as to provide the administration the necessary flexibility to coordinate assistance based on developments in the region, the cooperative international effort, and requests from the recipient countries.

Congress has not yet passed such legislation, with the Senate Foreign Relations Committee and House Foreign Affairs Committee each having its own version of an assistance bill for Eastern Europe. The administration remains hopeful that in the next few weeks, at most, there will be an appropriation of new funds, along with necessary authority to operate—with the needed flexibility—throughout the region.

The International Effort

It should be apparent that the U.S. strategy has deliberately been to avoid pumping money willy-nilly into the region. The reason for this is that, despite the calls for some kind of new "Marshall Plan" for Eastern Europe, the needs of the region today are substantially different from those of Western Europe in 1947.

After World War II, the United States had to help rebuild a region physically devastated by war but nevertheless generally possessing the entrepreneurial know-how, economic infrastructure, and democratic institutions necessary for a quick recovery. As I have noted, in central and Eastern Europe today, those skills and institutions are, to one degree or another, lacking. That is why, in addition to the financial assistance the United States is providing to back meaningful stabilization and structural adjustment programs, we are seeking to transfer a wide range of technical assistance so that these countries will become equipped to absorb Western investment and aid. Simply throwing money at the region, even lots of it, without relating it to progress toward structural reforms may only postpone the advent of change—as happened in the 1970s—and squander our assistance efforts.

There are a few additional points I would make in response to those who are saying the administration is not doing enough. First, in large part because of past U.S. efforts, we now have powerful and prosperous West European allies who can share with us the burden and responsibility of helping to rebuild the other half of their continent. Indeed, President Bush was instrumental in establishing the group of twenty-four (G-24) Western governments that has already coordinated approximately $14 billion in grants, credits, guarantees, and technical assistance for Poland and Hungary.

The G-24 is designed to harness the concerted efforts of the West to support political and economic reform in Eastern Europe. The European Commission serves as the secretariat to the G-24. Its functions include the following:

- Coordinate the bilateral assistance programs of the donor countries.
- Serve as an information clearinghouse to exchange information and avoid duplication of effort.
- Conduct needs assessments and set indicative priorities for the East European countries.
- Help implement initiatives and joint projects, such as the Polish stabilization fund and the regional environmental project headquartered in Budapest.

The G-24 has agreed on criteria for eligibility for its coordinated assistance that are similar to those adopted by the United States. These criteria are progress toward the rule of law, respect for human rights, the introduction of multiparty systems, the holding of free and fair elections, and the development of market-oriented economies. The G-24 has also established working groups on food aid, investment, training, and the environment. The group on food aid was especially successful in coordinating emergency agricultural assistance to Poland.

Finally, I think it needs to be said that when one looks at the actual budgetary outlays for assistance to Eastern Europe—as opposed to the credits, insurance, and guarantees that make up the assistance programs of many of our partners—the United States is right at the top of the list of donor countries.

The Administration of U.S. Assistance

The fact of the matter is that what is being attempted in Eastern Europe is something that has never been tried or accomplished before—that is, managing the rapid transition of centralized command economies into free-market systems, and of totalitarian regimes into democratic states under the rule of law. As a result, the United States as well as our friends and partners in Eastern and Western Europe have been feeling our way as we go. It is a new experience for all of us. It is a dynamic process, with continually changing demands and requirements. Everyone has made mistakes along the way—committing too many resources here, too few there, duplicating efforts unnecessarily, and not always coordinating among ourselves as best we might.

This is still a very early stage—an experimental stage—in the effort to bring Eastern Europe out of a fifty-year time warp. Although what has been accomplished thus far may seem prosaic in light of the enormous task ahead, the endeavor is off to an excellent start. The manifold and diverse problems of transition to market economies in Eastern Europe cannot be solved in one fell swoop, but I believe that we have the right strategy to do so over time.

I would like to comment for a moment on the task of coordinating U.S. assistance to Eastern Europe. I am referring in the first instance to the issue of *coordination within the U.S. government.* Over twenty-five government agencies have become involved in providing assistance of one form or another to the countries of central and Eastern Europe. Some of these agencies are normally engaged in foreign affairs and are therefore familiar with operating in the international environment. In many cases, however, domestic agencies are seeking to become involved in the assistance process. These agencies have an important role to play, but coordinating among them has been a difficult task, especially when all agencies are competing for scarce resources. I suspect our West European counterparts have had similar experiences.

It is even more difficult to *coordinate private-sector activities*, which include for-profit ventures, proposals for technical assistance that require government funding, and volunteer efforts. With regard to for-profit ventures, we can—and do—provide guidance and encouragement, because such ventures are critical to successful reform in central and Eastern Europe. It is not the government's role, however, to subsidize or favor one business venture over another.

As to private-sector groups seeking government funding, this is in many instances the most difficult issue with which we deal. Both the U.S. administration and the governments of central and Eastern Europe have been overrun by a vast array of private-sector proposals to provide technical assistance and the like, proposals that vary significantly in quality. We have to find ways to sort out the good from the bad.

Finally, voluntary assistance represents a great untapped potential. The administration is now seeking to organize voluntary activities in the United States through the president's recently announced Citizens Democracy Corps. We plan to develop a clearinghouse that will provide an inventory of the technical skills and services that the U.S. private sector can provide. We will then be able to match these skills and services with needs of the central and East European countries.

In recognizing the difficulties of coordinating U.S. government and private assistance activities, I should note one fact about which Americans should not be ashamed. Free-market economies, such as ours, are not completely compatible with the provision of coordinated assistance. The very virtue that we are trying to promote in Eastern Europe—a private sector with a free-market orientation—is what has led a multitude of different groups, both within and outside the government, to compete for scarce budget resources. The government must wrestle with these problems and seek to give as much guidance as it can to the assistance process, providing policy priorities and leadership on major initiatives. In the end, however, it cannot rigidly control the process.

All of these problems of national coordination have sometimes led us to think—mistakenly—that international coordination is virtually impossible. Certainly, it is a formidable task for the G-24 to coordinate the provision of assistance. The simple fact of the matter is that you cannot tell the domestic constituency in one country that, for example, it should participate in sponsoring agricultural programs but not in environmental ones. Each donor country has a full range of interest groups that want to be involved in central and Eastern Europe, and though it may be desirable, it is just not always practicable to divide up areas of responsibility among donor nations. The West should make sure, however, that its assistance efforts are additive in value. In this regard, the United States has played a key role in launching joint projects, such as the Regional Environmental Center in Budapest, in which others have joined.

One other important point to note is the need for coordination in-country by the recipients of U.S. assistance. As new governments are formed in the region, they must develop their own sets of priorities, so that they can provide greater specificity of direction for the donor countries. In urging this, the United States also encourages the new governments of central and Eastern Europe to increase the degree of dialogue and cooperation among themselves, and even to consider approaching some of their problems—such as energy efficiency—on a regional basis.

The Role of the Private Sector

I am convinced that a high priority must be accorded to the role of the American private sector in assisting the transformation and recovery of the central and East European economies. Western public-sector money alone is not going to be the answer to the needs of the East Europeans today. In the long run, it is through American and Western private-sector investment that the region will obtain the amounts of capital needed to create jobs and self-sustaining economic growth.

Clearly, the involvement of the private sector will not come simply from government exhortation or from a sense of charity or adventure on the part of U.S. businessmen. It goes without saying that American companies will have to be satisfied that the mix of risk and return is competitive with opportunities elsewhere. I can assure you that the U.S. government is doing everything it can to make central and Eastern Europe a level playing field and an attractive place for American investment.

In my view, American investors will enjoy certain intangible advantages over much of the competition. The fact is that we have great friends in the emerging democracies. They remember us for not ever having wavered or compromised in our support for their freedom and independence, and they have absolutely no qualms about our being present on the ground as active participants in the economic and political regeneration of their societies. But if Americans wait until the situation fully stabilizes in central and Eastern Europe, they will find the region already overcrowded with West European and Japanese investors.

Conclusion

The task ahead for the East Europeans will not be an easy one. The crisis in the Persian Gulf highlighted some of their energy problems; the Soviet conversion to hard currency trade based on market prices in January 1991 has brought further problems. Moreover, new regimes are learning that it was easier to unite in opposition to the communists than it is to develop the political skills necessary to govern under democratic conditions.

The United States and the rest of the West must be patient and realistic. We must acknowledge that reform is going to be a lengthy and painful process. In the final analysis, success depends on the democratically elected governments of the region. Western assistance can make a difference, however. If we do it right, we will have created a model for the transition in central and Eastern Europe that can be applied to transitions we face elsewhere today, such as in the Soviet Union, and to transitions we will surely face tomorrow.

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11 *Carol Adelman*

USAID Programs in Central and Eastern Europe

This is an exciting time to be working in the field of development assistance. Economic and political freedom are on the march on every continent, but the world's spotlight is focused on Eastern Europe. While political science has sometimes been called the "queen bee" of the social sciences, today economics sits on the throne. It remains to be seen if the leaders of Eastern Europe can exhibit the same skill in the realm of economics that they have shown in the political arena.

The program of the United States Agency for International Development (USAID) can be depicted generally by three characteristics:

- There are no models for transforming communist countries into capitalist countries. While the world's libraries are full of books on how capitalist countries became Marxist, there are no books on how to reverse the process. We are therefore providing a wide range of assistance in the areas of legal and regulatory reform, as well as in privatization and development of business, banking, and capital markets.

- Events are happening so quickly that one idea or effort can be outdated or overtaken by events within the week. This creates great challenges for government bureaucracies and intergovernmental coordination, which are more ponderous and cautious in approach.
- The most basic types of assistance are needed. Essential economic and political reforms, such as laws on private property and decentralized control, are very important. Frequently, donors' regulations and stipulations are limiting and not helpful to the recipient countries, particularly if the bulk of the aid is in the form of credit tied to the donors' products. This is the case with most of the West European aid programs. The United States, on the other hand, is able to provide valuable assistance in a rapid and direct response to help ministries or the private sector with essential supplies such as medicines, paper, faxes, and other equipment.

In discussing the U.S. government foreign assistance program for Eastern Europe—the modus operandi and the implications for development assistance in general—the most striking feature of the assistance effort is the high degree of interagency coordination involved. The entire effort is guided by Deputy Secretary of State Lawrence Eagleburger as the chairman of the Coordinating Committee for Aid to Eastern Europe. The Agency for International Development works as the executor or implementor for the policy decisions of the coordinating committee.

This coordination, and the conduct of the assistance program more generally, is, we believe, benefiting substantially from lessons learned in the conduct of prior assistance programs. Among some of the most important lessons are the following:

- These programs have been designed to reward countries by providing assistance after they have undertaken free and fair elections and implemented sufficient economic reforms. Secretary of State James Baker has said that U.S. support is to be measured by a single test: whether it advances democracy and economic liberty. Thus, we are moving ahead with programs in Poland, Hungary, and Czechoslovakia. We have limited our assistance in the other countries to humanitarian aid and modest economic technical cooperation until the complete criteria have been met.

- The projects are regional rather than country-specific. Thus, there are no entitlements or expected annual dollar amounts for any one country. Instead, the assistance program is viewed as a regional one, within which a country can draw upon various sources of technical assistance, training, and some commodities. The assistance projects can thereby provide incentives for countries to continue economic and political reforms; this is in contrast to a frequent attitude among some traditional USAID recipients that their foreign aid will be forthcoming regardless of their behavior.
- The foreign aid extended is explicitly intended to be temporary or transitional. The aid should be a catalyst to the private investment and trade flows that are the desired goal of foreign assistance. Indeed, the leaders of Eastern Europe discuss foreign aid in this context, and we too expect to see these countries "graduate" during our tenure or shortly thereafter.
- In contrast to generally negative attitudes in the United States about foreign aid, Eastern Europe has the support of a strong and active domestic political constituency. Therefore, this program is more visible than most and must be more responsive to the interests and demands of these constituencies. This implies concrete "deliverables" requiring minimal research and studies. The strong domestic interest enables the government to draw upon the services and skills of Americans from Eastern Europe as well as to better leverage assistance from the private sector.
- These programs are intended to embody and espouse U.S. political values of capitalism, democracy, political pluralism, and human rights. While these values and programs have always been a part of U.S. foreign policy and assistance efforts, the current approach is

more coherent and assertive. As a bilateral donor, the United States has an important role to play in the development of political institutions such as elections, parliaments, and judicial branches, as well as those in the nongovernment sector.

- Programs associated with the Support for East European Democracy Act emphasize technical assistance and training rather than large-scale cash transfers, equipment, or commodities. This is essentially a function of the type of program that promotes institutional development. Moreover, the funds available are not sufficient for financing larger-scale programs.
- A concerted effort is under way to streamline the entire system for delivering assistance under this program. One aspect of this effort is the placing of the locus of program management and financial control in Washington, with oversight and monitoring conducted through frequent visits and communications. Thus there will not be large USAID missions in East European capitals, but rather a minimal presence, with the bulk of personnel remaining in Washington. The entire USAID project design and contracting system has been "debureaucratized" to promote a faster turnaround time, less red tape, and more project responsibility and accountability, with the actual team leaders in charge.

These are just some of the new approaches being applied to our assistance program in Eastern Europe. They reflect years of knowledge and experience in both correct and incorrect ways of executing programs. To be sure, the excitement and interest in working on aid to Eastern Europe has enabled USAID to recruit an excellent staff. The increased emphasis on results, to be achieved through more management responsibility, along with the visibility of the program and rapidity of its responses, has also served to generate a high degree of interest and enthusiasm for working on this program. The experience of frequent and in-depth interaction with other U.S. government agencies has been an added advantage.

Notes

1. Charles Wolf, Jr., "Transforming Command Systems"

1. These papers contain facts and reflect conditions as of the date of the conference, September 21–22, 1990. The papers have not been updated to reflect subsequent events.

I would like to acknowledge the contribution that Michael Dardia and Vladimir Shkolnikov, RAND Graduate School Fellows, made to the conference in their role as rapporteurs. Their draft of the proceedings was drawn upon in the writing of this introduction.

3. Nicholas Eberstadt, "A Skeptic's View of Aid"

1. Roland Vaubel, "The Moral Hazard of IMF Lending," *The World Economy* 6, no. 1 (1983): 293.
2. See U.S. Agency for International Development, *US Overseas Loans and Grants and Assistance from International Organizations: Obligations and Loan Authorizations, July 1, 1945–September 30, 1985* (Washington: USAID, n.d.): iv.
3. Derived from World Bank, *World Debt Tables 1990/91* I (Washington: World Bank, 1990): 70–86.
4. Derived from *International Financial Statistics* 44, no. 5 (1991): 22.
5. Like Haiti, Bolivia, and Paraguay, virtually all the countries in the sub-Sahara are long-term recipients of American "development assistance."

6. One need not vouchsafe the accuracy of these estimates for our purposes; they merely illustrate our argument with the data most frequently cited in discussions of "development economics."

7. The information in this paragraph and those immediately preceding it refer to data from the World Bank's 1990 *World Development Report* and to the IMF's *Government Finance Statistics Yearbook* for the same year.

8. Figures derived from Organization for Economic Cooperation and Development, *Geographical Distribution of Financial Flows to Developing Countries 1985/88* (Paris: OECD, 1990). Estimates are for direct investment, 1985–1988. By OECD's reckoning, China's net total for the period was around $1.6 billion; for the recipients of U.S. economic aid (excluding European countries), the total was *negative.*

9. Not the least important of these differences pertains to population policy. By and large, Eastern Europe's governments embrace pronatalism, although the intensity and expense of their activities vary widely. Explicitly pronatal policies, by contrast, are rare among long-term recipients of U.S. "development assistance." Responding to a United Nations questionnaire, only two of these many governments (Equatorial Guinea and Israel) indicated that they viewed "interventions to lower fertility rates" as "appropriate"; by contrast, nearly forty long-term recipients endorsed "interventions to raise fertility rates" in their countries. Derived from United Nations, *World Population Monitoring 1989* (New York: United Nations, 1990), table 34. This difference may in part reflect one impact of more than two decades of activity by USAID's energetic Office of Population; as one observer has noted, "AID's Office of Population had a single mission: to reduce the level of fertility in developing countries." Donald Warwick, *Bitter Pills: Population Policies and Their Implementation in Eight Developing Countries* (New York: Cambridge University Press, 1982): 47. It may also be relevant that the central European region's fertility rates had been close to, or below, net replacement since the early 1960s.

10. Two examples may suffice. The first is from the World Bank's only country study on Romania, which was published barely months before the government suspended payments on its foreign debt.

> The major conclusion to be derived from a review of the past is that Romania, though still a developing country, has been successful so far in its development efforts and that the problems identified so far have not prevented targets from being carried out, although they may have increased the cost of meeting them. . . . It remains probable that Romania will continue to enjoy one of the highest growth rates among developing countries in the next decade [i.e., the 1980s] and that it will largely succeed in implementing its development targets. As a result of the comprehensive control of economic activities and the cautious policy of the government toward the use of foreign borrowing, external constraints will not reduce the country's creditworthiness. (Andreas C. Tsantis and Roy Pepper, Coordinating Authors, *Romania: The Industrialization of an Agrarian Economy Under Socialist Planning*, Washington: World Bank, 1979: 11, 15.)

Here, nearly a decade later, is the World Bank's official assessment of Polish "reforms" as of 1987:

> The sweeping program of economic reform, which was officially adopted by a Party Congress in 1981, legislated during the Martial Law period, and recently reaffirmed in the "Theses on the Second Stage of the Economic Reform," is fundamentally well-conceived. . . . There is therefore reason to be optimistic that the adjustment path proposed is one that will, after a current account balance is reached, open the promise of a path of faster growth, greater competitiveness, greater potential import liberalization, large imports of machinery, faster technological progress, a more rapid improvement of living standards, and a smaller external debt. . . . If the present proposals can be fully and consistently implemented, they offer an opportunity for a major and lasting improvement in the efficiency, international competitiveness and growth of the Polish economy. (World Bank, *Poland: Reform, Adjustment, and Growth, Vol. 1*, Washington: World Bank, 1987: xii, xviii, 198.)

11. For a more detailed account of those and other such events, see my *Foreign Aid and American Purpose* (Washington: American Enterprise Institute, 1989).

12. If USAID was presenting a less welcoming invitation to the hard-edged businessman or the tough-minded policy analyst, it was, increasingly, a congenial home for alumnae of the Peace Corps program—and naturally enough, since their previous field experience nicely meshed with the new specifications that had been laid down for development assistance. (One top-level USAID official recently told me that an internal audit revealed that nearly three-fourths of the agency's senior personnel in 1990 were Peace Corps alumnae; I have not seen those figures myself, however.) The emergence of USAID as a sort of safe haven for Peace Corps retreads, however, did not improve the institution's image or reputation among other international donors. Some have argued that USAID officials faced a growing disdain by their international peers; if this is true, it may have affected morale still further, and contributed to the ongoing attrition of earlier personnel.

13. USAID, *Development and the National Interest: US Economic Assistance into the 21st Century* (Washington: USAID, 1989): 16.

14. Some observers have attempted to explain this ostensible paradox in terms of individual personalities. In a recent analysis, for example, two students of American development assistance credited M. Peter McPherson, President Reagan's longtime USAID administrator, with "a skillful effort . . . to bridge the gap between the rhetoric of the more extreme right within the Reagan camp, the emphasis in the State Department on strategic considerations, and a personal commitment to the objectives of the [Basic Human Needs] Mandate." Mark F. McGuire and Vernon W. Ruttan, "Lost Directions: US Foreign Assistance Policy Since New Directions," *The Journal of Developing Areas* 23, no. 2 (1990): 168.

15. USAID, *Development and the National Interest*: 111–113, 121.

16. This, for example, is the thrust of "The European Bank for Reconstruction and Development: The Central and Eastern European Markets," by the EBRD's president-

designate, Jacques Attali (*Vital Speeches of the Day*, Southold, N.Y.: City News Publishing Co., 1991, especially pages 425–426), although his is naturally an argument for multilateral rather than bilateral aid.

17. For a description of these arrangements, see Alan S. Milward, *War, Economy, and Society 1939–1945* (Berkeley: University of California Press, 1977): Chap. 5.

18. See Ludwig Erhard, *Germany's Comeback in the World Market* (London: George Allen & Unwyn, 1954): 101.

19. Ibid.: 102.

20. For a range of starting points, see Tyler Cowen, "The Marshall Plan: Myths and Realities," in Doug Bandow, ed., *US Aid to the Developing World: A Free Market Agenda* (Washington: Heritage Foundation, 1985); Charles S. Maier, "The Two Postwar Eras and the Conditions for Stability in Twentieth Century Western Europe," *American Historical Review*, no. 86 (1981); and Alan S. Milward, *The Reconstruction of Western Europe 1945–1951* (Berkeley: University of California Press, 1984), especially Chap. 3.

21. William A. Brown, Jr., and Redvers Opie, *American Economic Assistance* (Washington: The Brookings Institution, 1953): 246.

22. Kazuo Kawai, *Japan's American Interlude* (Chicago: University of Chicago Press, 1960).

23. G. C. Allen, *Japan's Economic Recovery* (New York: Oxford University Press, 1965): 17.

24. Michio Morishima, *Why Has Japan "Succeeded"?* (Cambridge: Cambridge University Press, 1965): Chap. 5.

25. Jerome B. Cohen, *Japan's Postwar Recovery* (Bloomington: Indiana University Press, 1958): 18.

26. Ibid.: 19–20.

27. Brown and Opie, *American Economic Assistance*: 352.

28. For example, Chalmers Johnson, Laura D'Andrea Tyson, and John Zysman, eds., *Politics and Productivity: The Real Story of Why Japan Works* (New York: Harper & Row, 1989), and Karel van Wolfreren, *The Enigma of Japanese Power* (New York: Knopf, 1989). While these authors do not contest that radical transformations have been exacted, they see in present-day Japanese economics and politics some continuities in arrangements that were developed under the prewar military dictatorship, or earlier. Scholars who dispute their interpretation, one may note, do not always challenge the facts that they adduce. See, for example, Robert A. Scalapino, *The Politics of Development: Perspectives on 20th Century Asia* (Cambridge: Harvard University Press, 1980): 105.

29. Edward S. Mason et al., *The Economic and Social Modernization of the Republic of Korea* (Cambridge: Harvard University Press, 1980): 105.

30. David C. Cole and Princeton Lyman, *Korean Development: The Interplay of Politics and Economics* (Cambridge: Harvard University Press, 1971): 170–171.

31. A. M. Rosenthal, "U.S. Will Cut Off Aid to South Koreans," *New York Times*, April 4, 1963: 1.

32. Mason et al., *The Economic and Social Modernization of the Republic of Korea*: 95.

33. K. T. Li, *The Experience of Dynamic Economic Growth on Taiwan* (Taipei: Mei Ya Publications, 1976): 59.

34. K. T. Li, *The Evolution of Policy Behind Taiwan's Development Success* (New Haven: Yale University Press, 1988): 137.

35. Irena Grosfeld, "Privatization of State Enterprises in Eastern Europe: The Search for a Market Environment," *Eastern European Politics and Societies* 5, no. 1 (1991): 160.

36. Anders Aslund, *Private Enterprise in Eastern Europe* (New York: St. Martin's Press, 1985).

37. See Edward Shils, "The Virtue of Civil Society," *Government and Opposition* 26, no. 1 (1991).

38. Douglass C. North and Robert Paul Thomas, *The Rise of the Western World: A New Economic History* (Cambridge: Cambridge University Press, 1973).

39. Nathan Rosenberg and L. E. Birdzell, Jr., *How the West Grew Rich* (New York: Basic Books, 1986).

40. For more on this comparison, see Branko Milanovic, "Privatizations in Post-communist Societies," *Communist Economies and Economic Transformation* 3, no. 1 (1991).

41. Nicholas Eberstadt, "Health and Mortality in Eastern Europe, 1965–1985," *Communist Economies* 2, no. 3 (1990).

42. World Health Organization, *World Health Statistics Annual, 1989* (Geneva: WHO, 1989).

43. Various links between institutional maladaptation and deterioration of human capital in the East European setting may be surmised. Environmental degradation of an appalling nature, for example, appears to have been a direct consequence of communist policies and arrangements; that deterioration may have been sufficiently severe to affect the health of the populations in question. By the same token, the region's state-owned health systems, which reserved for themselves the right to decide on availability, quantities, and qualities of service for potential patients, may have been incapable or unwilling to respond to the needs evidenced or articulated by the individuals they were, in theory, to serve. Other, more subtle interactions might also be imagined, including those regarding attitudes, outlook, and motivation on the part of the general populace.

44. Nor are "development economists" the only academic specialists who seem to have trouble focusing on the "actually existing problems" of Eastern Europe. "Political scientists" and "political economists" betray many of the same difficulties. One recent comment from such quarters warned that "establishing a property rights regime is by no means equivalent to formulating an appropriate economic policy: even the best microeconomics will not solve macroeconomic problems." (Ellen Comisso, "Property Rights, Liberalism, and the Transition from 'Actually Existing' Socialism," *Eastern European Politics and Societies* 5, no. 1, 1991: 163.)

These assertions in themselves are unobjectionable, but their implication seems to be that the shortage of good technocratic advisers is one of the main obstacles to economic liberalization in Eastern Europe. While such a viewpoint may be congenial to many who feel equipped to dispense such advice, it would nonetheless seem to be a serious and indeed bizarre misreading of the current situation in any and all of the countries in question.

45. World Bank, *Poland: Economic Management for a New Era* (Washington: World Bank, 1990): xii, xiii, xvi, xvii, 32–37.

46. *Communist Economies and Economic Transformation* 3, no. 1: 137.

John Van Oudenaren, "Comment"

1. See United Nations Economic Commission for Europe, *Economic Survey of Europe Since the War: A Reappraisal of Problems and Prospects* (Geneva: UNECE, 1953).

2. See Jean Monnet, *Memoirs* (Garden City, N.J.: Doubleday, 1978): 232–263; and Charles de Gaulle, *The Complete War Memoirs: Salvation*, 3 (New York: Simon and Schuster, 1964).

3. See, for example, Alan Milward, *The Reconstruction of Western Europe, 1945–1951* (Berkeley: University of California Press, 1984); Michael J. Hogan, *The Marshall Plan: America, Britain, and the Reconstruction of Western Europe, 1947–1952* (New York: Cambridge University Press, 1987); and Lawrence S. Kaplan, "The Cold War and European Revisionism," *Diplomatic History* 11, no. 2 (1987).

4. Milward, *The Reconstruction of Western Europe*: 466–469.

5. UNECE, *Economic Survey of Europe Since the War*: 62.

4. Graham Allison and Robert Beschel, "Can the United States Promote Democracy?"

1. Support for East European Democracy (SEED) Act of 1989 (H.R. 3402), 101st Congress, 1st Sess., November 17, 1989.

2. Secretary of State James Baker, address before the World Affairs Council, Dallas, Texas, March 30, 1990.

3. The Tocqueville and Bryce quotes are cited from Samuel P. Huntington, "Will More Countries Become Democratic?" Huntington's article originally appeared in the Summer 1984 issue of *Political Science Quarterly*. It was reprinted in Raymond D. Gastil, *Freedom in the World: 1984–85* (Westport, Conn.: Greenwood Press, 1985): 193–225.

4. Cited in Daniel Patrick Moynihan, *A Dangerous Place* (Boston: Little, Brown and Co., 1978): 229.

5. Huntington, "Will More Countries Become Democratic?," in Gastil, *Freedom in the World*: 197.

6. Huntington, "Will More Countries Become Democratic?," in Gastil, *Freedom in the World*: 221–222.

7. See R. Bruce McColm, et al., *Freedom in the World: 1989–90* (New York: Freedom House, 1990): 3–7.

8. Robert A. Dahl, *Democracy and Its Critics* (New Haven: Yale University Press, 1989): 28.

9. Rousseau did, though, accept representation in his *Government of Poland.*

10. Dahl, *Democracy and Its Critics*: 214.

11. In 1787, James Madison claimed that one of the great innovations of the American, compared to the traditional, conception of republicanism is representation. See Madison, Federalist Paper no. 63, in *The Federalist Papers*, reprint (New York: Mentor, 1961), 382–390.

12. Dahl, *Democracy and Its Critics*: 311–21. The quotes are from pages 316 and 317, respectively.

13. Huntington, "Will More Countries Become Democratic?," in Gastil, *Freedom in the World*: 221–222.

14. Gabriel A. Almond and Sidney Verba, *The Civic Culture: Political Attitudes and Democracy in Five Nations*, reprint (Newbury Park, Calif.: Sage Publications, 1989); Guillermo O'Donnell, Philippe C. Schmitter, and Laurence Whitehead, *Transitions from Authoritarian Rule: Prospects for Democracy* (Baltimore: Johns Hopkins University Press, 1986). The citation is from Part IV, pages 3–4.

15. Larry Diamond, Juan J. Linz, and Seymour Martin Lipset, eds., *Politics in Developing Countries: Comparing Experiences with Democracy* (Boulder, Colo.: Lynne Rienner Publishers, 1990).

16. Seymour Martin Lipset, *Political Man*, reprint (Baltimore: Johns Hopkins University Press, 1981): 31.

17. Diamond, Linz, and Lipset, *Politics in Developing Countries*: 1–37.

18. Dahl notes a strong association between polyarchy and societies marked by a host of interrelated characteristics: "a relatively high level of income and wealth per capita, a high level of urbanization, rapidly declining or relatively small agricultural population, great occupational diversity, extensive literacy, a comparatively large number of persons that have attended institutions of higher education, an economic order in which production is mainly carried on by relatively autonomous firms whose decisions are strongly oriented toward national and international markets, and a relatively high level of conventional indicators of well being, such as physicians and hospital beds per 1,000 persons, life expectancy, infant mortality, percentage of families with various consumer durables, and so on." As the plot thickens, lines between definition, colinearity, and correlation become even more difficult to draw.

19. Diamond, Linz, and Lipset, *Politics in Developing Countries*: 6–7.

20. Dahl, *Democracy and Its Critics*: 260–262; Huntington, "Will More Countries Become Democratic?," in Gastil, *Freedom in the World*: 211.

21. See Huntington, "Will More Countries Become Democratic?," in Gastil, *Freedom in the World*: 199–203, 221.

22. Barrington Moore, Jr., *Social Origins of Dictatorship and Democracy* (Boston: Beacon Press, 1966): 508; Robert A. Dahl, *Polyarchy* (New Haven: Yale University Press, 1971): 45. Moore's and Dahl's views are discussed in Huntington, "Will More Countries Become Democratic?," in Gastil, *Freedom in the World*: 211–216.

23. Graham T. Allison, Albert Carnesale, and Joseph S. Nye, Jr., *Hawks, Doves, and Owls* (New York: W. W. Norton, 1985): 223–246.

24. See Graham T. Allison, "National Security Strategy for the 1990s," in Edward Hamilton, ed., *America's Global Interests, A New Agenda* (New York: W. W. Norton, 1989): 198–241.

25. George F. Will, cited in Paul Kennedy, "Fin-de-Siecle America," *New York Review of Books*, June 28, 1990.

26. John Maynard Keynes, *The General Theory of Employment, Interest and Money* (London: MacMillan & Co., 1957): 383–384.

27. Boris Yeltsin, *Against the Grain*, trans. Michael Glenny (New York: Summit Books, 1990): 255.

28. Keynes, *General Theory*: 383–384.

29. See table 1 in Marc Lindenberg and Shantayanan Devarajan, "Strong Economic Medicine: Revising the Myths about Structural Adjustment, Democracy and Economic Performance in Developing Countries," *Journal of Developing Areas*, forthcoming.

30. Hans Morgenthau, cited in Samuel P. Huntington, *American Politics: The Promise of Disharmony* (Cambridge, Mass.: Belknap Press, 1981): 247.

5. James F. Brown, "Helping Eastern Europe: Thoughts, Suggestions, and Some Mild Obsessions"

1. See Giuseppe DiPalma, *To Craft Democracies: Reflections on Democratic Transitions and Beyond* (Berkeley: University of California Press, 1990); and his "Transitions: Puzzles and Surprises From East and West," paper presented at the Conference of Europeanists, Washington, March 23–25, 1990.

7. Leif H. Olsen, "The Intellectual and Political Barriers to Free Markets"

1. Jozef Wilczynski, *The Economics of Socialism* (Chicago: Aldine Publishing Company, 1970): 29.

2. David Lipton and Jeffrey Sachs, *Brookings Papers on Economic Activity, I: 1990* (Washington: Brookings Institution, 1990): 119.

3. Ibid.: 125.

4. Milton Friedman, *Capitalism and Freedom* (Chicago: University of Chicago Press, 1962): 9.

5. James A. Dorn, in James A. Dorn and Henry G. Manne, eds., *Economic Liberties and the Judiciary* (Fairfax, Va.: George Mason University, 1987): 5.

6. Peter H. Aranson, in Dorn and Manne, *Economic Liberty and the Judiciary*: 88, 109.

7. Lipton and Sachs, *Brookings Papers*: 130.

8. Robert L. Heilbroner, *Between Capitalism and Socialism* (New York: Random House, 1970): 88.

9. Robert L. Heilbroner, "A Look at the Future of Capitalism," in *Sea Changes* (New York: Council on Foreign Relations Press, 1990): 110.

10. Heilbroner, *Between Capitalism and Socialism*: 113.

8. Steven W. Popper, "Aid from Western Governments: The First Steps"

1. "West" is used here in the political sense, thus including Japan, Oceania, and such potentially influential nations as South Korea.

2. Never intended for excellence but rather to meet the output goals of what was essentially a monopsonistic consumer, namely the state planning agency as an arm of the political leadership, the capital stock is old both in age and in terms of technological vintage. Enterprises, industries, and entire nations will find it difficult to escape the legacy of their past mediocrity now that they are being asked to earn their living by competing on world markets.

3. The temporal or even operational location of which is almost impossible to determine *a priori*.

4. This should not be understood as stating an extremist faith in the ability of the market to solve *all* problems.

5. Until the mechanism for price formation allows prices to capture real resource costs, as long as other administrative restrictions apply, and while accounting practices are not reexamined, it will not be fully clear which enterprises are truly capable of independent, profitable operations.

6. The Ministry of International Economic Relations and the Ministry of Industry and Trade are amalgamations of functions derived from earlier incarnations.

7. There is no separate discussion of assistance received from foundations. The prescription for the first of the two types of assistance by Western governments would apply as well to the types of programs these organizations might entertain.

8. The new European Bank for Reconstruction and Development, intended to become operational in early 1991, is a potentially large but currently unknown factor. It has the character both of an international agency and of a main funding source from its member governments in the developed West to Eastern Europe. Established with an initial capital authorization of 10 billion ecu (c. $12 billion), it has at least the potential of making large capital infusions at an early date. It needs to do so judiciously, with sufficient attention to its responsibilities to assure primarily the fundamental transformation of the economic systems in the recipient states,

while ignoring political pressures from any side, lest it inadvertently add to the burdens of transition. This should not be a problem if the bank remains true to the spirit of its charter. According to the EBRD's articles of incorporation, 60 percent of its aggregate lending per year, and 60 percent of the lending to any recipient country over five years, must be committed to aiding privatization and to building the private sector.

9. There is a third class, not requiring active fund appropriation. These initiatives are designed to create a climate for easier economic and other interaction between East and West. They range from granting most-favored-nation status, signing tax and investment treaties, and granting access to the various programs maintained by Western governments, to such things as easing visa requirements for East European nationals. This last is by no means the least important step Western governments could take. Though largely economic in character, the trigger for these initiatives should be a perception that democratic processes have gained the ascendancy in any given country. Thus, they fall chronologically and operationally between the two types of effort discussed above: the initiatives of the first type pursued wherever they are permitted and those of the second requiring a demonstrated dedication to fundamental economic transformation.

10. Again, the real possibility of generating private commercial solutions to local infrastructural deficiencies should not be minimized. In several respects this would be preferable to sovereign assistance because the continuing presence of a Western partner as part operator of the resulting systems would reduce many of the risks inherent in Western governmental assistance.

11. The Department of Commerce's East European Business Information Center might be a natural conduit.

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