

*I*

*Market Socialism Revisited*

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*II*

*The Soviet Union's Road to a Free Economy:  
Comments of an Outside Observer*

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THE TANNER LECTURES ON HUMAN VALUES

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# I

## INTRODUCTION : DELIMITATION OF THE SUBJECT<sup>1</sup>

The great transformation taking place in Eastern Europe, the Soviet Union, and China has revived the discussion about market socialism.<sup>2</sup> Since this study does not cover the whole issue, I would like to begin by delimiting the subject examined and briefly noting the methods of approach.

1. Initial conditions have a strong effect on any formation that actually occurs in history. Where did it start from before reaching its present state? Because of the differing circumstances in which the genesis occurred, it is worth distinguishing clearly between two subject-areas. One is market socialism as a system to replace capitalism, and the other market socialism as a system to replace old-style, Stalinist, prereform socialism or, as I call it in my works, classical socialism.<sup>3</sup>

The subject of this study is the development and operation of market socialism during the process of reforming the socialist sys-

<sup>1</sup> The Soviet Union and Yugoslavia still existed when the lecture was delivered. This written text uses the terminology current at that time. I owe thanks for valuable observations particularly to Eric Maskin and John M. Litwack, the discussants of my lecture in Stanford, and to all who commented on the first draft, above all Zsuzsa Dániel, Mária Kovács, and Carla Krüger. Exclusive responsibility for any errors in the study is the author's, of course. I am grateful to Brian McLean and Julianna Parti for their excellent translation. I take this opportunity of expressing thanks to the Tanner Foundation for the honor of their invitation, and also to Kenneth J. Arrow and Partha Dasgupta for preparing the discussions on the lecture and for the inspiring conversations I had with them and other Stanford colleagues.

<sup>2</sup> Almost every book and study discussing the reforms, particularly in the first stage of the changes, mentions the concept of market socialism. Market socialism is the main topic of some major pieces of writing; I pick out here the ones that had a thought-provoking effect on me while I was working on this study: P. Bardhan (1990), W. Brus and K. Laski (1989), A. de Jasay (1990), D. Lavoie (1985), J. Le Grand and S. Estrin (1989), G. E. Schroeder (1988), and G. Temkin (1989).

<sup>3</sup> The concept of "classical socialism" is clarified in more detail in my book *The Socialist System* (1992).

tem.<sup>4</sup> I do not discuss at all the other problem of market-socialist-style reform of capitalism.

Of course the two sets of problems overlap, since both of them entail thoroughly weighing the same value choices and the same instruments. But when it comes to practical conclusions and normative proposals they hold only in a specific context. What is true in the framework of reform socialism does not necessarily apply to the reforms of capitalism or vice versa. History does not move like a pendulum; having swung one way, it does not return to its original state. Explanations in which the unidirectional, “whence-and-whither” nature of history is ignored can easily lapse into serious fallacies.

2. Influential ideas tread a long path from their first formulation in theory to their realization in practice. For simplicity’s sake, three stages in this path are distinguished here.

*The vision:* This may be a utopia presented in an outline form,<sup>5</sup> or a normative model of pure theory. The series of the latter was opened by E. Barone ([1908] 1935); an outstanding work is the study by Oscar Lange (1936–37). Ideas related to Lange’s can be found in the works of F. M. Taylor (1929) and A. Lerner (1946).<sup>6</sup> Because of its outstanding significance for the history of theory, the Lange model will be returned to regularly in subsequent parts of this study.

<sup>4</sup> A terminological observation is needed. The term “socialism” in this study, as in my other works, denotes actual socioeconomic systems marked by the monopoly rule of the Communist party. While I am aware of the importance to adherents of socialist ideas of clarifying whether these systems merited the name “socialism,” I use it in a value-free sense. It is what the countries concerned called or still call themselves, and I have abstained from renaming them.

<sup>5</sup> On the concept of vision, see J. A. Schumpeter (1954), R. Heilbroner (1990), and J. Kornai (1986a).

<sup>6</sup> Formalization of the Lange-Taylor-Lerner models is dealt with in several works; I would stress the classic work of K. J. Arrow and L. Hurwicz (1960), E. Malinvaud’s model (1967), and, of the most recent literature, the studies by I. Ortuno-Ortin, J. E. Roemer, and J. Silvestre (1990).

*The blueprint:* This can appear in a variety of forms, for instance as the practical proposals of reform economists,<sup>7</sup> the political declarations of leaders, or resolutions on reform passed by a Communist party and government in power in a socialist country.

*Realization:* This covers what actually goes on in the economy, the de facto rules of the game, and the attitudes and behavioral regularities of the actors in the system.

Although the first stage is very important, it is not discussed here in all its details. The main subject of this study is political and economic history, not intellectual history, and so attention is centered on the blueprint and realization.<sup>8</sup> Although I admit the relevance of utopias and pure theoretical models, I would like to point out to Western readers that the practical experience of what took place in the socialist countries cannot be ignored even in the debate at the “visionary” level. The old ideas must be reconsidered in the light of the new evidence.

3. A whole range of countries went through a stage in which certain ingredients of market socialism were applied. Changes pointing in this direction occurred from 1949 onward in Yugoslavia and from 1953 in Hungary. Certain elements of market socialism appeared much later in Poland, the Soviet Union, China, and Vietnam. It is not possible here to discuss the matter country by country. Although there were appreciable differences between the specific formations that came into being in each country and its pace of historical development, an attempt will be made to formu-

<sup>7</sup> A few pioneering works are mentioned, grouped by countries. *Yugoslavia:* B. Kidric (for the works he wrote in the 1950s, see his 1985 volume); *Hungary:* Gy. Péter (1954a, 1954b), J. Kornai ([1957] 1959); *Poland:* W. Brus ([1961] 1972); *Czechoslovakia:* O. Sik (1966); *Soviet Union:* E. G. Liberman ([1962] 1972); *China:* Y. Sun ([1958–61] 1982).

<sup>8</sup> When Hayek (1935) took issue with the adherents of market socialism during the famous debate in the 1930s around the article by Oscar Lange, he stepped out of the realm of pure theoretical models by also bringing forward practical counterarguments that belong, according to the terminology of this study, to the blueprint stage.

late general statements. A common *prototype* will be outlined for each blueprint and for each practical realization. A prototype blueprint consists of a compression of thousands of political speeches, party programs, proposals submitted to the authorities, and resolutions passed by the state. A prototype realization is a generalized image of common practice, intended to describe what goes on in the offices of finance ministers or chief executives of state-owned firms and what are the characteristic tendencies in the economy.

The prototypes of both kinds result from a high degree of abstraction. They omit the less essential, ad hoc features and are intended to reflect the fundamental characteristics of market-socialist reforms. Neglecting the differences between countries, they focus on the properties in *common*.

This study sheds light on the problems posed by market socialism from various angles. The first part approaches the matter mainly from the point of view of *political economy*, and the second from the point of view of *philosophy*. The latter examines both the epistemological-methodological and the ethical-political aspects.

## 1. BLUEPRINT AND HISTORICAL REALIZATION: THE VIEWPOINT OF POLITICAL ECONOMY

### 1.1 *The Blueprint*

The main features of the prototype blueprint can be summed up as follows:

1. The political monopoly of the Communist party must be maintained. Some degree of political liberalization may occur: *glasnost* may develop, that is, a higher degree of honesty in the provision of political information and greater tolerance for alternative views; there may be more openness in relations with the West. But no fundamental change in the political structure is permissible.

I propose to make a sharp distinction between two stages. In the first of these a *reform* of a market-socialist character takes place, while the Communist party's monopoly of power basically

remains. The point of departure for the second stage is a *revolutionary* change in the political sphere, when the monopoly of the Communist party is broken and parliamentary democracy develops after free, multiparty elections. At that point the system commences the *transition* from socialism toward a capitalist market economy. The issues of this transition are extremely important, of course, but they are outside the scope of this study. Occasional references are made to the problems of the transition, but the subject here is the reform socialism associated with the names of Tito in Yugoslavia, Kádár in Hungary, Deng Xiaoping in China, Rakowski in Poland, and Gorbachev in the Soviet Union.

2. The predominance of public ownership must be maintained. Except in Yugoslavia's case, this means the predominance of state ownership. The specific characteristics of Yugoslav development cannot be dealt with here in detail, and the discussion that follows is concerned with state ownership. The observations, however, are applicable to Yugoslavia's case as well.

An important —perhaps the most important—component in the economic changes at the stage of historical realization is the evolution of the formal and informal private sector. Although it provides a relatively small proportion of production, it plays a big part in improving supply to the public and introducing property relations that conform with the market economy. But the idea of developing the private sector does not appear in the *blueprint* for market socialism before the actual transformation begins. The blueprint exclusively prescribes a renovation of the conditions under which state-owned firms operate. So in the rest of this study the remarks on market socialism refer exclusively to the state sector.

3. The relative share of decisions made at central level must diminish radically in favor of decentralized decisions made at local-government or more frequently enterprise level.

A similar idea is expressed by another formula. A state-owned firm is linked vertically with its superior authorities and hori-

zontally with its sellers and buyers. In the blueprint, the vertical links remain but the horizontal links are radically reinforced.

4. The main indicator of success for a firm is profit. The incentives for managers are to be tied to profits, and profit-sharing is to be introduced for the firm's workers.

5. The range of instruments available to the center must alter. Direct commands, the main instrument so far, should give way to indirect instruments or "economic levers." The blueprint's drafters assume that if firms are profit-maximizing, their actions can be influenced by changes in interest and exchange rates, taxes, subsidies, and specific prices. Centrally set prices and other financial parameters are to be strings pulled by the center to which firms will react like puppets.

6. The prototype blueprint does not clarify the kind of prices it seeks to introduce. Prices set by a decentralized process will reflect the market situation. But on what principles will centrally decided prices be set, including wages, interest rates, and exchange rates? The blueprint *fails* to say these must be market-clearing prices.

7. The economy must be opened up to relations with the capitalist world. The international credit market must also be entered, and it is worth raising loans from capitalist governments, banks, and firms in order to advance socialist development.

Let us look briefly at the best-known vision, the Lange model. The prototype blueprint is akin to it in aiming to operate profit-maximizing state-owned firms with a high degree of autonomy. It shares its aim of using central prices and financial levers to influence firms' decisions, but clearly departs from Lange theory in not stating firmly that market-clearing prices will be introduced.

The most important difference is that the blueprint contains a far richer set of rules. Pure theory can abstract away many important factors. Not so practice, which *must* settle all problems of choice one way or another. The prototype blueprint outlines many features of the system ignored in Lange's work and the theoretical controversy on market socialism in general.

That is not a shortcoming of the Lange model or the debate on it. Richness of detail cannot be expected in an intellectual construct belonging to the realm of pure normative theory. But it is not a mere shortcoming, but a fatal fallacy to take the theoretical model too seriously, so to speak, and treat it as a blueprint.<sup>9</sup>

In fact, even the blueprint falls far short of the complexity of reality, disregarding several considerations that prove highly important in practice. These will be returned to later.

The leitmotiv running through the seven attributes listed is that a new *Third System* must be created. This is to differ from the prereform, Stalinist classical socialism, but also from capitalism.<sup>10</sup> It is considered not a transitory stage that leads from socialism to capitalism, but a separate social formation, a lasting and robust new system.

## 1.2 *The Economic Performance*

In many features, if not in its entirety, the blueprint was applied for varying periods in the countries listed in the introduction. But it must be added that the historical realization differed from the blueprint in several respects, developing many characteristics that the drafters of the blueprint had not foreseen. Before turning to these departures, let us take a quick look at the economic performance produced by the blueprint's application. There is an ample body of empirical literature on the subject, and works discussing the issues of the transition to a market economy usually summarize the earlier period's economic successes and failures as well.<sup>11</sup> Rather than going into detail or presenting statistics, just a few of the main characteristics will be emphasized here.

<sup>9</sup> This Oscar Lange himself never did,

<sup>10</sup> This Third Road idea is well reflected in the following quotation from Gorbachev: "What alternatives are before us? . . . One is to maintain the command-administrative system, the strict planning, and the commands in culture as well as the economy. The other . . . suggests reverting to capitalism. Can we take either of these roads? No, we reject them. . . ." (*Pravda*, November 26, 1989).

<sup>11</sup> See, for instance, the articles of D. Lipton and J. Sachs (1990a, 1990b) and G. W. Kolodko (1991) on Poland, the article by J. Kornai (1986a), and the OECD

- Signs of slowdown had appeared before the reform began and were among the motives for breaking with the old command economy. The market-socialist reforms at most bring a measure of temporary revival; they do not halt the downturn permanently. The economy arrives at a point of stagnation, and later, in fact, an absolute contraction of production sets in. If appreciable growth does appear in any sectors, as it did, for instance, in Chinese farming for a good many years, it is due not to the realization of the market-socialist blueprint at all, but to *de facto* privatization, which falls outside the original market-socialist blueprint, as mentioned earlier.

- The stagnation or decline in GDP is accompanied by stagnation or decline in real consumption. Once again, the only countervailing force is the evolution of the private sector, which helps to improve supply and living conditions.

- Severe disequilibria are caused. Classical socialism is a chronic shortage economy, with distorted relative prices, but quite a stable general price level. Market-socialist reform is accompanied in most countries by a new, more complex problem: the “shortage-cum-inflation” syndrome. A grave and growing budget deficit develops, becoming one of the main factors fueling the growing inflation, which develops into open hyperinflation in some countries. In others the inflation is artificially repressed and a huge monetary overhang is created.

- There is no significant improvement in efficiency and factory productivity. Nor are there any tangible results in goods quality, innovation, or technical advance.

- The share of foreign trade conducted with capitalist countries increases, but the performance in this field is again poor. There is a deficit in trade with the capitalist market. Foreign debt rises and certain countries reach the brink of insolvency.

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report (1991) on Hungary, and the joint IMF, IBRD, OECD, and EBRD report (1990) on the Soviet Union.

If the blueprint was meant to create a Third System, it certainly did not prove its economic superiority over the First, modern capitalism. Nor can clear conclusions be drawn from a comparison with the Second System, classical socialism. On the one hand there are benefits. Although state-owned firms do not turn into real profit-maximizing economic units, some impression on the mentality of managers is made by the market-economic rhetoric, coupled with a few actual measures. They learn to pay more heed to financial indicators and buyer requirements. (This eases the later, real transition toward a market economy after the great political changes have taken place.) The main factor tending to improve the economic situation is the development of the formal and informal private sector. Perhaps most importantly of all, life becomes more tolerable, mainly because there is a measure of political liberalization and human rights are asserted more easily. On the other hand there are serious negative consequences, primarily for the macroeconomic equilibrium. Take, for example, East Germany, Czechoslovakia, and Romania, three countries whose political leaders stubbornly resisted all market-socialist reform, and compare them with Yugoslavia, Hungary, Poland, and the Soviet Union, which took the market-socialist road for varying periods. The macrosituation on the eve of the postsocialist transition is clearly worse in the second group than in the first: the budget deficit is greater, inflation faster (or the combination of shortage and inflation more acute), and foreign debt higher. The market-socialist experiments led to a situation in which the leadership lost control.

The economic leadership fails to understand what is happening. Repeated promises of an improvement cannot be kept, and this leads to frustration and protests from the general public. Since the reform has been coupled with political liberalization, the discontent takes open forms: demonstrations and protest meetings take place, and new parties opposed to the Communist party are organized. The old political system disintegrates.

So what has gone wrong with the market-oriented reform ?

One view is that the original blueprint is basically a good one, but it has one or two shortcomings that need rectifying. “Reform the reform.”

Another view is that the blueprint was wrongly implemented. The blueprint is in order, but it has not been applied in a consistent way because the bureaucrats and other conservative forces have sabotaged it.

In my view these factors are only a small part of the explanation. The main proposition in this study is that *the blueprint of market socialism is doomed to failure*. Although classical socialism causes great suffering and operates inefficiently, it is at least coherent. Combined with the “requisite” degree of brutal repression, it is viable and robust. The market-socialist reform, on the other hand, is not capable of becoming a robust system. In fact it is only its predecessor, classical socialism, in the process of falling apart. The subsequent sections of this study advance arguments in favor of this proposition, grouped under the following themes: the role of the state and politics; property rights and the soft budget constraint; social discipline; and exit, entry, and natural selection.

The causal explanation for the failure is far from exhaustive. Several important issues are missing: for instance, the problem of prices and the related problem of information, mainly because they have been adequately covered in other works. In my view, however, the phenomena to be examined are among the main factors explaining the failure.

### 1.3 *The Role of the State and Politics*

The authors of the Lange model and the purely theoretical ideas related to it do not refer specifically to a particular theory of the state. But some underlying tacit assumptions can be discerned, and these are not merely naive, but ultimately quite false. The theory assumes that the state will be content to perform three

modest functions: (1) to determine the market-clearing prices, (2) to enforce the profit-maximization rule for state-owned firms, and (3) to perform some redistribution of personal incomes. The theory disregards the real nature of any modern state, let alone such an exceptionally powerful state as the one that operates under the socialist system.

The prototype blueprint is not so naive as the utopian pure theory. On the contrary, its axiomatic point of departure is a special form of state, the party-state. It postulates that on the one hand the Communist party's political monopoly is to remain, and on the other the market will coordinate a substantial proportion of the economic processes. Yet these two postulates cannot be satisfied together, because each precludes the realization of the other. That is the biggest flaw in the blueprint.

Let us look at the modern reformulation of market socialism in the light of contract theory and the so-called principal-agent model.<sup>22</sup> This suggests there is a specific kind of *contract* between the state-center and the manager of a state-owned firm, with the center as principal and the manager as agent acting on its behalf. Western theoretical economists today are often found to draw the following conclusion: the experiments in market socialism so far have failed because the terms of the contract were wrong. With a better contract, the market-socialist system will work.

To counter this view, the main thesis put forward in the previous section can be rephrased like this. It is *impossible* to devise and enforce any contract between the state-center (as it actually exists in these countries) and the managers of firms (those actually operating in these countries) that would ensure an efficient allocation of resources. Let me draw attention to the qualifiers in parentheses. A contract between an imaginary principal and an imaginary agent is quite irrelevant to the subject of this study. Let me repeat for the sake of emphasis: our concern is with actual

<sup>12</sup> An overall view of this promising new line of research is provided by O. Hart and B. R. Holmström (1987) and J. E. Stiglitz (1987).

organizations and actual persons whose actions are dictated by their real natures and circumstances.

I hope that further research will produce an exact formulation of this assertion. In terms of strict logical proof, this assertion can only be rated as a conjecture for further research to prove or disprove. It can, if you like, be classed as a bold conjecture, as can the other assertions in this study. But the intuition rests on clear observation of a plain fact: thousands of highly intelligent, well-intentioned people in all the countries that experimented with market socialism were unable to hammer out and consistently implement a contract that was guaranteed to operate efficiently.

Here are a few arguments to support the conjecture.

1. It is a false assumption to expect any government (let alone an individual dictator or a politburo as a collective dictator under a Communist-dominated political system) to maximize the social-welfare function. It is even doubtful whether any other well-defined utility function can be assumed. If there is an ultimate objective at all, it is to maintain the power of the political rulers, not further the welfare of society. The real motives are described more precisely, in fact, by saying that Communist leaders have multiple objectives. To mention just a few, these include fulfilling their deeply entrenched ideological obligations; in the case of smaller countries, faithfully serving the master-country, the Soviet Union; increasing their military might; accelerating growth in the shortest time possible; and, alongside all these, improving the population's standard of living, of course. It is an elementary truth to empirical political scientists that no politician ever has a consistent order of preferences. Unless stupid or stubborn, he or she will improvise, always adjusting to the contingencies, putting one thing first today and another tomorrow.

Since state ownership places the machinery of the whole economy in the hands of politicians, it is naive to expect that production can ever be "depoliticized." On the contrary, it will invariably be subject to the ever-changing political winds. Important though

efficiency, growth, technical advance, and so on remain as tasks, they can be easily pushed into second place if the day-to-day considerations of politics so require: for instance, if politicians give popularity priority over other tasks or need to extract more revenue for military purposes.

No politician wants to “sign a contract.” They do not like to state their goals plainly, because it ties their hands and limits their room for maneuver. They do not want to be absolutely faithful to any kind of commitment or contract. They prefer flexible action adjusted ad hoc to the changing circumstances.

Even under modern capitalism, the business sphere primarily governed by criteria of profit and efficiency is never separated perfectly from the political sphere moved by considerations of power, but the separation goes quite a long way. The Communist monopoly of political power and predominant state ownership preclude that separation altogether.

2. Another approach is to look at *roles* instead of *objectives*. Capitalist owners basically fulfill one role: they behave as owners. In this role they primarily seek to enhance their income and the value of their property. The state, however, particularly the socialist state, has several concurrent roles. Apart from drawing income from its property, it performs the following other functions:

- legislator, setting the rules for the economy;
- police officer, enforcing the law;
- judge, arbitrating in cases of conflict;
- allocator, redistributing wealth and income;
- insurer, providing a cushion against risks, a dispenser of social security, and a paternalistic benefactor;
- union official, defending workers from managerial abuse.

Conflict between these roles is inevitable. In a democratic constitutional state they are separated, but market socialism, arising under the conditions of Communist power, conserves a political and governmental structure that combines these functions in a totalitarian party-state, instead of separating them.

The role of judge needs special mention. A contract between the state-center and a firm's manager is inevitably incomplete. If it covered every possible detail, it would be hopelessly complex and opaque, and its observance extremely expensive to check. But if the contract between the state-center and the manager fails to cover every detail, legal disputes may arise. Who adjudicates? There is no judicial independence in a totalitarian state. "Plaintiff," "defendant," and "judge" are all dependent on the party and all subordinate to the upper levels of the party-state bureaucracy.

3. Mention was made under point 1 of an individual fictional politician, but in fact every political leadership in existence is a coalition, and that applies under a one-party system as well. Within the coalition there are factions and power struggles. Any coalition is temporary and fragile. So whatever contract is drawn up between the state-center and the management of a firm, its enforcement and the conditions under which it can be renegotiated are subject to the power struggle. There is no stability and persistency, only capricious volatility. Even if the members of the coalition agree with the firm's management on the terms of their relations (the "contract") at a given time, its enforcement remains subject to monetary future configurations of power in the coalition.

4. Market socialism assumes that the bureaucracy exercises self-restraint. (Party apparatchiks are to be understood as included in the bureaucracy as an aggregate term; the members of the party apparatus are not just members of the bureaucracy, they are its core.) However great the bureaucracy's power, it is expected to refrain from using it and leave the decisions to the management of the firm and the market agreements between buyers and sellers.

This assumption rests on a vain hope. In fact the temptation is almost irresistible. If power gets into the hands of power-hungry people, they will use it. Moreover, it has become the tradition and routine for them to do so in the period of classical socialism. Both the bureaucrats and the citizens are used to that, and it is

sometimes actually demanded even by those over whom the power is exercised. If there is a shortage of a product or service, for instance, the authorities are expected to intervene and organize an administrative distribution.

Oscar Lange's model sought to confine itself to two simple rules. The prototype blueprint intended the bureaucracy to have much greater power, but it set limits, saying where the role of the bureaucracy was to end and the role of the market to begin. But in reality the bureaucracy constantly oversteps the bounds with millions of interventions. Microregulation prevails.

The leadership under reform socialism appeals time and again to the bureaucracy to assist instead of obstructing the process of reform. This proves to be absurd, since the situation contains an innate contradiction. The bureaucracy cannot "assist," because its very existence is a basic obstacle to market-socialist reform.

The growth of the bureaucratic apparatus is not easy to halt, and a reduction is more hopeless still. Once a position in the bureaucracy has come into being, it is extremely difficult to abolish it. Far from falling, the number employed by the party-state and total spending can sometimes even rise during the experiments with market socialism.

There is a struggle going on around the reform, a struggle for power, prestige, influence, and privilege. The more autonomy individuals gain and the more scope there is for voluntary contracts between individuals, the less power bureaucrats are left with. So it is in their own interest to resist.

#### *1.4 Property Rights and the Soft Budget Constraint*

A return can be made here to an issue mentioned earlier, the principal-agent relation and the "contract" between the principal and the agent. The following argument is often used to defend the concept of market socialism.

Ownership has been separated from control under modern capitalism. The owners of a large joint-stock company are a large

number of shareholders, while control is concentrated in the hands of the senior executives. The former constitute the principal and the latter the agent. If this works well under capitalism, why should it not work well under market socialism, even though the owner is the state (or the government representing it) ? After all, the output of General Motors is presumably no smaller than Albania's or Mongolia's.

This argument rests in my view on a false analogy, the criticism following from the ideas introduced in the previous section.

The *objectives* of the owners are radically different. In the first place, shareholders in General Motors seek financial gain in the short and long term, whereas the government under market socialism has complex motives that are ultimately subordinate to political goals.

The *instruments* in the hands of the owners are also different. The shareholders of General Motors can dispense financial rewards and penalties, with dismissal as the ultimate sanction; they do not have a KGB. A totalitarian party-state has countless administrative and ideological instruments available to it, though they have weakened since the classical socialist period.

So *the situation of the agent* differs fundamentally under the two sets of contractual circumstances. A General Motors manager has an exit: he or she can quit. (To stick with the U.S. car industry, Lee Iacocca left Ford after conflicts with Henry Ford, the main shareholder, and went to the rival firm of Chrysler as chief executive.) There is no real exit for a company manager under market socialism, since ultimately there is just one employer, the state. (Staying with the same analogy, it is like being able to move from Buick to Pontiac, but not escape from General Motors altogether.) Wherever managers go they are accompanied throughout life by a personnel file. Instead of jobs being allocated by a competitive labor market, top executives are assigned to them by a strongly centralized, ubiquitous network of personnel departments controlled by the party and secret police. A quarrel with the cen-

tralized bureaucracy can badly damage or even ruin a manager's career prospects, while good connections in the party and other branches of the bureaucratic apparatus open up a wide range of other careers, as a party functionary, for instance, a high-ranking official, or a diplomat.

This situation decides the motivation of the subordinate agent in the principal-agent relationship. The key trait is loyalty to superiors, not business success or concern for customers. A manager is a bureaucrat, a member of the *nomenklatura*.

A simple conclusion can be drawn: *there is no real decentralization without private ownership*. This well-known proposition was first emphasized strongly in the works of Mises and later expounded in more detail by the "property-rights school."<sup>13</sup> The practical experience of the socialist countries supplies new and convincing evidence to support the old truth. The experiments in applying market socialism confirm that the survival of state ownership inevitably conserves a high degree of centralization.

Let us look at the various property rights more closely.

(a) *Income*. The residual income of a capitalist joint-stock company, after deduction of expenses and taxes, clearly belongs to the shareholders. Though there are institutional owners as well, a high proportion of the shares are held by individuals with direct *personal interests*. With a firm under market socialism this income flows into the state treasury, which is quite *impersonal*. Even if part of the residual income is passed to the managers under various incentive schemes, the proportion is uncertain and the subject of constant negotiation.

(b) *Alienation*. Property rights in a capitalist joint-stock company are transferable, whereas the ownership of a market-socialist firm is inalienable: its sale is precluded by legal constraints.

<sup>13</sup> See L. von Mises ([1920] 1935), and also A. A. Alchian (1965, 1974) and A. A. Alchian and H. Demsetz (1972). The position is summarized concisely in the title of W. G. Nutter's study (1968): "Markets without Property: A Grand Illusion."

(c) *Control*. A substantial part of this shifts from the center to the management of the firm, but the rights are not clearly separated, since the center continues to exercise control in a variety of ways. The line dividing the provinces of the superior state organizations and the firm's managers at any time depends on negotiation.

A clear, plain assignment of property rights is lacking. The key to grasping the situation is to see how every decision is based on ad hoc negotiations between the upper levels of the bureaucracy and the managers of the firm. The relative bargaining positions are uncertain. The superior bureaucratic authorities combine strength and weakness: strength in possessing the instruments of state power and weakness in being unable to resort to extreme instruments of terror. But the firm's managers are strong and weak too: strong in that they can resort to blackmail —“our output is vital in the shortage economy”; “we cannot dismiss our workers” —but weak because their careers depend on their superiors' grace and favor.

This is the context in which the syndrome of *soft budget constraint* emerges.<sup>14</sup> As mentioned before, the blueprint states profit to be the main indicator of a firm's success, but this is not taken seriously. With the prevailing political structure and predominance of state ownership there must be softness of the budget constraint. The state cannot let down an insolvent firm; it must bail it out. This conclusion can be drawn directly from what has been said about relations between the party-state and a state-owned firm.

Private ownership is an essential requirement for a hard budget constraint. Private owners can be left to their fate; it is their problem, not the state's. Softening of the budget constraint is the result of deep state involvement, since the state bears ultimate responsibility for the fate of the firm.

<sup>14</sup>This concept was introduced in my work *Economics of Shortage* (1980); for a more detailed explanation see my 1986b article and chapters 8 and 21 of the 1992 book.

### 1.5 *Social Discipline*

The bargaining that permeates society ties in with another noteworthy problem: social discipline.

Any complex process of coordination demands a measure of discipline. There must be a combination of positive and negative incentives, the carrot and the stick.

Discipline is needed at work to ensure full use of working hours, obedience to technological imperatives, and cooperation between the various phases of work.

Discipline in pay or wages can become divorced from performance, which has harmful micro- and macroeconomic effects.

Discipline is needed in finance. Among the many facets of this multiple requirement is that persistently loss-making firms must be wound up, since their survival merely contributes to social costs.

Classical socialism rested on commands, mandatory planning instructions, and a brutal enforcement of obedience. There were rewards for discipline and loyalty to the party and the state, but harsh penalties for violations of discipline.

Capitalism applies market discipline mainly by economic means. Work discipline is reinforced by refined pay schemes, and most of all by the threat of dismissal and unemployment. Wage discipline is ensured by the self-interest of the owners, since extra pay unjustified by performance ultimately comes out of their pockets. Financial discipline in the business sphere is enforced primarily by the hard budget constraint: a firm that gets into difficulties will not be rescued by the state with tax breaks or subsidies, or with soft loans from the banking system.<sup>15</sup>

Under the reform pointing toward market socialism, the discipline of the command economy is lifted without true market discipline being applied. Softness is not confined to the budget con-

<sup>15</sup> Certain symptoms of the soft budget constraint syndrome appear in modern capitalism due to various factors: there are rescues of insolvent firms and even whole sectors. How inevitable this is and to what extent it brings an erosion of financial discipline, along with all the detrimental consequences known from the experience of the socialist countries, is a matter of debate.

straint; all the other forms of discipline slacken too. Superiors and subordinates connive to flout the law. Inspectors turn a blind eye to laxity and indiscipline. Laws and rules lose their prestige.

The breakdown of discipline is also to blame for the low efficiency at microlevel, and on a macrolevel it is the main contributor to the macrotensions—the wage spiral, excess state spending, and the practice of wantonly distributing credit and never demanding its repayment. All these phenomena ultimately bring about inflation, monetary overhang, and indebtedness.

### 1.6 *Entry, Exit, and Natural Selection*

In the discussion of market socialism to this point, the composition of the firms sector was taken for granted. In fact the multitude of firms is not constant, and the regularities governing entry and exit, birth and death, are extremely important.

One of capitalism's great virtues is the freedom of entry into all areas where it is unimpeded by monopolies. Opportunity is the mother of enterprise. The entrepreneur in Schumpeter's sense pools his or her talents with the financial resources of the lender.<sup>16</sup> Loan capital may come from various sources. The financial backing for the enterprise is provided by a competitive banking sector and a decentralized capital and money market.

Market socialism differs little from classical socialism in this respect. Entry is governed by bureaucratic decisions. The foundation of firms is the bureaucracy's task and privilege. There are strong monopolistic tendencies: why create rivals for oneself? Competition and the right of free entry are inseparable, and they are just what market socialism lacks.

The situation is similar on the exit side. With a hard budget constraint, a loss-making firm cannot survive. This applies invariably to the normally small and medium-sized firms in the non-

<sup>16</sup> "Capitalism is that form of private property economy in which innovations are carried out by means of borrowed money," writes Schumpeter (1939: vol. 1, p. 223).

corporate sector. Here the exit rate is very high, amounting to 20–30% of firms a year in many countries. The proportion is far lower in the corporate sector, but a similar selection effect operates there through the mechanism of corporate takeovers. If the earlier management was incapable of drawing the maximum profit from the firm, the potential new owners hope for new profitmaking opportunities by taking over control of the shares, and this is usually accompanied by aggressive dismissal of the previous management.

These strict principles of selection fail to apply in an economy with a soft budget constraint. There is a bureaucratic redistribution of profits, which are taken from strong firms and given as assistance to weak ones. The state has sunk investments in an existing firm, and so it has a vested interest in its survival.<sup>17</sup> Exit is relatively rare, and when it does occur it is by an arbitrary bureaucratic decision.

The overall effect of the entry-exit rules set is that no rivalry occurs. A brief return must be made to an issue mentioned several times before: Can an effective “contract” be made between the state-center and a firm’s manager? To the counterarguments advanced so far another can be added. For the “principal” (in this case the state-center) to gauge performance by the “agents” (in this context the managers of firms), it must be able to compare firms. But that requires free entry and competition, which makes a real comparison with winners and losers, not just paper assessments.<sup>18</sup>

Without free entry and without exit by the losers in the competition, the “creative destruction” that Schumpeter deemed so important cannot occur. Once the production structure has formed, it is frozen. That is one more reason for the low efficiency and weak performance.

<sup>17</sup> This mechanism is formalized and its negative results graphically shown by M. Dewatripont and E. Maskin (1990). The effect of the phenomenon on innovation is analyzed by Y. Qian and C. Xu (1991).

<sup>18</sup> Although this study does not deal with the issue of prices, it must be mentioned here that the comparative reports on paper of firms’ performances are useless in any case because distorted and irrational prices are used to compile them.

To sum up, there are various arguments to support this study's main proposition that the failure of market socialism is not due to weaknesses in the blueprint or in the way it is implemented. Given certain fundamental features of the sociopolitical system—namely, the survival of the Communist party's political monopoly and the predominance of state ownership—the quest for a truly efficient economy is hopeless. There is a built-in instability, and the experiment sooner or later breaks down.

## 2. LEARNING BY DISAPPOINTMENT: THE EPISTEMOLOGICAL AND ETHICAL VIEWPOINT

### 2.1 *Understanding the Process of Understanding*

Some of the arguments against market socialism put forward in this study were known a good while before the present collapse of the Eastern European system. Reference was made earlier to Mises, Hayek, and the exponents of the "property-rights school," whose writings advance numerous objections still valid today. Why did the warnings fall on deaf ears in Eastern Europe? Why did reform politicians and reform economists not take the critics' words to heart? A broader problem lies behind these questions. What are the constraints on enlightenment and rational argument?

Some autobiographical elements appear in this part of the study; introspection contributes to the analysis. I envy those who never change their *Weltanschauung* from the moment they start to ponder the great issues of life to the day they die. No doubt this is not rare in relatively stable societies, but it is hardly possible in the troubled region of Eastern Europe. Many people, even those who tried to serve the same set of fundamental ethical principles throughout their lives, have come to change their philosophy, perhaps more than once, under the influence of disturbing experiences and dramatic changes in their social environment.

One side of people's lives is the history of their opinions. What doctrines did they subscribe to and when? In what period (if ever) were they faithful Marxists? When did they become

adherents of reform, perhaps of market socialism itself, and when did they abandon hope of reforming the socialist system (assuming they went through that stage as well)? The discussion here does not cover the way *individuals* differ in the pace at which they go through the process of faith, disappointment, and enlightenment. The question I am interested in is what induced *large groups* of reform politicians and reform economists to devote themselves to the cause of market socialism. What drew them to it and what repelled them from it? The concern in this part of the study, as in the first, is not with individual cases, but with a *prototype* history of ideas: an intellectual movement and the general formulae of moral and political conviction that inspired it.

The question remains topical, because the idea has not been dispelled. It still influences many people despite the historical failure; the greater the difficulties encountered in the transition from socialism to capitalism, the greater the influence of market-socialist ideas tends to become.

## 2.2 *The Struggle with Marxism*

The reform politicians and reform economists of Eastern Europe were brought up in the Marxist intellectual tradition, with *Das Kapital* as their bible. Acceptance of market socialism is quite alien to the spirit of Marxism. Marx recognized the high degree of organization and efficiency *inside* the factory in a capitalist economy, but he emphasized that complete anarchy reigned on the market connecting the factories.<sup>19</sup> According to this concept, the market is a poorly operating, blind coordination mechanism based on *ex post* reactions to signals. So it must be replaced in the superior socialist society by conscious planning tuned to *ex ante* signals.

Nor was the market attacked merely by the spread of rational arguments. There was indoctrination that delved deep into the

<sup>19</sup> “. . . the most complete anarchy reigns among . . . the capitalists themselves,” Marx writes in *Capital* ([1867–94] 1978: chapter 51, p. 1021).

metarational, emotional realm, inducing prejudices against the market. A true Marxist views the market with suspicion and contempt. The need to free humanity from its market fetters is one reason why private property must be eliminated.

Overcoming these prejudices requires a great effort of will. Many formerly dogmatic Marxists never manage to overcome them entirely, an example being the frequent fulminations against “speculators,” “profiteers,” and “black-marketeers” even during the reform.

Despite this antipathy, market socialism seemed to many Communist politicians inclined toward reform to be a necessary concession. They wanted to retain the earlier structure of power, the political monopoly of the Communist party, because that for a Leninist was the prime consideration.<sup>20</sup> And they also wanted to retain the predominance of state ownership. These two attributes of socialism had more than an instrumental value in the Communist system of values, more than a purpose in terms of some other, ultimate aim like the welfare of the people or human happiness. They themselves possessed an intrinsic value, being absolutely indispensable characteristics for a system worthy of the name “socialist.” So market socialism seemed to be a promising combination of socialism and capitalism: a dominant role is assigned to the fundamental socialist attributes in the power structure and property relations, and a little injection of capitalism is administered: some influence of the market on coordination. The new combination will improve efficiency without abandoning socialism.<sup>21</sup> As

<sup>20</sup> Stalin quotes Lenin’s statement that “the question of power is the fundamental question of the revolution,” adding himself: “The seizure of power is only the beginning. . . . The whole point is to retain power, to consolidate it, and make it invincible” (1947: p. 39).

<sup>21</sup> As an illustration, a quotation from Gorbachev: “In short: the advantages of planning will be increasingly combined with the stimulating factors of the socialist market. But all of this will take place within the mainstream of socialist goals and principles of management” (1987: p. 91). A later statement: “The superiority of the market has been demonstrated on a world scale . . . it is really the regulated market economy which allows us to increase national wealth. . . . And, of course, state power is in our hands” (*Izvestia*, July 11, 1990).

long as politicians and economists retain their belief in this combination, they can be classed as *naive reformers*.

The reform camp broke up into conflicting groups as it became increasingly clear that *the alternatives were mutually exclusive*. There could *either* be socialism with Communist party rule and predominant state ownership *or* a genuine market economy.

### 2.3 *Compatibility with Walrasian Thinking*

Let us turn to another intellectual current: Walrasian economics.<sup>22</sup> Several groups must be considered here: (1) economists in Eastern Europe who were converts from Marxism to contemporary Western economic ideas; (2) again in Eastern Europe, a small number of economists, mainly of the older generation, who never went through a Marxist phase; and (3) Western economists who had an interest in market socialism.

The great attraction of Lange-type normative theories is the neat way they fit into the Walrasian tradition and combine nicely (on an intellectual plane, not in reality) with certain socialistic ideas such as a more equitable distribution of income through redistribution by the state. Even the ownership question can be ignored. What really matters is not ownership, but correctly setting the rules and drawing up the contracts with managers, which in turn assures the right motivation and rational prices.

The shortcomings of this view have been outlined in the first part of this study. The Walrasian model, along with most of its later variants including the Lange-type model, is a marvelous piece of intellectual machinery placed in a sociopolitical vacuum. It is a construction that lacks *a positive theory of politico-socioeconomic order* as a foundation. Walrasian economics and its more recent theoretical, mathematical-cum-economic kin like game theory, contract theory, and organization theory are very powerful tools for

<sup>22</sup> The term “neoclassical” is intentionally avoided here in order to leave open the question of whether the Austrian school (including von Mises and Hayek, who have an outstanding role in connection with the subject of this study) belong inside or outside the neoclassical school.

analysis. Analysts using them can arrive at sharp and relevant results, so long as the work is based on the right social theory. But they can reach misleading conclusions if their work is grounded on a false social theory, irrespective of whether their points of departure in social theory are spelled out or just implicit in the construction of the model.

The word “vacuum” has been used because the Lange model lacks, among others, the following attributes required by a more complete theory:

- understanding of the sociopolitical environment of the actors and the institutions that influence their behavior;
- incorporation of the state, as an endogenous constituent of the system, in the overall theory of the economy;
- an explanation of how the preferences of decision makers and the changes in these preferences, the decision-making routines, and the political and social constraints on human actions are determined by the social circumstances and by the extent to which the social situation explains the goals of individuals and groups.

The Austrian school certainly offers a richer explanation of these attributes of the socioeconomic order than sterile application of Walrasian theory, but it is still not rich enough. Much can be learnt from Marx if the explanatory theory of the economic order is being examined (although Marx and Hayek are admittedly strange bedfellows. Economists should make far greater use of the accumulated knowledge offered by modern sociology, political science, social psychology, and history. All this knowledge is required in order to reach the right normative conclusions.

There is nothing wrong with the tools of the Walrasian school, or, more widely, with the analytical methods of the neoclassical school, so long as they are treated with care and circumspection. But there are dangers in using them in an easygoing way because they tempt people to employ the wrong *research strategy*. Research should never *start* with formal analysis. The right questions must be put to start with; sound assumptions and sound conjectures

must be devised. An erroneous strategy holds fewer dangers when the research is into “small” questions, especially if they can be compared with observable, repeatedly occurring facts. In that case it is simple to confront theory with praxis, which acts as a safeguard against serious error. An erroneous strategy becomes more dangerous in the case of “big” and rarely repeated issues, and more dangerous still, in fact positively fatal, with never-repeated future events of vast import like the transformation of whole societies. Starting the analysis “in the middle,” with precise formalization but without very carefully weighing all the relevant political, sociological, and psychological assumptions and implications, can be very harmful indeed.

To add a personal note here, these ideas inspired me to write the book *Anti-Equilibrium* (1971). In retrospect I can see I was too harsh in my rejection of some analytical instruments that can actually do good service if they are used with sufficient precaution. I was not sufficiently confident in the Walrasian school’s powers of rejuvenation, whereas prominent members of it have made great progress in expanding its range of tools and improving the realism of its models since then. Yet I still feel there was an element of justice in my bitter reproaches at that time. When I wrote the book, very widespread use was made of the narrow-minded, technique-oriented research strategy just outlined —starting research “in the middle” of the cognitive process by devising a formal model. Paucity of knowledge about the real workings of society often led to false positions. I might add that this approach is none too rare today. The artificial barrier and mutual mistrust between “institutionalists” and “analytical” economists still persists, damaging the usefulness of both approaches.

So far as I can see, the intellectual convenience of combining Walrasian thinking with socialistic principles of distribution still has an effect on the thinking of many economists. My request to my colleagues is to face up to Eastern European experience, especially the political, social, and psychological aspects of it; this may

induce them to reexamine their adherence to the concept of market socialism.

#### 2.4 *Three Fallacies*

Closely related to the issue discussed in the previous section are three fallacies with which I would like to take issue.

1. Schumpeter's pioneer theory of the role of the entrepreneur is highly relevant to the subject of this study, market socialism.<sup>23</sup> (See section 1.6 above on the role of entry, exit, and natural selection.) When the Walrasian normative theory was devised, the question was evaded of how "creative destruction" would occur in a Lange economy: elimination of obsolete technology and organization and introduction of revolutionary new products, technologies, and forms of organization.

Schumpeter later drew some far-reaching conclusions from his earlier theory and other observations on the future of capitalism and socialism.<sup>24</sup> Let me try, with a little simplification, to sum up his line of thinking. The main role in modern capitalism is played by large corporations, including monopoly firms. These have become bureaucratized to a great extent. The role of the entrepreneur has weakened. The bureaucratic monopoly firm is capable of taking over the entrepreneur's function, primarily in innovation. If that is the case—capitalism itself has become bureaucratic—and if Lange has proved anyway that market socialism is viable and efficient, it is best to acknowledge that socialism will replace capitalism. This is foreseeable, and even if it is not glad tidings, there is no need to oppose it.

This prophecy of Schumpeter's has been a subject of controversy ever since.<sup>25</sup> I am convinced that Schumpeter's reasoning here is erroneous.

<sup>23</sup> See J. A. Schumpeter (1911) 1968).

<sup>24</sup> J. A. Schumpeter ([1942] 1976).

<sup>25</sup> See, for instance, the volume published for the 40th anniversary of the appearance of *Capitalism, Socialism and Democracy*, ed. A. Heertje (1981).

First, the analysis of modern capitalism given by Schumpeter is biased and exaggerated. Luckily, the “entrepreneur” of Schumpeter’s earlier works has not disappeared from the world of contemporary capitalism at all. On the contrary, it is often the entrepreneurs as battering rams for innovation who induce large corporations to innovate after all in spite of their indolent tendencies. Think, for example, of the role played in revolutionizing the computer industry by the founders of Microsoft or Apple, or other initially small ventures, in relation to the near-monopoly IBM. Strong bureaucratic tendencies have certainly arisen, and the role of the state has grown to a large extent. But those like myself, who know from personal experience what *real* bureaucratization of a system means, may be better placed to appreciate that the process of bureaucratization has not gone very far. Modern developed capitalism has basically remained a decentralized, competitive, private market economy.

Second, market socialism in real life did not fulfill the expectations of Lange or the later Schumpeter, as the first part of this study set out to show. Fifty years after the appearance of Schumpeter’s book, its prophecy has been refuted by history. Instead of socialism replacing capitalism, capitalism is regaining lost territory that classical socialism ruled for a long time and the market-socialist experiments could only occupy temporarily.

2. Some reform economists familiar with contemporary Western theory favor the idea of market socialism for the following reason. They realize the various shortcomings in the operation of an unrestrained private market economy. The list is well known: the problems of externalities, public goods and monopolies, the income distributional troubles, and so forth. They are also aware of the many drawbacks of planning and overcentralized state control. The former they like to call market failures and the latter planning failures.

Now market socialism offers the prospect of a nice *complementarity*, with planning and the market coexisting peaceably side

by side, each curbing the other's excesses. While the central authorities make corrective interventions when the market errs, the market and the partial degree of decentralization prevent the state from becoming excessively bureaucratic.<sup>26</sup>

No such nice complementarity materialized under the market-socialist reforms in Eastern Europe. The market failures persisted: the harmful externalities (air and water pollution, environmental damage, congestion), the monopoly position of vast state-owned firms, and the unjust distribution of income. At the same time, the market failed to gain vigor because it was throttled by the bureaucracy, which intervened even where the market had not failed.

3. There are a great many illusions about the potentials of "system design" and "system engineering." Some think they can be applied on a national scale, not just in a particular firm or smaller sector. The optimal schemes of organization and rules of operation must be thought out methodically. Once a wise and benevolent government possesses them, it will see they are implemented successfully.

That is not what happens in practice. Rules are only effective if they are compatible with the nature of the government and society concerned. Otherwise the implant will be rejected. The necessity for compatibility and coherence among the elements in a system is clearly recognized, but a detailed explanation is still lacking. Promising though the mathematical and economic researches into the compatibility of incentives are, they are still only in the initial stages of exploring the problem. They remain for the time being insufficiently associated with the nonformalited empirical studies of society's functioning and human behavior.

A high proportion of social institutions come into being by *evolution*. Again there is a process of natural selection. A large number of mutations occur, with some of the new institutions and rules that arise proving viable, while others disappear. One of the

<sup>26</sup> This idea also appeared in my book *Anti-Equilibrium* (1971: pp. 334–43).

innate weaknesses of market socialism is that it is an artificial construct, a constructivist creature, to use Hayek's term.<sup>27</sup> Nor is it merely that the theoretical model and later the blueprint were artificial, for it also imposed a great many governmental interventions on people.

As an illustration, let me refer to one of the problems discussed in the first part of the study. Market socialism rests on the assumption that firms will behave *as if* they were profit maximizers. If that is so, they can be stimulated to do what the center wants by well-calibrated subsidies, tax concessions, administrative prices that ensure a high profit margin, and credit at concessionary interest rates. At the same time, firms can be dissuaded in a similar way from actions the center opposes by well-calibrated taxes, the setting of prices unfavorable to the firm, and deterrent interest rates. True, but to exert this influence, each bureaucratic agency builds up its own system of incentives and deterrents. Toward the end of the Hungarian experiment with market socialism, state-owned firms were subject to restraint or inducement from some 200 types of special taxes and subsidies. The outcome was for the impact of any scheme to be canceled out by the others. The firm failed to react like an obedient puppet when all its strings were pulled from various directions because they were tangled up. This also meant the profit motive ceased to apply, because the financial impact of market success and failure was cushioned by the tailor-made taxes, subsidies, and other interventions in prices and the firm's financial affairs. Instead of a natural environment of free contracts, the firm operated in an artificial setting of bureaucratic decrees.

The arguments against such artifacts do not imply that the state and political movements should be passive bystanders observing the evolution of society. Their activity is required, so long as it reinforces existing healthy trends that arise in a natural way and does not impose artificial constructs on society.

<sup>27</sup> See L. von Mises (1981) and F. A. Hayek (1960, 1989).

### 2.5 *The Democratic Choice of an Economic System*

That brings us to the question of *choice* of a system. A distinction was drawn in the introduction between seeking to introduce market socialism instead of capitalism and seeking to introduce it instead of classical socialism. All politicians and economists have a self-evident right to recommend market socialism as a replacement for capitalism or a way of reforming it, if that is what they believe, provided they seek to do so by democratic, parliamentary means. A party proposing to introduce market socialism may stand in the elections, and if it wins it can put the necessary legislation through in accordance with the democratic constitution. The fact that I would not vote for such a party myself is irrelevant to my argument—I fully recognize the legitimacy of forming such a party and of its political activity.

But the question of “whence and whither” must be raised again in the case of Eastern Europe. The idea of market socialism did not gain ascendancy through a free competition of ideas. What happened was that the group which had happened to gain power in the Communist party embraced this idea and then imposed it on society. Although the methods used were less brutal than the earlier confiscation of the factories and mass collectivization, the introduction was nonetheless made by government decree. Once again it was a question of “forced happiness.” The ruling group considers this will be good for the people, so let them have it.

For a long time many reform economists did not even consider this side of the matter. It seemed to be self-evident that the ruling elite of the party-state should decide. The elite had to be convinced (or its membership altered) for the idea of reform to prevail. One of the greatest shortcomings in the market-socialist blueprint is its failure to enquire whether this is really what the people want.

It is still too early to make general predictions. Majorities were won in the Hungarian, German, and Polish elections by parties that rejected market socialism and sought to introduce a

private market economy. What happens in the elections in the other countries which have turned to parliamentary democracy remains to be seen. My guess is that if any party comes out clearly in favor of market socialism, it will fail in free elections to win the majority required to apply its ideas.

This line of argument, by the way, strongly backs up another cardinal point of departure in this study: the sharp difference between the initial positions in the East and in the West. Those in a developed Western country who favor market socialism are normally racked by ethical and political dilemmas. They would like to retain the efficiency of the market economy, but they also demand a more equitable distribution of income and taxation—greater equity. Rightly or wrongly, they hope that some form of market socialism will produce a better compromise between these conflicting sets of values. The tacit assumption behind this line of thinking among Western economists is an axiomatic acceptance of democracy and respect for human rights, including the right to private property.

The debate in the East was about something else; relatively less attention was given to the dilemma of “efficiency versus equity.” For a long time the opposing sides merely argued about which kind of socialism was more efficient, taking as axiomatic the absence of democracy, the one-party system, and the harder or softer kinds of totalitarianism. Once this axiom was questioned and doubt cast on the legitimacy of the political structure, it marked the beginning of the end for the system.

## 2.6 *The Tutors: Disappointment and Trauma*

From introspection, and also from conversations with friends and colleagues, I can state that those who at some stage in their lives changed their opinion on the subjects discussed in this study were not influenced to do so by books or articles. Thinking is strongly affected by metarational factors: values, sentiments, prejudices, and hopes. These act like gates, or at least like filters, either

receiving certain influences or rejecting them. The soul and intellect of an individual are either open to an idea or closed to it.

I read Mises and Hayek thirty years ago and rejected their objections to market socialism. Later I read them again in a different frame of mind, and suddenly I became receptive to their arguments. The resistance was gone from my old self, the “naive reformer” who took certain axioms of Eastern European socialism as unquestionable and merely sought greater decentralization instead of overcentralization.

What changed many of our minds was a series of political traumas and disillusionments. With professional experts like economists, the decisive blow was not dealt in many cases by negative experiences in their own areas of competence. Revision of their professional opinions might have come later. First, the foundations of their *philosophy of life* collapsed, usually under the influence of some earthshaking event: the sight of Russian tanks in Budapest, Prague, or Afghanistan, or the experiences related by a friend on being released from prison. Once this enlightenment has happened, suddenly or gradually, as a result of a psychologically searing experience, the mind immediately opens to the rational arguments as well. A passion to read and reread is aroused. Works whose ideas had bounced off the walls of prejudice suddenly appear convincing. More superficially or more deeply, people plow up the layers of their own thinking, revising their philosophies and their professional principles. This tilling of the soil is needed before an economist who has had a blind faith can start thinking seriously about professional issues like free entry and market-clearing prices.

This kind of retrospection is a painful process that teaches modesty and intellectual humility. But a little pride can also be taken in remembering that we had the strength at least to struggle with our own prejudices, to open the intellectual gates and to help others to open theirs.

But while admitting the moral virtue in such a gradual awakening, one has to ask whether it was worth painfully seeking the answer to a few very difficult questions if that answer was already known. I am sure it was; there was sense and value in the search.

This ties in with the limits of predictive force in the social sciences, a matter that was touched upon in section 2.3 above and must be returned to here. The social sciences are capable of giving comparatively reliable predictions only for “small,” frequently recurring events. No firm prediction can be given *by scientific means* for “large,” nonrecurring events. The warnings of a Mises or a Hayek about market socialism are brilliant guesses, but they are not scientifically proved *ex ante*. A vision was confronted by a guess, not a scientific proposition by a scientific repudiation of it. An *ex post* position has now been reached; a large enough body of knowledge has accumulated for assertions to be proved. The economists of countries where an experiment was made in applying market socialism are now in a position to make statements based on firsthand experience. Reports from eyewitnesses and victims have special weight in any trial. It is not the same thing to debate about market socialism in London or Chicago in the 1930s as to debate about it in Budapest, Warsaw, or Moscow today. The second debate has the special weight; it is greater, richer, and in many ways more convincing than the debate in the 1930s.

I spoke just now about the limits of rational convictions and the prejudices that obstruct ideas. But that does not mean people should be left to themselves to go through their own process of learning and disillusionment. The problem still remains. It is still on the agenda where the socialist system persists, which is no small part of the world, including, for instance, China and Vietnam, two countries where experimentation with market socialism continues on a nationwide scale.

In addition, a special rearguard action is being fought to defend market socialist ideas in the postsocialist countries where par-

liamentary democracy has been introduced. This curious notion, which might be called “anti-Bolshevik market socialism,” can be summed up like this: “The Communists could not cope with the state-owned firms. Now we, as the successors in power to the Communists, will show we are capable of managing the state sector well, however large it may be.” So state ownership is retained over a far wider sphere than is economically justified, bureaucratic centralization is reintroduced into the management of the state sector, and executive appointments to it are made on political instead of professional grounds. These are phenomena familiar from the period of the socialist system, and their effect will be as damaging now as it was under the leadership of the Communist party.

So the problem continues, which is why it is worth continuing to deal with it. Perhaps there are enough enlightened or potentially enlightened people by now who will listen to what those who have been through the experiments in market socialism have to say. I would like to hope that the experience in Eastern Europe will make it easier for them to avoid the blind alleys and choose the right path.

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## II

### 1. INTRODUCTION<sup>1</sup>

The transition to a market economy is an incredibly difficult task. The job can only be done and the great problems that arise can only be resolved in each country by those living *in* the society concerned. It is inevitable that the situation can be understood only to a limited extent by an *outsider*. That warns me to be modest; no one can be sure whether his advice is applicable or points in the best possible direction. I immediately state this emphatically at the outset, but I shall not add repeated warnings and reservations to my proposals later. To all the recommendations in my lecture the general comment applies that they must be taken critically; Soviet economists must formulate their own views on the basis of their own far greater local knowledge.

I am not a “Sovietologist.” In trying to grasp the Soviet Union’s problems and the choices before it, I draw on two kinds of sources.

<sup>1</sup> This lecture was given shortly before the city’s name was changed to St. Petersburg. Apart from the city reverting to its old name since then, the Soviet Union has ceased to exist and many other great changes have occurred in the political and economic fields.

The text here is the written form of the lecture delivered orally in June 1991, with nothing altered. It is easy to be wise or at least wiser after the event, but I feel I must take responsibility for the lecture given then even in retrospect. A comparison of the proposals made then with the actual course of events may be instructive —it will certainly be worth me or someone else undertaking such a comparison later.

I am grateful to the Tanner Foundation for the honor of being invited to deliver the first Tanner Lecture in the Soviet Union. This provided a forum at which I could express my ideas and proposals before noted Soviet economists and a chance for me to become acquainted with the views and problems of my Soviet colleagues during a whole series of conversations.

I also owe thanks to the rector of Leningrad University, Professor S. L. Merkuriev, and his colleagues for organizing the meetings and for their kind hospitality.

I express my gratitude to Brian McLean and Julianna Parti for their precise and fluent translation.

As a Hungarian I have studied all that has happened in my own country at close quarters. Hungary is small by comparison with the Soviet Union, but it can rightly be considered a laboratory where some very important experiments were conducted. In this respect it has moved far ahead of the Soviet economy in recent decades. The first hesitant, interrupted, and mercilessly suppressed experiments aimed at a radical transformation of society took place in the period 1953–56. Dismantling of the old-style command economy then recommenced in 1968. Finally came the great political turning point in 1989, with the formation of the institutions of political democracy, followed by free elections and an open, declared transition toward the kind of market economy in which private ownership will become the dominant property form. I think a thorough familiarity with Hungary's historical experience is very instructive for all countries seeking to advance in a similar direction.<sup>2</sup>

Another part of my knowledge comes from the fact that I have specialized in comparing economic systems. I deal primarily with the comparison of East and West, capitalism and socialism. This I do not do merely by studying professional literature and statistics. Half my time in the last decade has been spent in the socialist world (more recently the postsocialist world) and the other half in the capitalist world. One of my workplaces is the Hungarian Academy of Sciences and the other Harvard University. This “commuter” life-style has enabled me to gain experience of both systems *from within*, by living under them.

In 1989, before the completion of the political change and the free elections, I wrote a book about Hungary called *A Passionate Pamphlet in the Cause of Economic Transition*. This later appeared in English in a somewhat expanded form as *The Road to a Free*

<sup>2</sup> Works on the history of the Hungarian economic reforms available in English include L. Antal (1979), T. Bauer (1983), I. T. Berend (1990), P. Hare, H. K. Radice, and N. Swain (1981), J. Kornai (1983, 1986, [1989] 1990a), J. M. Kovács (1990), G. Révész (1990), and L. Szamuely (1982, 1984).

*Economy* (1990). I was delighted that the book also became available to readers in Russian.<sup>3</sup> My belief is that much of the book's message also applies to the Soviet Union's case, when adjusted, of course, to the conditions here. This lecture is connected with the book. I sum up its content briefly, adding a few ideas inspired by experience gained since it was written.<sup>4</sup> I would like to emphasize particularly the proposals I consider of prime importance from the point of view of Soviet practice at present.

The lecture consists of two main parts. The first two sections contain warnings: they discuss which are the blind alleys that should be avoided in my opinion. The remaining sections of the lecture present my proposals.

## 2. REFORM SOCIALISM

I draw a distinction between two "prototypes" of the socialist system. To make them more graphic, I attach the names of party leaders to the two types. One is *classical socialism*: the socialism of Stalin and Brezhnev (Soviet Union), Mao Zedong (China), Honecker (East Germany), Husák (Czechoslovakia), and Ceausescu (Romania). The other is *reform socialism*: the socialism of Tito (Yugoslavia), Kádár (Hungary), Deng Xiaoping (China), and Gorbachev (Soviet Union).<sup>5</sup>

<sup>3</sup> The book appeared in Russian on three occasions: first in a limited exclusive edition, then in four installments in the very widespread and popular periodical *EKO*, and finally in a large edition from the publishers Ekonomika (1990b).

<sup>4</sup> A great influence on my ideas was exerted by the experiences of the Polish stabilization, and in connection with these the conversations I had with Professor Jeffrey Sachs, to whom I would like to express my thanks here. I learned much from the first radical programs of the Soviet transition, which are generally associated with the names of A. Shatalin and G. Yavlinsky, with several other Soviet and foreign economists also taking part in the elaboration of them. See the so-called Shatalin Plan under Working Group (1990) and edited by G. Allison and G. Yavlinsky (1991). The proposals put forward in the lecture conform with other stabilization programs to a large extent, but differ from them on a few essential points.

<sup>5</sup> In this section of the Leningrad lecture I dealt with issues dissected in much more detail in my study "Market Socialism Revisited," published in this volume. In this written text I have made some radical cuts in the ideas presented orally at

Within each prototype there are many variants that show different specific characteristics from country to country, and within each country at various times. A “prototype” is a theoretical construct that disregards the detailed differences between these variants and emphasizes their common characteristics.

The reform is an effort to combine socialism and capitalism to some extent. The idea is for the following facets of classical socialism to remain: (1) the ruling role of the Communist party, but somewhat mitigating the repression and allowing a degree of freedom for alternative views; (2) the pervasive role of state control and the subordination of the economy to the bureaucracy; (3) the predominance of state ownership. The following elements of capitalism should concurrently appear: (4) market coordination as the main (or one of the major) integrators of the economy —this embraces far-reaching decentralization, a high degree of autonomy for the firm, and partial liberation of prices; (5) the development of the private sector, although confined within very narrow limits.

Reform socialism's adherents hope that this combination will unite all the real (or perceived) advantages of socialism and capitalism. They intend it not as a temporary state but as a lasting, robust Third System or Third Road that will sooner or later prove its superiority over the First, capitalism, and the Second, classical socialism.

The market-socialist experiments undoubtedly scored some notable achievements, primarily in transforming the thinking of economic leaders. In places where the economy went through the stage of reform, managers have a better understanding of what is meant by profit and loss, a contract between buyer and seller, and adjustment to demand. Trade and financial, scientific, and scholarly relations with the West expanded, which had an effect on production inside the country as well. In this respect countries

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much greater length at the time, in order to avoid duplication. However, a degree of overlap between the two cannot be avoided.

where a period of reform socialism began well before the political turning point have better starting positions in the transition to a market economy than countries jumping straight from the classical system onto the road of capitalist development.

I repeat that the reform had useful consequences, but it failed to attain its fundamental objectives; it was incapable of convincing and permanent good economic results.

There is no real market without the autonomy of the firm, and that can be guaranteed only by private ownership. State ownership is compatible with a market economy, but only where confined within relatively narrow limits and where the various forms of private ownership —for example, individual enterprises and joint-stock companies —account for the overwhelming majority of production.

So long as the predominance of state ownership remains, the head of a firm is basically dependent on the party and the state bureaucracy; appointment, promotion, and dismissal are in their hands, and on them depend his or her power, prestige, and financial privileges. While that is the case, it is far more worthwhile to pay attention to the bureaucracy's wishes than to the buyers'. Nor do the party apparatus, the ministries, and the other authorities respect the autonomy of the firm in any case; they intervene in its life in thousands of ways.

So the *microeconomy* did not gain a truly market-economic character. This connects with several unfavorable *macroeconomic* phenomena. There is a runaway in nominal wages. Although the firm is not really autonomous, its partial independence is enough to produce a reckless rise in wages divorced from productivity growth. The banking system distributes loans irresponsibly and does not insist on them being repaid. In fact credit becomes one of the main instruments for salvaging firms on the brink of financial ruin. Fiscal discipline loosens. On one side there is a growth in subsidies to loss-making production and exports and in price

subsidies for various consumer goods and services. Meanwhile there is unjustifiably generous financing of state investments that yield a poor return or an actual loss. Huge sums are consumed in maintaining the armed forces and further rearmament. On the other side there is laxity in collecting state revenues. The ever greater discrepancy between expenditure and revenue raises the budget deficit, which is covered by taking up foreign loans or printing money, that is, by inflationary means.

Three dangerous macrodisequilibria appear: a chronic, worsening shortage, accelerating inflation, and growing indebtedness. These three problems appear in differing proportions in each country and period. The threefold problem used to be called the "Polish syndrome," because that is where it arose in its most extreme form. But Poland has embarked on radical changes since then. These days it is more apposite to call it the "Soviet syndrome," for it is here in this country that the three negative phenomena are developing in parallel and in combination to the most oppressive degree.

*Perestroika* brought an end to the brutal oppression of classical socialism, but it also loosened its tight discipline and coherence. Meanwhile it proved unable to create a true market discipline in its place, for which laws passed by a legitimate parliament and market competition would have been required. What is needed are real private owners who take costs and profit seriously because they affect their own pockets and who cannot rely on the state invariably bailing them out of any financial trouble.

The market-socialist experiment that has taken place in the Soviet Union so far has been incomplete and inconsistent, since it was unbacked by radical change, either on the political scene or in property relations. It is a system that falls between two stools: it is not viable socialism (because it cannot operate permanently without firm repression and limitation of civil liberties) and it is not a modern capitalist market economy either. Failure is inevitable.

### 3. THE ROMANTIC THIRD ROAD

Market socialism, as mentioned before, is itself an attempt of a Third Road kind; it has been tried out in several countries, including the Soviet Union, and it did not work. However, there is another intellectual trend one might call the Romantic Third Road which has never been tried out anywhere. It appears only in writing, or more frequently in conversation, mainly among writers, politicians, and social scientists. There are also some economists whose ideas can be placed here.

Although the trend is not uniform, I shall try to pick out a few common traits in their ideas.

All kinds of socialist systems ruled by the Communist party must be rejected —not just classical socialism, but socialism that experiments with market reforms as well. Capitalism must be dismissed as well, including its modern Western forms, because the profiteering, commercialism, and degenerate morality that flourish under it are repulsive.

So what kind of society must be aimed at? The answers vary according to the roots and outlook of the respondent:

- There must be a return to the pure and natural life of the village.

- A truly communal life must be created. This entails communal ownership. A great many versions of this are put forward in the discussions: the village community, the peasant community, genuinely, voluntary cooperative ownership, and so on.

- Although it can be considered a version of the previous item, special mention must be made of the idea that worker communities must be established and ownership of the factories given to them. To this is connected the demand for workers' self-management.

There should be direct relations between producers and consumers; the profiteers and speculators of commerce must be eliminated.

- There should be discipline, but it should rest on tradition, on the commandments of religion. Some people want an autocratic ruler — a king or a tsar — to impose order in accordance with age-old tradition. Others oppose autocratic rule, rejecting the idea of discipline based on respect and coercion. Their ideas come close to the old and more up-to-date forms of anarchism and anti-étatisme, advocating a voluntary discipline complemented by a kind of “direct democracy” that avoids the forms of modern Western parliamentarianism and the multiparty system.

I am afraid that the list just given is too orderly. In reality there is a tangle of ideas that are unclarified and emotionally inspired rather than rationally ordered.

Let me try without prejudice to assess these views. In fact the only view that I reject on *ethical* grounds is autocratic rule: discipline is not worth it *at that price*. Liberty and human rights are things of such value that they cannot be subordinated to other desires — for instance, the demand for order and discipline.

All the other aspirations are not repugnant in themselves to my mind; I respect people's desire for honesty, community life, and liberation from bureaucracy and profiteering. My prime objection is a pragmatic one: we seem to be presented only with a collection of desires, not with a realistic constructive program. The First System was not imposed on people by the force of the state. There was no politburo or government to declare in earlier centuries: “Let there be capitalism.” The capitalist market economy developed by evolution as the combined outcome of millions of voluntary individual decisions. Although the state promotes this evolution with its laws and apparatus, the capitalist economy is basically built up “from below”; the entrepreneurs decide about accumulation and the expansion of production.

The position was different with the Second System, which was established by the force of the state. Each of its institutions was brought into being “from above.”

Adherents of the Third System need to consider: Why do the forms and patterns of behavior they favor not appear on a mass scale and come to predominate? And if people do not choose this Third Road even in places where there has been freedom of choice so far, why do they expect people to choose precisely this in our region? Or if people do not choose it of their own accord, should it be the system imposed upon them at this time?

Churchill said that democracy was a bad system, but no one had yet found a better one. The same can be said of the capitalist market economy: it is a bad system, but no one has yet discovered anything better. There are many versions of it: the individualistic North American and the more egalitarian Scandinavian models differ from each other, but both form a capitalist market economy. This system too could do with fundamental repairs through reforms, but however much it is repaired, it will be far from perfect. The *real choice* is between the socialist system that has existed hitherto and the Western type of market economy. The choice must be made without illusions: the socialist system cannot really be repaired, and the capitalist system will have many repulsive attributes even in its repaired form. Yet basically we must choose these days the relatively better of the two. Third Road views are an effort to sidestep that choice, but I do not believe they offer a road that can be followed or an alternative that can be realized.

#### 4. REFORM AND REVOLUTION

Having explored the two blind alleys, let us turn to the road that leads to a free economy. A short clarification of terms is required first of all, concerning the distinction between reform and revolution. There are many different current definitions, but for my part I use the following in this lecture and my other works: While reform yields important changes, it retains the fundamentals of the system concerned. Revolution, on the other hand, changes the fundamentals radically, so bringing about a *change of system*.

So the distinction between reform and revolution in this vocabulary is *not* whether it takes place slowly and steadily or explosively and rapidly. A reform may be swift and a revolution may be gradual. Moreover, the distinction is *not* that a reform is peaceful and a revolution violent and bloody. The process of reform may also be induced by bloody uprisings, and those impeding it may use violence against the reformers; a revolution, on the other hand, may take place without bloodshed. The difference lies in how superficial or deep the change is. To use a Hegelian expression here, revolution brings a qualitative change.

Applying these definitions, it can be stated that *perestroika* was not a revolution but a reform, despite the many assertions to the contrary in the Soviet debates on the matter. What is now required in this country is a real revolution, a change in the fundamental characteristics of the system. If that does not occur, the problems will worsen and the crisis will continue and in fact deepen.

It is clear from these definitions that what I advocate is the need for a revolution, not an explosive rapidity of change. I am not recommending an uprising or any other violent action. The more smoothly and peaceably it takes place, the better. In terms of my value judgments, the most attractive solution is the kind of "velvet revolution" that took place in Prague. Revolution in my vocabulary means this and only this: radical events that make no concessions and consistently alter the bases of the system are required. It means "only" this, but it is no small thing, of course. The country's citizens need a new system if they want to prosper.

The title of my 1990 book contains the expression "free economy," not simply market economy, because the former is more comprehensive and contains more elements. Let me briefly sum up the main criteria for a free economy.

- A political system with free competition of ideas, freedom of speech, freedom of the press, freedom of assembly, and freedom of association. These freedoms contain in themselves the

abolition of the one-party system, freedom for alternative parties to organize, and free parliamentary elections.

- An economic system that guarantees the right of free enterprise and freedom of entry into economic life.
- Freedom of property belongs among the liberties that need to be respected. Private property must be protected; legal guarantees must be given that it will not be confiscated. The economy must be led toward property relations in which private ownership is the predominant property form.
- The role of the state must be reduced, with the authorities subject to control by the law, parliament, and publicity.
- The market must be the main (although not the exclusive) coordinator of the economic processes.

##### 5. THE NEW POLITICAL ERA: DEMOCRATIC CONSENSUS

An essential condition for solving the economic problems is a fundamental change of the *political* system. I am an economist, but I have to underline that the primary problem is political and not economic.

I make no comment on the present situation or on what will happen in the coming days. I do not feel competent to do so. I shall describe instead a hypothetical political situation, the beginning of a *new political era*. The main factors would be the following.

1. Several parties form and compete with each other. A fair election campaign takes place, followed by a fair multiparty election. A new legitimate parliament gets down to work. A new government is formed and can count on strong parliamentary support.

2. A satisfactory solution is found between the federative organizations and the republics, which the latter accept. Viable cooperation develops among the republics. The division of spheres of authority, rights, and obligations is clearly defined. It may be that several republics secede. It can be assumed that most of the present territory of the Soviet Union will continue to form a common economic area in the future.

3. An agreement is reached on the role of the army, which comes under civilian supervision.

4. Reconstruction and the program of transition toward a free economy receive widespread support. A consensus develops, in two senses. On the one hand there is overwhelming majority support in parliament for the economic program, and on the other it receives support from both the employees and the employers, the latter including the entrepreneurs of the private sector as well.

From now on I shall call the political position summed up in those four points the *democratic consensus*.

The government of the democratic consensus would have political, legal, and moral grounds for addressing the people like this: We want to open a new chapter in the country's history. We cannot promise that life for everyone will improve swiftly or markedly. Great difficulties can be expected, with much suffering for many people. But we are capable of leading the country toward a better system under which growth along a better path will begin in a few years, bringing an improvement in the economic situation.

I regard what I have just outlined as a historic, nonrecurrent opportunity, but not as a *prognosis*, for it is by no means certain that the situation will really develop in this way. What I have put forward is a *desire*: this is how I would like to see the political situation for this long-suffering people develop. Although a great deal of trouble and deprivation would still accompany this desired situation, it would entail relatively less suffering than any other and bring a resolution of the economic crisis relatively sooner.

There is a historic, nonrecurrent opportunity, but this opportunity can be missed. The situation may become far worse: bloody conflicts may break out, the changes may be held up, and the troubles may be aggravated by domestic political strife and the lack of agreement between the interested parties. The painful but vital measures may be deferred by a leadership that shrinks from the sacrifices and tries to prevaricate instead. Measured in historical terms, this will only delay the radical turn, not take the edge

off it, but procrastination that continues for several years is undesirable because it will demand sacrifices that might have been avoided.

The rest of the lecture sums up the economic tasks ahead, to each of which a label is attached.

Some of the proposals are *conditional*. This means that their feasibility is strongly dependent on the political situation; for them to succeed completely, a democratic consensus must develop.

The other proposals are *unconditional*. Even if a democratic consensus fails to develop, there is still a good chance of implementing them and they will still contribute to improving the economic situation.

This categorization also shows that I am not arguing for an “all-or-nothing” strategy. I am not claiming that *either* the optimal political conditions are achieved, in which case everything can be accomplished, *or* the position on the political front is worse than desired, in which case everything is hopeless. A great many useful changes can be made in either case, but a new political era will be required for a real breakthrough.

My proposals are grouped under three themes: (1) macro-stabilization and liberalization, (2) the transformation of property relations, and (3) social welfare policy.

I have not tried to make my proposals “original” in an academic sense: I do not come up with some hitherto secret magic cure for all the ills. Economists have been debating these matters in other parts of the world for a long time. On most of them there is no general agreement, but I would like at least to convey to my Soviet colleagues which of the alternative views I subscribe to myself.

## 6. MACROSTABILIZATION AND LIBERALIZATION

I am convinced of the need for a large-scale package of measures for stabilizing and liberalizing the Soviet economy.<sup>6</sup> This is

<sup>6</sup> This idea was proposed for the Hungarian economy in my book ([1989] 1990a). Practical implementation of the stabilization package for the Polish economy

absolutely necessary: in my view it is impossible to set the Soviet economy to rights without one.

The expression “shock-therapy” is widespread in this context. It is a very unfortunate expression, and to the extent that a name can do damage this one has certainly done so by scaring many people away. The expression was taken from psychiatry, where the shock itself is thought to have a healing effect. In economic stabilization, however, it has nothing of the kind. To stick to the medical analogy, the shock is not the actual therapy, because it is an undesirable but in some cases inescapable side-effect. If the job can be done without administering a “shock” to people, that is all to the good. It is worth aiming to minimize the upheaval and pain.

In fact I employ a medical metaphor in my own writings, advocating surgery for stabilization. This, in my view, is a better way of conveying that this is a quick, radical intervention, to be preceded by presurgical treatment and followed by after-care.

The expression “package” conveys that it consists of a set of measures closely dependent on each other. If single measures were divorced from the package and introduced by themselves, the effect would be doubtful or perhaps even positively detrimental. It is a condition for success that the measures be introduced at about the same time, or condensed into a short period, and harmonized with each other in detail.

The main components of the package, in my view, should be the following:

1. Elimination of the state budget deficit. This in itself is a complex task, of which only a few elements will be noted here.

Numerous steps must be taken toward eliminating subsidies (both price subsidies and subsidies to loss-making firms). Even if

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is associated primarily with L. Balcerowicz. A great influence on the Polish stabilization package was exerted by the work of J. Sachs; the ideas and early experiences on this are summarized in his articles written jointly with D. Lipton (1990a, 1990b). Many other economists support this strategy. See, for example, O. Blanchard et al. (1991) and S. Fischer and A. Gelb (1990).

all subsidies cannot be eliminated in a single stage, a large-scale partial dismantling of subsidies must be accomplished straight away in the first stage and a clear timetable worked out for complete elimination of them.

Another vital measure is a drastic cut in military spending.

At the same time, tax revenues must be raised. Sooner or later it will be necessary to devise an up-to-date tax system that includes value-added tax and personal income tax. However, I feel the first step should be to standardize turnover taxes and raise their average rate.

Under no circumstances can the budget deficit be covered anymore by credits from the central bank, since that fuels inflation. If the measures listed prove insufficient, foreign or domestic loans will be necessary.

2. A tight, restrictive monetary policy is required, with tight control on credit. If the banking system continues to distribute credits indiscriminately, the stabilization will be gravely endangered.

3. Care must be taken to ensure wage discipline. It is extremely important for the employees and the unions representing them to behave in a self-restrained and responsible way. This was one of the things I was thinking of when I talked about the need for the democratic consensus. But it must be added that the fate of the stabilization cannot be entrusted exclusively to voluntary self-restraint. Punitive taxes, using an appropriate fiscal formula, must be levied on firms that fail to impose wage discipline, causing nominal wages to run away by comparison with the trend in productivity.

4. All prices must be freed. The chance of certain firms abusing their monopoly position must be prevented by antimonopoly legislation and adequate state supervision.

5. The ruble must be drastically devalued. An exchange rate must be set that corresponds realistically with the market conversion rate between hard currencies and the ruble and can then be sustained over a longer period.

Stabilization of shaken currency invariably entails changing every price, every exchange rate and interest rate, every wage, and the nominal value of every quantitative index at once. There must be some “fixed point” to hang onto. For this the literature on stabilization uses the expression “nominal anchor”; it is something to which the tossing ship of the economy can be chained. A wide variety of economic quantities may appear as applicants in various kinds of stabilization —for instance the money supply, the average wage level, or a fixed foreign exchange rate. I share the view of other economists that the best candidate for nominal anchor during the process of stabilization in Eastern Europe and the Soviet Union today is a predetermined foreign exchange rate. This will concurrently lighten task no. 4, the liberalization of prices. At least for products and services that are items of foreign trade on the world market, the starting point for the calculation must be the world-market price multiplied by the stable foreign exchange rate. The domestic price may differ from this due to the relations between supply and demand, but it is a calculation from which a start can be made, so that the new price system need not be conjured out of thin air.

6. When and how the domestic currency should be made convertible is a matter of debate. My proposal, in agreement with many other economists, is that the first stabilization package should already contain substantial steps toward convertibility, even if all the complex criteria for it cannot be satisfied immediately in every respect. I would draw special attention to two interrelated measures. One is to legalize private foreign exchange dealings. It is needless and dangerous to force them underground. The public should be able to place foreign exchange in their possession as deposits in foreign exchange accounts without restriction or enquiries into the source of the money. The other measure required is an undertaking from the state banking system to convert foreign exchange without limitation at the stable foreign exchange rate.

This is just what turns this rate into an “anchor.” Everyone understands —state-owned firms, the private sector, individuals, and foreign business people —that the money has a stable value, because they can always obtain hard currency for domestic money at the fixed exchange rate.

There are numerous conditions to satisfy, of course, before convertibility can be applied in reality, not just declared. Some of them will be mentioned later, but there is another condition that ties in with task no. 5 above —the correct foreign exchange rate. It is hard to gauge the figure. If a “miss” cannot be helped, it is better to undervalue the domestic currency than overvalue it. Let imports be a trifle too costly and exports unrealistically profitable; though this places a greater burden on the public, it enhances the stabilizing effect.

7. A final very important task is to liberalize foreign trade, including imports. Foreign goods flowing into the country improve the supply, while the competition encourages domestic producers to perform better. What is more, foreign prices are imported along with the foreign goods; as mentioned earlier, this is highly important in a situation where a previously absurd and irrational system of prices has to be replaced swiftly with a realistic system of market prices.

There is a whole range of requirements for the success of the stabilization surgery.

Above all there must be painstaking preparation. The partial measures must accord with each other; careful calculations must be used to work out the harmony between a few of the most important macroindices.

Prime importance attaches to creating the requisite political conditions, the state referred to earlier in this lecture as democratic consensus. Among the factors behind inflation are inflationary expectations; in other words, the participants in the economy expect the inflation to continue. This expectation is a self-fulfilling prophecy. It must be dispelled and replaced with a new expecta-

tion, so that the public, the firms, and the economic leaders believe the situation will change and inflation will be curbed. For such a belief to take hold, the words of politicians and the promises of the government must gain credibility, which is not something created by command; it must be based on political legitimacy and trust. Without such trust, credibility, and consensus, the stabilization program will crumble away under the effect of obstruction and a crisis of confidence.

Also required from the outset is at least a minimal private sector. There must be in operation a formal and informal private sector able, in the weeks of the changeover, to plug the gaps left by the state sector in the supply to the general public and deliver the main staple articles from the producer to the consumer. This will be returned to later.

Reserves are required. On the one hand there must be reserves of goods, above all stocks of foodstuffs that appear in the stores in the first hours of the stabilization operation and engender confidence in a better future. On the other hand there must be foreign exchange reserves to ensure that convertibility can be maintained. These also allow quick auxiliary imports to be made if there are problems with supply.

The stabilization operation must rest fundamentally on the country's own resources, but it is desirable to have substantial Western aid to lighten the burden. The most favorable forms for this assistance are contributions to a stabilizing foreign exchange reserve and to goods stocks in the form of import credits.

Even if all these conditions are satisfied and the government decides to perform the stabilization surgery, there will still be an enormous upheaval. It can then be expected (after an initial surge of price rises) that the currently rising rate of inflation will be curbed, and also that one of the gravest chronic ailments of the socialist system —shortage— will be overcome in wide areas of the economy. But great difficulties must be awaited nonetheless: a fall in production in numerous sectors and the appearance of unem-

ployment that continues to grow for some time. Even when accomplished, the stabilization achievements will be very hard to defend.

Unfortunately there are other possible scenarios that cannot be ignored: many of the conditions listed may be lacking. I fear it is impossible here to give any simple prescription. If certain elements in the package summed up under the seven heads above are introduced individually (or slowly), they may well do more harm than good. Economic politicians cannot be given a blank check inviting them to set about any of the seven tasks they fancy, at any pace or in any order, just so as to get things under way. That would be a dangerous game that could discredit the stabilization plans altogether.

But I do not say either that it is a case of “all or nothing.” To take just two examples, any progress in reducing the budget deficit or curbing the supply of credit can be beneficial. All an adviser can do is to weigh the advantages and drawbacks of single partial measures on a case-by-case basis. The Soviet Union today is at any rate in a situation where no partial measure can substitute for a large and drastic package of measures.

#### 7. TRANSFORMATION OF PROPERTY RELATIONS

The main direction of the changes is clear: it is toward building an economy in which the majority of social production derives from enterprises in private ownership. Let me say a few words first of all about the ultimate position.

It can be expected that the private sector will not be an absolute ruler, any more than it is in developed Western countries. A smaller share of the firms will remain in public (state or municipal) ownership. It is still too early to decide exactly where the line will be drawn. That will emerge from the competition between the various property forms, with attention being paid to international experience. Here again, the will of the public must be exerted through parliament; what is to remain in state ownership and what is to be privatized must be decided by legislation.

As in advanced capitalist countries, the private sector will not present a uniform picture. Small, medium-sized, large, and even gigantic firms will operate side by side. There will certainly be an increase in the relative weight of small and medium-sized firms, because production in the Soviet economy, as in the other socialist countries, has been excessively concentrated.

Private firms of various types in terms of their legal form will exist side by side: joint-stock companies in which all or most of the shares are in private hands and listed on the stock exchange, limited-liability companies (companies not listed on the stock exchange), personal enterprises, and so on. It is worth remembering that —with the United States and Britain as exceptions — the joint-stock companies listed on the stock exchange in most developed countries account for only the smaller proportion of aggregate production, in spite of their large role.

The transition cannot achieve this terminal situation in a short period. On this matter I take issue with many of my Western and Eastern European colleagues, who urge “rapid privatization.” Let there be no misunderstanding — I too want the process to take place, as soon as possible. But a desire is one thing and a realistic chance of attaining it another. The government may decide about convertibility or the foreign exchange rate and having made up its mind accomplish it in a short space of time. But the government cannot decide to “introduce capitalism”; it cannot appoint entrepreneurs by decree. The word itself sheds light on the matter: private enterprise assumes that people undertake risky investment voluntarily in the hope of making a profit. Once they have done so, some of them will go bankrupt, while others accumulate wealth and expand their undertakings. In other words this is an *evolutionary* process that wise government measures can speed up and stupid measures or indifference can slow down. Whatever the case, it will take several years to run its course.

To use the qualification mentioned earlier, development of the private sector is an unconditional task, unlike macrostabilization,

which is a conditional task (at least in its most advantageous, “packaged” form). Turning immediately to the partial tasks, most of them can be embarked on at any time, even if some of the conditions for a democratic consensus are lacking. And it would be a good idea if some of the energies currently expended on political battles were transferred to these tasks instead. That is not to deny, of course, that radical political change and the creation of a democratic consensus would greatly boost the development of the private sector as well.

Let us list the component tasks:

1. The “legal infrastructure” for the operation of the private economy must be created. Here are a few examples of the legislation indispensably required: a law on contract, a company law, a law on foreign investment, a bankruptcy law, a banking law, and a labor law. Even if these subjects have been covered by earlier laws and decrees, the legislation must be redrafted in line with the requirements of a modern market economy.

2. It is desirable for the changes in the law to be accompanied by a reeducation of public opinion. Appreciation and respect for private property and business undertakings must be developed and prejudices overcome. Here a great deal depends on the politicians and on the press and television.

3. Private business activity was largely banned earlier, and even since the beginning of the reforms private enterprise has only been permitted under exceptional circumstances within narrow limits. A significant part of the private sector has been forced underground and been operating as a “second economy.” It is time to change the proportions of what is permitted, what is restricted, and what is banned. The point of departure should be freedom to pursue all private activity; “free enterprise” should become a fundamental right. This right can then be restricted, but only where important public interests dictate. The restrictions should be laid down in carefully drafted legislation, not subject to the whims and ill-will of bureaucrats.

4. It follows from the previous points that harassment of private entrepreneurs by the police, the authorities, and the political organizations must cease. The private sector cannot be expected to accumulate unless it feels that its property is totally secure.

5. The foundation of private enterprises must be encouraged. Apart from moral and political inducements, they need credit on favorable terms; the state should lighten the credit system's task by offering guarantees for these "start-up" loans; it should also give tax concessions for private investments.

6. Great importance attaches to what is known in several Eastern European countries as "small-scale privatization." This covers the sale of stores, restaurants, small hotels, small factories, vehicles, housing, and agricultural smallholdings to private owners, either individuals or partnerships. I have only mentioned transactions that could be entered into by a buyer with a relatively small stock of capital. Special long-term credit and repayment schemes must be devised and generous finance must be made available for small-scale privatization.

In many cases it is justified to break up a large state-owned firm into smaller parts, thus making it amenable to small-scale privatization. It is not right to do this, of course, where advantages of mass production, the economies of scale provided by a large factory, would be lost. But as mentioned before, the socialist economy is excessively concentrated; the size of many gigantic firms is economically unjustified. Breaking them up into smaller units will have a beneficial effect.

Tasks 5 and 6 are closely connected. A new private firm may in fact start life by buying an asset owned by the state, or a private firm that has come into being by some other means may purchase state property at a later stage in its development as a way of expanding its factory.

7. The property rights in large state-owned firms that (a) it is not advisable to retain in state ownership, (b) it is not desirable to break up into smaller units, and (c) are economically viable

must be transferred into private hands. There is a lot of debate about the most effective way of doing so.

The main instrument in my view should be to transform these firms into joint-stock companies and *sell* their shares. The buyer may be either domestic or foreign. It can prove useful for managers and employees to take part in the privatization program; it is worth encouraging them to take up a percentage of the shares by offering suitable credit schemes, for instance. Once the market economy has normalized, a significant proportion of the general public will be willing to hold some of the savings in the form of shares. Equity will also be purchased by various large institutions (e.g., insurance companies and private foundations).

Many people support the idea of a *free* distribution of shares, either to the employees of the firms concerned or to the whole population through a system of coupons or vouchers. For my part I do not feel this is an expedient solution to the problem. At most I would give property free of charge to certain institutions (for instance, decentralized pension funds) as a way of supplying them with initial operating capital. A detailed account of the arguments for and against would exceed the bounds of this study, and so I shall merely draw my Soviet colleagues' attention to the literature on the subject.<sup>7</sup> In any case correct planning of Soviet privatization will be made easier by having the early experiences in Eastern Europe available by the time it comes onto the agenda. The strategies chosen differ from country to country: Germany and Hungary have basically opted for sales, while free distribution on a mass scale is being prepared in Czechoslovakia and Poland. It will be instructive to compare the results.

8. All the tasks mentioned so far tie in with a forceful development of the financial sector. There is a need for decentraliza-

<sup>7</sup> I put my own position in my 1992 article. To my knowledge, the idea of a free transfer of property rights was first advanced in an article by J. Lewandowski and J. Szomburg (1989); see also R. Frydman and R. Rapaczynski (1990) and D. Lipton and J. Sachs (1990b).

tion of the banking system and for the development of private pension funds and insurance companies (alongside the social security system). A modern market economy includes a great many other kinds of financial institutions such as investment and mutual funds, venture capital funds that can finance high-risk new undertakings, financial institutions specializing in housing investments, and so on.

While emphasizing the multiplicity of the paths and instruments, I would like to pick out from the many partial tasks one that I consider to be the most important of all: *the evolution of a new middle class*, the emergence of a million entrepreneurs on a small and medium scale. By entering the private sector, this new stratum, along with its employees, whose earnings will normally become appreciably higher as well, can become a bulwark for the new system in the cities and the countryside alike. I would measure the speed of the transition primarily by the rate at which this stratum grows. The degree to which the growth of this entrepreneur stratum is promoted also constitutes one of the major measures of economic success for the new democratic governments.

#### 8. SOCIAL WELFARE POLICY

All active participants in the new democratic political era must strive from the first day to accomplish the tasks of the transition in a humane way. This too is among the "unconditional tasks"; whether the conditions favoring the changes emerge or not, all believers in the new democratic political order and an efficient market economy must do everything they can in their own field to alleviate the grave problems and suffering that accompany the transformation of society.

Politicians can win popularity with populist rhetoric at most for a time, until it emerges that they are doing nothing to help with the problems. I do not want to disguise the fact that implementation of the program outlined in the earlier parts of this lecture is accompanied by sacrifices of many kinds. Production in

many sectors falls, producing unemployment. Relative prices and wages are readjusted, reducing the real income of many people. Masses of people will be afflicted by the freed prices and raised taxes and compensated for them only in part. As the real market becomes dominant in the economy, insecurity increases as well in many respects: businesses fail and jobs are no longer secure. All this happens at a time when the country is down at heel, its reserves exhausted.

So what is the minimum that can and must be ensured even under these circumstances?

First of all, unemployment must be openly recognized as a permanent concomitant of life. That means setting up a system of unemployment benefits, after responsible consideration of the country's financial potentials, augmented by better organization of labor exchanges and retraining schemes.

Apart from that, a welfare system must be developed to give at least temporary help to those of the needy whose reintegration takes time and permanent support to those incapable of helping themselves.

Under socialism there were large, cumbersome, overcentralized systems of redistribution in operation; these allocated housing and dispensed health care and pensions. There is a great need for decentralization in this area, and also for private institutions to take part in the provision alongside the institutions of the state. But the transformation must be accomplished in a way that does not cause a further trauma to people already shaken during the stabilization process. A gradual, very tactful approach is needed here.

I notice social welfare policy being relegated into the background in many Eastern European countries, which impedes the development of the democratic consensus. I sincerely hope that my Soviet friends will learn from this experience and try to avoid committing the same error.

The need is not just for new state regulations and new institutions, but for a new public morality. Too great a role was played

in our earlier lives by a state that was both repressive and paternalistic; people expected it to take care of them. With the advent of the market economy, the idea of individual liberty and autonomy becomes the center of the system of values. The chief commandment for all active people is to help themselves, not wait idly for the state to decide instead of them and do something on their behalf. But this prime imperative should be complemented by another: that society must assist those in need of help, both by voluntarily and spontaneously organized solidarity and by state means.

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