

# From Socialism to Capitalism and Democracy

János Kornai on the trials of socialism  
and transition

*An interview with introduction by Brian Snowdon*

“Capitalism is a necessary condition of democracy...There has been no country with a democratic political sphere, past or present, whose economy has not been dominated by private ownership and market co-ordination.” (Kornai, 2000a)

“The transition from socialism to capitalism has to be an organic development. It cannot be done otherwise. It is a curious amalgam of revolution and evolution.” (Kornai, 2000b)

János Kornai is generally regarded as the world's leading scholar on socialist economic systems. To date Professor Kornai is the author/co-author/editor of 18 books and over 100 academic papers, most of which have been concerned with providing a comprehensive analysis of various aspects of the operation and reform of socialist economies. Reflecting the worldwide interest in his work, many of his papers and books have been translated into other languages; for example, his book, *The Road to a Free Economy*, 1990, has been translated into 16 languages.

In almost 50 years as a professional economist, Professor Kornai's principal interests and contributions have been directed towards questions relating to the analysis of comparative economic systems, quantitative aspects of the planning process in socialist economies, the political economy of reform under socialism, the economics of shortage and the 'soft budget constraint', the economics of post-socialist transition to capitalism,

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various issues relating to reform of the welfare state, and most recently, research into 'Honesty and Trust' in transition economies.

In addition to pioneering the use of mathematical programming and two-tier planning in the Hungarian planning process, in his book, *Anti-Equilibrium* (1971), he also provided a penetrating critique of neoclassical Paretian general equilibrium theory that typically dominates mainstream 'Western' economic analysis. In the latter case, Kornai's insightful critique contributed to providing a framework for the development of a non-Walrasian style of analysis, thereby stimulating new approaches to the interpretation of practical real world problems.

In addition to the numerous prizes and honours he has received, the main highlights of Professor Kornai's distinguished academic career include:

- 1955–8, Research Fellow, Institute of Economics, Hungarian Academy of Sciences;
- 1958–63, Head of Economics Research Department, Institute of Textile Industry;
- 1963–7, Head of Research Department, Computing Centre, Hungarian Academy of Sciences;
- 1967–91, Research Professor, Institute of Economics, Hungarian Academy of Sciences;
- Visiting Professor of Economics at the London School of Economics, 1964; Sussex University, 1966; Stanford University, 1968, 1972–3; the Cowles Foundation, Yale University, 1970; Princeton University, 1972; Stockholm University, 1976–7; Institute of Advanced Study, Princeton, 1983–4; Harvard University, 1984–5;
- 1972–7, Vice Chairman, Committee for Development Planning, United Nations;
- 1978, President of the Econometric Society;
- 1987, President of the European Economic Association;
- 1986–2002, Professor of Economics, 2002 to date, Professor Emeritus, Harvard University;
- 1989–94, Member of Scientific Advisory Council, European Bank for Reconstruction and Development;
- 1995–2001, Member of Board, Hungarian Central Bank;
- 1992 to date, Permanent Fellow, Collegium Budapest, Institute for Advanced Study, Budapest.

Born in Budapest, Hungary, in 1928, János Kornai survived the traumatic events of the Second World War and subsequently experienced, first hand, life under socialism from 1945 until its collapse in 1990. In the period leading up to and following the failure of the Hungarian uprising of October 23–November 4, 1956, Kornai also became one of the most perceptive and informed critics of socialism, one of the few economists from inside the ‘Eastern bloc’ to have provided a series of insightful and detailed critiques of the ‘socialist system’. According to Kornai (1992a), the socialist system reached its zenith in the period 1980–87. By 1987, there were 26 socialist countries in the world containing some 34 per cent of the world’s population. Thereafter, following the fall of the ‘Berlin Wall’ in 1989, the socialist system around the world has largely collapsed. Even in China, where the Communist Party retains political control, it is also clear that since 1979 the leadership have been moving the economy towards a system where capitalism and markets are playing an ever increasing role. However, from the outset we need to be clear what Kornai means by ‘socialist system’. Kornai’s (2000a) ‘parsimonious minimalist’ system specific characterisation of ‘the socialist system’ is one where the following main attributes have been historically observed:

- the Communist Party (Marxist-Leninist) has undivided political power;
- a dominant position for state and quasi state ownership;
- a preponderance of bureaucratic co-ordination of economic activity;
- the ‘soft budget constraint syndrome’, weak responsiveness to prices and a ‘sellers market’;
- ‘chronic’ shortages (hidden unemployment and suppressed inflation).

It is to economies exhibiting the above characteristics that Professor Kornai’s research over 50 years had mainly been directed.

I would argue that there were five main economic events that dominated the twentieth century, namely, the spread of the industrial revolution and economic growth across the world, the ‘Great Depression’ of the 1930s, the ‘Great Inflation’ of the 1970s, the fall and rise of international economic integration (globalisation), and the rise and fall of the socialist system (see Snowdon, 2002). Many commentators would argue that the latter was *the* defining feature of the world economy in the twentieth century. In the interview that follows, I discuss with Professor Kornai the

evolution of his thinking on the political economy of the socialist system, its characteristics, reform, transition and future.

## INTERVIEW<sup>1</sup>

### Early life

*You were born in 1928 and so you were a teenager during the Second World War. What were your early life experiences during this traumatic period of history?*

My father was a lawyer and I had two brothers and a sister. I went to primary school and high school at an excellent German-speaking school and so grew up bilingual, speaking Hungarian and German. My first real interests as a young teenager were in literature, philosophy and history. My interest in economics came much later. My family was Jewish and we were very assimilated. But the fact that I am Jewish had a strong impact on my life because Jews were persecuted; there were anti-Jewish discriminatory laws in Hungary at that time. Then of course came the German military occupation of Hungary in 1944, which amplified that persecution to the extreme.

*So when the Soviet army finally drove the Nazis out of Budapest in February 1945, after a long siege, this must have come as a great relief to you. The Soviet army were your liberators.*

Those were terrible times with horrible brutal events taking place. Our lives were in permanent danger and many people around me were killed or died, not only Jews, but many others who hated and opposed the Nazi regime. So yes, for us, the Russians were looked upon as liberators in 1944–1945.

*When did you first get the opportunity to continue your education at University?*

I finished high school in 1945 after the change of political regime and it was then that I became a student at the Pázmány Péter University of Budapest. I registered for an undergraduate programme in History and

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<sup>1</sup> I interviewed Professor Kornai in his office at the Collegium Budapest, Institute for Advanced Study, on 25th October, 2002. References throughout this article were added by the author after the interview was completed.

Philosophy but I was not a very diligent student [*laughter*]. At that time I became rather active in the Youth Movement of the Left and was only nominally a student although I did pass my exams. Then, in 1947, I became a journalist at the main communist newspaper, *Szabad Nép*. Although I was very young I was appointed to ever higher positions at the newspaper, so there came a point when I gave up my university studies.

I started my graduate studies much later and was admitted without having first completed an undergraduate course. It was at the newspaper that I became very much interested in economic affairs. At that time I was really enthusiastic about socialism. Initially I was very much in favour of the new system of socialist economic planning. I became the economic editor of the newspaper and was becoming more and more involved and fascinated in trying to understand what was going on in the Hungarian economy. I had access to important statistical data, which others didn't have, so I was getting an insider's view of how the system operated.

So this was the real beginning of my studying and understanding the economics of socialism. In a sense I was getting much more insight into how the system actually worked than a university student might acquire from just reading books.

*What brought your career in journalism to an end?*

It ended because of a series of political events. The sequence began in 1953, the year when Stalin died. There began a relaxation of the rigid Stalinist regime. In Hungary we had a new Prime Minister, Imre Nagy.<sup>2</sup> Back in 1953 he was a very different Prime Minister from his predecessor, Mátyás Rákosi, who was the Stalinist dictator of Hungary. Nagy began to liberalise the regime, encouraging greater production of consumer goods and relaxation of the collectivisation of agriculture. As a result of these changes there developed tremendous in-fighting within the party between those supporting Nagy and Rákosi, respectively.

Very early on I supported Imre Nagy and published a long review in the newspaper praising his book, a volume of his collected essays. In the editorial office of the newspaper there was strong protest against Stalinism. What made the situation particularly interesting was that the protest came

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<sup>2</sup> Imre Nagy was removed from power in 1955, became Prime Minister again in October 1956, and after the defeat of the revolution and his overthrow, he became a martyr when he was executed in 1958.

from people who still regarded themselves communists, but wanted a different type of socialism. I suppose to a Western observer this period in Hungary might be likened to the ‘Prague Spring’ of 1968. We wanted socialism with a human face and a more democratic style of government. The so-called reformists did not form an anti-socialist movement. I myself and my friends were personally active in promoting reform at meetings during this period. Unfortunately, in February 1955 Nagy lost the contest with Rákosi. The leading members of the reformist group at the newspaper *Szabad Nép*, were fired by a Politburo decree. Luckily Stalin was gone and we were not sent to a Gulag or executed.

As it happened, by 1955, and for a few years before, I had wanted to leave journalism anyway but I had been prevented from doing so. By then I had already been a part time graduate student for two years at the Academy of Sciences and had passed various exams. The official name for the qualification that I was studying for, following the Soviet terminology, was Candidate of Science. This is more or less equivalent to the Doctor of Philosophy degree in the West. Having been fired from the newspaper gave me the opportunity to concentrate on my studies and I joined the Institute of Economics of the Hungarian Academy of Sciences as a Junior Research Fellow. In spite of the drastic fall in my earnings—I earned about a third of my salary as a journalist—I was glad to work in a research environment. So 1955 marked the start of my professional academic career. I had begun to think about my thesis while I was still working at the newspaper but I actually worked on it and finished it after my dismissal, in 1956.

*What did you write your thesis on?*

My dissertation for my Candidate of Science degree was eventually published in 1957. The English version, entitled *Overcentralization*, was published by Oxford University Press in the UK in 1959. This was my first appearance as an author in the West. The book reflects my naïve but honest belief at that time that the socialist system could be reformed. I thought then that replacing bureaucratic coordination with market coordination would, without making any changes in the political structures, suffice to improve the system. Later I realised that ‘market socialism’ could never work.

*During all of this came the Hungarian uprising of 1956. How did that momentous event affect you?*

When the uprising of 1956 broke out, I was, so to speak, already mentally prepared. The transformation of my own thinking had already started in 1954 with my earlier disappointment with the way things had turned out. I was commissioned by one of Imre Nagy's deputies to write an economic programme for the new government. So for many days after October 23 I worked on this. The idea was for Imre Nagy to take the new proposals to Parliament and present the ideas in a speech. But there was no speech and no Parliament as the uprising was shortlived; it was suppressed and defeated. Before 1956 I was a member of the Communist Party, but after the uprising I turned my back on the party and never returned. Not only did I leave the Communist Party, I also emphatically declared that I was no longer a Marxist or Leninist.

## **Overcentralization in economic administration**

*You have already mentioned that your thesis formed the basis of your first book, Overcentralization, which is a critique of the Classical Socialist model of central planning. How were you able to publish this critique in the aftermath of the failed 1956 uprising?*

I actually wrote the book in 1955 and 1956, before the October revolution, and published it after the revolution. In the immediate period following the revolution, the government of János Kádár was preoccupied with consolidating power and suppressing resistance. So they were not concerned about or did not pay much attention to what was going on in academic publishing. There was a courageous publisher who brought out my book in Hungarian in 1957. I pointed out in the preface of *Overcentralization* that I had written it before October 23, 1956, and that if my arguments were valid before the events in October, they were also valid later. While many people changed their ideas, I did not. The manuscript was smuggled out of Hungary and arrived in Oxford, England, where it drew the attention of John Hicks. As far as I know it was Hicks who recommended my book to Oxford University Press, and they published an English translation of it in 1959.

*Overcentralization* was the first critical book on central planning from an insider and that is why it attracted attention in the West. From then on there was a bifurcation of the story of that book. In Hungary it was heavily attacked, even by my own boss at the Institute of Economics who labelled it ‘revisionist’. Later on I was called a traitor to socialism, which was a very harsh accusation. At the same time the book received high praise in the Western press. It was favourably reviewed in the *Manchester Guardian* and *The Times*. It also got long appreciative reviews by economists in several of the leading Western academic journals. So it was praise in the West and condemnation in the East [*laughter*]. A Communist Party investigation at the Institute of Economics led to the decision to fire me, together with my friend András Nagy, who expressed similar views on various occasions. In those months and years many of my friends were arrested and tried and one was sentenced to death and executed. Some of my friends emigrated.

*So by publishing this book you were not only risking your career, you were also risking your personal safety.*

This was a period of great uncertainty. There was no way to tell whether Stalinism would be resurrected in its extreme form or replaced by a milder form of repression. As is known in retrospect Stalinism was not restored, but immediately after the failed revolution of 1956 nobody knew that would be the outcome. So it was a dangerous period. The reprisals were extremely brutal after 1956. Three hundred and fifty people were executed for political reasons. That’s a huge number. It exceeds the total number of executions that took place following the defeat of the anti-Habsburg revolution in 1849, the Hungarian Communist revolution in 1919, plus those sentenced to death in the 1945 anti-Nazi trials in Hungary.

## **Intellectual influences**

*How exposed were you in the 1950s to Western economic ideas? Did you have access to such work and were you at liberty to study “bourgeois” economic analysis?*

The main obstacle had nothing to do with not being allowed to read such material, because if I had been eager to read it I could somehow have

gained access to it. The main problem is that so long as someone is a strong believer in Marxism, he does not feel compelled to read anything else. A committed communist believes that Western bourgeois economists simply do not understand the true nature of capitalism, unlike Karl Marx did in *Capital* [1867]. Marxists believe themselves to be beholders of the truth. This feeling comes from within. You are completely committed from the start to one specific interpretation or vision of capitalism and markets. It's about as close to dogmatic religious fervour as one can get. A devoted believer in one particular religion will rarely convert a believer in another religion. Certain ideas are regarded as axiomatic and they are not to be questioned. Once you accept the axioms of Marxism the rest follows naturally.

My eagerness to read the work of Western economists started with my disappointment with Marxism-Leninism and the Communist Party. That more or less coincided with the beginning of my graduate studies. Once my own axiomatic belief in Marxist political economy had collapsed, I began to search for and read books by the hundred. Initially I read more in politics than economics. After the defeat of the revolution and especially after I had been fired from my job, I had plenty of time to read and educate myself. It was a period of rigorous self-training. I had long discussions with mathematicians and computer scientists. I worked with a brilliant mathematician, Tamás Lipták, with whom I later co-authored some papers.<sup>3</sup> He helped enormously with my understanding of mathematics.

*When you started to read the mainstream literature on economics, who impressed you the most?*

My first guide was a very good book on the history of economic thought written by Farkas Heller [1943], a Hungarian University Professor before the war. His book gave me a good guideline for selection. Then, very early on, I read Oskar Lange's *Economic Theory of Socialism* [1938]. This interested me very much and immediately exposed me to ideas and analysis concerned with market socialism and reforming a socialist planned economy.

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<sup>3</sup> Kornai and Lipták, 1962, 1965.

Then I read a very good three-volume German textbook by Erich Schneider [1956], followed by Paul Samuelson's famous principles textbook, *Economics* [1948]. I also read his *Foundations of Economic Analysis* [1947]. I then moved on to Gottfried Haberler's book *The Theory of International Trade* [1936], and Joseph Schumpeter's books, *Capitalism, Socialism and Democracy* [1942] and his *Theory of Economic Development* [1911]. I got my introduction to Keynes from Paul Samuelson and Erich Schneider who were early converts to Keynesianism. Later on, when I was working on linear programming and head of the Economics Research Department at the Computing Centre of the Hungarian Academy of Sciences [1963–67], I used the book by Robert Dorfman, Paul Samuelson and Robert Solow [1958], *Linear Programming and Economic Analysis*. I became deeply influenced by neoclassical economics in this period.

My first trip outside the Eastern Bloc was to a conference at Cambridge University in 1963. It was Edmond Malinvaud and Tjalling Koopmans who invited me, and I made a lot of useful contacts and friends at that conference. In 1968 I visited Stanford on invitation from Kenneth Arrow. This was when I was working on a critique of general equilibrium theory, and I received helpful and supportive comments from both Arrow and Koopmans.

*What about the writings of the Austrian school, e.g. Ludwig von Mises and Friedrich von Hayek?*<sup>4</sup> *They were the earliest critics of central planning and the socialist form of economic organisation. When did you first come across their critiques?*

I read their work in the mid-1960s, much later than Lange's. Hayek had a strong impact on my thinking. He showed that all economic systems must make efficient use of information. Certainly, it's a great advantage of decentralised market systems that information is created and utilised efficiently. In bureaucratic systems, it may not always be possible or in the interest of agents to transmit information efficiently. Marx and committed Marxists thought planning would be a relatively easy task that would rescue the world from the chaos created by markets. Hayek's work showed how this ran counter to reality.

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<sup>4</sup> See Hayek, 1935.

*In all of your work, but particularly your 1992 book *The Socialist System*, you prefer to call the centrally controlled economies we are discussing 'socialist' economies rather than 'communist' economies. Does this relate to some intellectual influence from Marx?*

I don't think so. You will notice that the subtitle of my 1992 book *The Socialist System* is *The Political Economy of Communism*. I prefer to use the term socialist economy because that is what the political leaders of these countries called their system. They did not refer to their system as a communist economic system. According to Marxist-Leninist ideology, communism that provides everyone according to their needs, represents a later stage of development. If you talked to a communist in a socialist country, say, in the 1970s, he would say that we have not yet arrived at communism, we are still at the earlier stage, socialism.

It was Western commentators who tended to use the term 'communist system' or just simply 'communism' when referring to these economies. In the Eastern Bloc they always talked about 'socialist camp', 'socialist system' and 'socialist economy'. In my book *The Socialist System* I make it clear from the outset that I wanted to examine only those countries that were under the control of a Communist Party.

## **Mathematical modelling**

*Much of your early professional work as an economist was concerned with designing mathematical models to help make the planning system work better.<sup>5</sup> What motivated you to follow that line of interest and, looking back, how do you now view that work?*

To understand my motivation first of all you have to go back to the context, to the political and social environment at that time. My *Overcentralization* book was empirical and based mainly on my interviews with enterprise managers. It analysed how the system worked in practice. I wanted to continue my investigation to write a second volume. But after November 4, 1956, came the period of harsh repression and me being fired from my job. I realised it would be impossible, given the new political

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<sup>5</sup> See, for example, Kornai, 1965, 1967, 1969, 1970; Kornai and Martos, 1973; Kornai and Simonovits, 1977.

climate, to repeat my earlier success in getting *Overcentralization* published. I did not want or intend to write books and papers praising the unreformed socialist system, because I wanted to convey the truth. But it was no longer possible to write a critical book about the system; after 1956 this route was closed. So I had to look for another outlet for my work, and that's where the inspiration for my formal technical work on mathematical model building came from.

I was also motivated by my declaration of no longer being a Marxist. This was more than a political statement or protest, it was also an intellectual conviction. However, I did not want to enter into a polemical debate about fundamental theoretical issues. That was not possible. Having abandoned Marxism, I had to write in a different language that made it clear to the reader that the writer was a non-Marxist. I wanted to publish work that did not use the language or vocabulary of Marxism. The use of mathematics had a strong educational purpose. It was not only a method to help me arrive at coherent propositions and results. It also was a way of enabling me to depart from Marxism without stirring up a loud protest from the authorities. This is very different from what happened, for example, in Soviet economics where economists continued to use a Marxian language. I was trying to smuggle genuine economics into my writing in a way that would still be publishable. My choice was...do I want to write illegal or legal material? I chose the latter, and therefore had to write in a way that would not provoke the authorities.

Many years later, the leading Hungarian economics journal published an interesting study on citations in the Hungarian economic literature.<sup>6</sup> It looked at the number of references to Kornai, to Western scholars and to Marx, Engels and Lenin. In this study there is a diagram showing that I gradually became the most often cited author in Hungary. Also, the growing number of references to my work was strongly correlated with citations from Western writers. I regularly cited Western sources and so did quite a few other Hungarian authors. At the same time, reference to the work of Marx, Engels and Lenin went down. For me, mathematics was primarily a tool to contribute to the re-education and re-orientation of Hungarian economics.

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<sup>6</sup> Such and Tóth (1989).

*But surely your work also had a clear objective, to improve the planning system?*

Yes, of course. In all of my writing I took the view that my point of departure was that we have a plan anyway—that is given, at least for now. So is there anything we can do to make the plan somewhat more consistent and improve some of the indicators? But in fact I considered this work much more a learning process than an undertaking to improve planning. In retrospect, I think it proved to be a good education for those participating in the project. In the mid-1960s I led a team of two hundred economists working on mathematical planning. Later many of the participants in the project became leading figures in the field of research and teaching.

Ultimately my experience with mathematical modelling also taught me that planning does not, and cannot, meet its targets. I learned the hard way about the vital importance of having good information and incentives. I learned that from my research for the *Overcentralization* book and again from my work on mathematical planning. So I learned my Hayek from the real world rather than from a book [*laughter*].

*How does the incentive structure within the planning apparatus distort the development of reasonably consistent plans?*

Within the planning mechanism there are incentives but they are perverse incentives. At the lower end of the planning hierarchy, the planners are almost compelled to lie to their superiors. The people further up the hierarchy also have to lie to their superiors and to the people at the lower level. To achieve your plan targets, you need to convince those higher up in the hierarchy that you need more resources otherwise you can produce less than the plan target. There is bargaining for resources. If everyone had perfect information, and unselfishly served the common purpose of maximising an agreed welfare function, planning may work all right. But since all these assumptions are invalid, the theorems on optimal planning based on them are untenable.

By the way, some of these assumptions correspond to those made by Oskar Lange in his analysis of socialism in the ‘Debate on Socialist Calculation’.<sup>7</sup> That is why I have always been very critical of his theory as

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<sup>7</sup> See Vaughn, 1980; Stiglitz, 1994.

a basis for talking about a practical form of market socialism. Just as no perfect Walrasian equilibrium can be achieved in the real world of a market economy because of the lack of perfect competition, no perfect plan can be created in the real world of socialism. I did write a book on mathematical planning [*Kornai, 1967*], but I never claimed that it was possible to compute an 'optimal' central plan.

*Is this the line of thinking that led to your book Anti-Equilibrium first published in 1971?*

It certainly was one of my motivations. By 1968 I had become acutely aware of the problems connected to the practical implementation of planning that we have already discussed. I felt that I had to go back to the foundations of general equilibrium theory and study Arrow and Debreu [1954]. The result of that investigation was my book, *Anti-Equilibrium*, which is a critique of Walrasian general equilibrium theory and an attempt to work out an alternative analytical framework bringing in elements from information theory, disequilibrium economics, management and organisation theory. Walrasian analysis dominated the foundations of Western mainstream thinking, and I felt that it prevented economists from dealing effectively with problems of the real world. Many of the directions I was moving towards in *Anti-Equilibrium* have now been explored, for example work on asymmetric information, non-price signals, disequilibrium states, conflicts and bargaining.

## **Classical socialism and the economics of shortage**

*In your book The Socialist System [1992a], you distinguish 'Classical Socialism' from 'Reform Socialism' and 'Postsocialist Transition'. What are the key features of the Classical Socialist system?*

Classical Socialism is probably best exemplified as the type of system that operated under Stalin and was mimicked elsewhere in several Eastern European, Asian and African countries. This system, although repressive and very inefficient, was coherent. A key feature of Classical Socialism is a political structure where the Communist Party has a complete monopoly of power and there is no accepted competition between rival ideologies.

Growth through investment was seen to be the main economic objective, not least because it was important to catch up with the Western economies. There is almost complete elimination of capitalist property relations, as state ownership dominates the economy. The entire banking system is state owned, and the scope for any private property is extremely limited. The main co-ordination mechanism is carried out by a centralised bureaucracy whose task is to produce and implement a plan for the economy. There is direct bureaucratic control of employment, prices and wages.

*Your published work, especially in the 1970s and 1980s, builds on the theme that socialist economies suffer from endemic and widespread shortages.<sup>8</sup> In particular, your book Economics of Shortage [1980] received a great deal of international attention. What are the main elements of your argument in that book that made it so influential?*

The central idea of this book was that shortages in socialist economies are severely dysfunctional. In socialist economies shortages are all-pervasive, they are everywhere. Shortages are painful, welfare diminishing and a tormenting phenomenon for people living in these economies. Standing in queues for hours, week after week, year after year, is humiliating. It is difficult to comprehend, for people living in the West who have never experienced such things, how, as an individual, you feel powerless, at the mercy of the producer and the seller. There is no consumer sovereignty. So you buy whatever is available on a particular day. And you frequently buy as much as possible of some goods when they do become available because there is always uncertainty about future supplies. The people living under socialism were trapped in a sellers' market. I felt that it was much more important to highlight the phenomena of shortage than to continue writing about the technical details of planning. The main message of the book was that the shortages are systemic. They do not arise because a planner somewhere made a mistake which could be rectified in the future with some adjustment to demand or supply.

My discussions with Western scholars inevitably ended up with their referring to Marshall's demand and supply diagram. If the price is below

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<sup>8</sup> For example, see Kornai, 1976, 1982; Kornai and Weibull, 1978, 1983.

equilibrium there is a shortage, demand exceeds supply. From this the self-evident solution is to allow prices to rise, which will stimulate supply and reduce demand. Once the price is right the problem is solved. But the logic of this argument belongs to a capitalist market economy where agents respond to profit and price signals.

My empirical counter-argument was that in spite of frequent price increases in a socialist economy, widespread shortages remain. The adjustment of prices simply do not make them disappear. They are recurrent and endemic. That argument made a very strong impression, it struck a chord. I talked to many people all over Eastern Europe, and the feedback that I got from those conversations was that after having read that book people looked at socialism in a different way. *Economics of Shortage* did well all over Eastern Europe, and when it was published in China it sold over 100,000 copies. I believe it acted as a catalyst for thinking about system failure.

*Was Economics of Shortage therefore seen as a very radical book?*

Before this book many people believed that the system could somehow be corrected and improved by partial adjustments. They thought that maybe some reform could put things right and the faults could somehow be patched over. *Economics of Shortage* convinced many people that the problems were incurable. So I like to think of this book as revolutionary, not because it mobilised people for an uprising but because it suggested clearly that reforming would never be enough. To solve the problem you need to change the whole system. In that sense it was a good preparation for the events of 1989. I think this was well understood by many fellow economists in the Eastern Bloc, as well as many political scientists and sociologists in the West. But somehow quite a few of my economist colleagues in the West just could not see that. They were still getting excited by reading Oskar Lange and thinking about the possibility of creating some form of market socialism. Socialism without centralisation still captured the imagination.<sup>9</sup> They were less excited about the shortage issue, which is what everyone living in socialist economies cared about. People suffered from distressing housing shortages. They could not get a

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<sup>9</sup> See, for example Nove, 1983; Bardhan and Roemer, 1993.

telephone for years, or the food that they wanted. This is what bothered and really mattered to them.

## The soft budget constraint

*You also introduced the concept of the 'soft budget constraint' in Economics of Shortage as well as in your Econometrica paper published earlier in 1979. This concept certainly did raise interest and excitement among Western economists and has been incredibly influential because of its broad applicability. How does this concept fit into the broad theme of shortages under socialism?*

The existence of persistent endemic shortages has many reasons. It is a multi-causal phenomenon and *Economics of Shortage* provides an overview of these causes. Certainly, the soft budget constraint is not the ultimate but a very important intermediate cause of shortage. It is apparent in the socialist economic system, and coupled with a few other conditions it creates run-away demand and pervasive shortages. In addition to its role in explaining shortages, the soft budget constraint turns out to be a workable concept *per se*. The soft budget constraint syndrome appears in other economic systems as well. So it is worthwhile to look at the soft budget constraint as a general phenomenon that can usefully be applied to many other situations as well as help us understand certain problems that characterise socialist systems. There is now a huge literature on the subject, several hundred articles discuss it in a variety of contexts and a number of interesting models have been developed. The Dewatripont-Maskin [1995] model played a pioneering role and is now well known in this field. I have just completed a survey on the subject co-authored by Eric Maskin and Gerard Roland [2002]. This paper presents an updated survey of the literature on the soft budget constraint.<sup>10</sup>

*You imply that in a socialist system the soft budget constraint problem is unavoidable. Could you explain why?*

Let me first clarify what I understand and mean by the terminology 'socialist system'. By socialism I do not mean Western style social

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<sup>10</sup> See also Kornai, 1986a, 1993, 1998a, 1998b, 2001.

democratic systems. For example I would never refer to the Swedish economic system as socialism. We must also exclude the UK under Labour governments in the post-war period.

As we discussed it earlier in our conversation, in my definition a socialist system is an economy where political power is in the hands of a single party, the Communist Party. In this politico-economic setting, state ownership is the dominant form of ownership. If you have state ownership then those in possession of the political control will always be reluctant to let an enterprise fail. It is, so to speak, not part of their mindset. They are not playing a competitive economy game that emphasises prices and profits. Why should they play this game? They are not interested in achieving profit maximisation. They play by their own rules. So state ownership is the most important cause of the soft budget constraint.

Even in a capitalist system it is only on rare occasions that state owned enterprises are allowed to fail. There is also concern for the unemployment consequences of allowing a large state owned enterprise to fail. Socialist systems are driven by the desire for expansion so the idea of voluntarily shutting down existing capacity just because an enterprise is unprofitable is anathema to Communist Party officials. Profitability is not taken seriously as an important indicator that key decision makers should be concerned about. They are much more interested in growth rates.

*So would you say that the threat that an enterprise may go bankrupt is virtually zero?*

Bankruptcy is never a real threat. In Classical Socialism, enterprises could be confident that they would receive assistance from the state to overcome a financial crisis. Even chronic loss makers are bailed out on a regular basis. The financial assistance comes in a variety of forms such as soft subsidies, bargaining over taxation, soft administrative pricing and easy credit. Bankruptcy belongs to the world of hard budget constraints.

## **Reform and the 'socialist system': was there a third way?**

*Twelve years ago you were the first economist to offer a comprehensive set of proposals for post-socialist transition. In your book The Road to a Free Economy [1990a], you claim very forcefully that there is no third or middle way for socialist*

*economies. The idea of market socialism is a non-starter. You make the same point in your Journal of Economic Perspectives paper published about the same time [1990b]. Why did you become so convinced that there was no third way, no form of market socialism that the Eastern Bloc economies could embrace after 1989?*

First of all it is important to make clear that this debate about a third way is not connected to such debates that have been taking place in social democratic systems. Those debates are really about what the proper role for government is in a liberal democratic capitalist market economy. Everyone accepts that the government has an important role to play in any economy, and there is a legitimate debate about where the borders of the state should lie.<sup>11</sup> Debate about the possibility of a third way in the context of the socialist systems involved different issues. To make this clear, let us talk about the many proposals for a third way in socialist systems, including those put forward by Mikhail Gorbachev [1987].

First, we need to go back and remind ourselves about the characteristics of what I like to call the Classical Socialist system. What are the foundations of this system? There are three layers. The first and most important one is the monopoly rule of the Communist Party. The second one is state ownership. The third one is reliance on bureaucratic coordination instead of market coordination. Society is permeated by discipline enforced by the centralised control of careers. Any promotion is decided by the Communist Party. To climb up a career ladder you must please the party machine. The Communist Party is the integrating force of society. The dominance of the Communist Party, party discipline, and political repression are absolutely crucial for the system to function.

To use Albert Hirschman's [1970] terminology, there is virtually no *exit* for enterprises in socialist economies; employees and consumers also have little opportunity to exercise *voice*. Workers are always supervised by the *nomenklatura*, by the party apparatus. Now if you really understand how the socialist system operates, being based on these three layers just discussed, it should be clear that you cannot make adjustments by replacing bureaucratic coordination with some other mechanism to create 'market socialism'.

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<sup>11</sup> See Snowdon, 2002.

But this is exactly what all the naive reformers like Gorbachev thought was possible. No search for a third form of ownership and co-ordination mechanism will allow you to escape from the tough choices that have to be made. All these three layers of the foundation have to be changed! Otherwise you end up with a confused and incoherent system, or, at best, 'goulash communism'. Trying to reform socialist economies makes you fall between two stools. This is what happened to the Gorbachev-type reforms. This is not to say that a reformed socialism is not more flexible than Classical Socialism, and that those socialist countries that had introduced the greatest number of reforms were not better prepared for 1989. But the Gorbachev style reforms exposed all the cracks in the system. It allowed people to see that it was the system itself that posed the problem.<sup>12</sup>

*One type of response that is often heard from some 'anti-capitalists' is that the systems that operated in the former Soviet Union and Eastern Bloc economies were 'not real socialism' or 'not real communism'. These critics of capitalism then go on to argue that the Soviet system was just 'state capitalism'. They then proceed as if there was some utopian form of socialist system that could be established rather than accepting the need for transition to capitalism. How do you respond to this line of thinking which I am sure you have come across?*

I like to think about reality rather than dream of utopian forms of socialism. Just look at the historical realities. What has socialism been like in reality? The twentieth century witnessed a contest between two long-lasting, grand types of system: centrally controlled socialism dominated by a communist party, and various forms of capitalism. There is no third system. Market socialism is an unrealisable dream.

However, the debates on market socialism and the attempts to reform the Classical Socialist system paved the way for and played a crucial role in preparing these economies for the important changes taking place after 1989. That preparation for transformation was important. So I do not join those who belittle Gorbachev and the many other reformers in an arrogant style. They played a very important role even though in many cases they did not fully understand what they were doing.

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<sup>12</sup> On reforms see Kornai, 1981, 1986b, 1990a, 1990b, 1997a.

*So in effect reformers such as Mikhail Gorbachev let the cat out of the bag.*

Exactly. And that is also true for many periods of enlightenment in history. Reformers provide a catalyst for change. The socialist reformers contributed to the erosion of the foundations of Classical Socialism to which I have already referred. Those fundamental layers were well established and very rigid. Someone had to start chipping away at them before more profound changes could be made. Some erosion and loosening in the political sphere was needed and here is where Gorbachev played a crucial role. This is why I believe that Gorbachev should be recognised as a towering figure of this period, or indeed the twentieth century. Although some of his ideas proved unworkable, he at least knew things had to change, unlike previous Soviet leaders such as Leonid Brezhnev. Although he had no idea where the reform process would lead to, he understood that the Soviet Union had to move away from its existing economic organisation. So I have great respect for Gorbachev for creating the opportunity for change.

## **Trials of transition**

*Gerard Roland, in his paper ‘Ten Years After: Transition and Economics’ [2001] points out that, and I quote, ‘When the Berlin Wall fell unexpectedly, there was indeed no pre-existing theory of transition. We had no pre-existing theory of the effects of political constraints on transition strategies, the effects of liberalisation in socialist economies with no pre-existing markets, how to privatise socialist enterprises given the legacies left by socialism, and how to harden budget constraints and achieve efficient restructuring’. This is somewhat surprising, and gives the impression that no one expected the socialist systems to implode like they did and when they did. Economists were not prepared for this epoch making historical event. How do you explain this?*

That is a very good and legitimate question to ask given the huge importance of what happened in 1989 and since. These issues simply didn't feature in public discourse before 1989. The speed of collapse was quite unforeseeable. It came as a great and unexpected shock. Of course, those of us who had written about reform were convinced that sooner or later the system would have to change. We hoped for that to happen and were sure

that it would come some day. But nobody predicted that it would happen in 1989. In that sense it was a surprise. Maybe there are some exceptions that I do not know about, but it was certainly not a dominant feature of intellectual discussions in either the West or the East. Change was expected to come, but later and with a much longer period of transition.

Consider just one example. At the first Solidarity Roundtable meeting in Poland, a certain number of seats were reserved for the Communist Party to take after the election. They regarded it as self-evident that even if the election went one hundred per cent for Solidarity, the Communist Party would still be allocated a certain number of seats. Nobody was thinking in terms of allocating seats simply on the basis of votes.

These events should teach us to be modest about our predictions and forecasts. History has a habit of providing big surprises. Sometimes change is gradual, occurs step by step. Other times it accelerates, taking everyone by surprise. We know this from the study of business cycles. Panic can suddenly hit financial markets. Such explosive events have occurred repeatedly. Just look at what happened in East Asia in the late 1990s. Extrapolation from a curve is always a risk. After the initial surprise of 1989, the speed of change was not so unexpected for me because having lived through the events of October 1956 in Hungary taught me that things can change a lot in just one day. What happens on Wednesday can be very different from what happened on Tuesday. In three days everything can turn upside down.

*Do you agree with Francis Fukuyama's [1989] thesis that we have witnessed the 'End of History' with the demise of the great socialist experiment of the twentieth century?*

I have to admit I never understood what he really wanted to say with that astonishing announcement. On the one hand, the great 20th-century socialist experiment is not over. What will happen in China, that vast country? What kind of system will it turn into, after being a more or less standard socialist system in the initial period, and how much longer will the transformation take? There is no excluding the possibility of China's transformation requiring a whole period of history.

Who knows what the future has in store, what new, hitherto unknown social formations will come into being, for instance through the influence

of the technical revolution in information and communications? The term 'historical' means a great many things to me; among others, the birth, transformation and demise of systems, to use the concept in the sense my book *The Socialist System* employs it. History goes on.

*One interesting development that has come out of the debate on transition is that, in studying the problems of moving from socialism to capitalism, economists are also learning to understand better and appreciate the importance of institutions and how, for markets and capitalism to work reasonably well, there are specific institutional prerequisites. Many Western economists who have lived and worked all of their lives in capitalist market economies take many of these institutions that support the workings of markets for granted. The institutions that reduce transaction costs, protect property rights, encourage trust, and provide law and order are crucial ingredients of successful market economies. Would you go along with that interpretation?*

Yes, I would. I'd add further thoughts to that, the first more of a personal nature. Right from the start of my research career, I always gave precedence to describing the institutions associated with the system I was examining, and understanding and analysing how they operate. That is what I did in *Overcentralization*. The main message of *Shortage* was that the chronic shortage apparent in the communist economy was caused not by mistakes of economic policy, but by the institutions present in the system.

Analysis of the system's institutions runs all through my book *The Socialist System*. Many other works have discussed separately some institution or other or a narrower ensemble of institutions, such as the political structure, the legal system, property relations and suchlike. My book was an attempt to present the institutions as a coherent system, showing how they were built one upon the other and how affinity and cohesion developed among them—for as long as that cohesion lasts and does not break down. Now that this question has come up, I would add that I am sorry there was little professional recognition of this methodology, because I think it is an essential and characteristic feature of the book. This system-centred approach is, in my view, crucial for understanding how the communist order could survive for so long and how it came about that it collapsed eventually in 26 countries.

Analysis of institutions, separately and joined together in a system, was also emphasized strongly in my works about the post-socialist transition as well. I was influenced to think in this way by many other written sources and by my own experiences as a researcher. I have to say that unfortunately I did not know Douglass North's work at the time I was writing *Overcentralization*, the *Economics of Shortage* or *The Socialist System*.<sup>13</sup> That is why I did not link my ideas to his, and did not cite his works. Later, when the North school of modern institutionalism suddenly became fashionable, there were many who did not even notice how closely related my work was to institutionalism, not in its terminology, but in its methodology, its approach to the reality of society. I am sorry that it turned out that way.

While emphasizing the kinship, I would also like to point out differences. I am arguing here less with North than with some of his slightly one-sided and over-enthusiastic followers. The understanding of institutions (and if need be, alteration of them) is extremely important. It is necessary, but normally not sufficient in itself. Attention cannot be concentrated on institutional change exclusively. This we experienced, precisely in the period of the transition, sometimes in quite a bitter way. A splendid new institution is created, following strictly the most refined Western pattern, and it just does not want to work in the way we would expect. It won't because it is abused, for instance, by the autocratic political will and it cannot be supervised by a political sphere still insufficiently cultured and lacking in democratic traditions.

The transformation of society is a very broad and comprehensive process in which the transformation of institutions, the disappearance of old ones and the appearance of new, is just one, albeit essential, component. However, it does not preclude the influence of other factors, such as culture, tradition, the personalities of the occupants of important positions, etc.

*Focusing on the economic aspects of transition, how do you account for the variation in performance across transition economies?*

The transition of the economies in Eastern Europe, so far, has been more successful than in Russia. There are several reasons for this and I could not

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<sup>13</sup> See, for example, North, 1990; Snowdon, 2002.

single out one in particular. The Soviet Union had a longer history of communism than Eastern Europe, seventy years rather than forty. The Eastern Bloc has more organic linkages to Western Europe than the Soviet Union. It was much more problematic for Russia to feel close to Europe than for countries like Hungary, Poland and Czechoslovakia. These countries had always felt that they were part of Europe with more family ties, cultural, and commercial linkages.

Geographically these countries are also closer to the industrial hub of Europe and the main markets centred around Frankfurt, London, Paris, Milan, and Zurich. That is always an advantage. Also important is the fact that Eastern Europe has always had more exposure to reformist ideas in both the political and economic spheres. There was more experimentation with reforms in some of these economies. Another key influence on success or failure comes from the responsibilities and quality of personal leadership. Who made more and who made less mistakes in designing the transition strategy? I think the Russian leadership made many of the wrong choices. We should also consider policy mistakes made by the West in their relationship with the transition economies.

*Did some of the advice coming from Western-based economists turn out to be misguided?*

Yes. My main criticism relates to the way that privatisation was carried out, the way that ownership was changed.<sup>14</sup> I preferred a more ‘organic’ strategy of bottom up development of the private sector. Russia was too much concerned with privatising the run down state enterprises. It is important to allow new enterprises to emerge spontaneously including small and medium sized business enterprises. It is crucial to foster a new business ethos where Schumpeterian creative destruction and entrepreneurship become the norm.

Vibrant productive entrepreneurship is a crucial engine of economic progress, and I don’t think it was given enough emphasis in Russia or by the Western advisors.<sup>15</sup> The advisors also neglected to emphasise the importance of establishing secure institutions to protect the legal

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<sup>14</sup> See Kornai, 1992b, 2000b, 2000c; Djankov and Murrell, 2002; Stiglitz, 2002.

<sup>15</sup> See Baumol, 2002, for an excellent discussion of the importance of entrepreneurship.

framework of business activity.<sup>16</sup> Western advisors would mention this at the end of a report, but with too little emphasis being paid to it.

After 1989 the Holy Trinity of the ‘Washington consensus’, namely privatisation, liberalisation, and stabilisation, dominated the thinking of many reformers and advisors. There was not enough emphasis and discussion given to the importance of creating law enforcement and hardening the budget constraint. Then there is the neglected problem of tax collection. Under the socialist system no fiscal problem existed. There was a monobank and taxes were automatically collected by it directly from the enterprises. There was no question of tax evasion. Once the payment of taxes ceased to be automatic many stopped paying and serious fiscal troubles emerged.<sup>17</sup>

Also neglected was the position of the Welfare State in post-socialist economies.<sup>18</sup> Under socialism a premature Welfare State was created out of all proportion to resource constraints and fiscal capacity. With the shock of transition and problems with tax collection, economists need to give more attention to the necessity of reforming the Welfare State. So many Western ‘experts’ had to quickly learn how to widen their thinking beyond just economic theory and the concerns of the ‘Washington consensus’ to be able to provide relevant and useful advice.

*In your recent paper ‘Ten Years After The Road to a Free Economy: The Author’s Self Evaluation’ [Kornai, 2000b], you conclude by saying that the gradualism v. shock therapy debates of the early 1990s involved a ‘false dichotomy’.<sup>19</sup> What exactly did you mean by that?*

I have a number of problems with this dichotomy. One is that the transformation is a very complex process, and the speeds of its several components necessarily differ very strongly. Some regulations can be introduced very quickly. But there’s no way of creating by fiat a new private sector built up out of a hundred thousand new start-ups. The stock exchange can be opened soon enough, but diverting capital into joint-stock company form is a very slow process. Averaging the speed of post-socialist

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<sup>16</sup> See Roland, 2001; Hoff and Stiglitz, (2002).

<sup>17</sup> See Kornai, 1992c.

<sup>18</sup> See Kornai, 1997b, 1997c.

<sup>19</sup> See Marangos, 2002.

transformation is as meaningless a concept as arriving, for instance, at an average speed of movement in a big city, including the pedestrians, cyclists, private cars, lorries and underground railways. If the features of the transformation are examined one by one, different criteria appear for deciding what speed is best for each.

I have an aversion to placing a decision about speed in the foreground of the debate. There are many other questions to decide. For instance, there are economic, legal, moral and political criteria to apply to developing the private sector. People can each form their own opinion bearing these in mind. And once we have chosen according to these criteria, then come the implications of speed. If we feel it is important for a broad entrepreneurial stratum to emerge and for foreign capital to participate willingly in investment, it is clear that we cannot achieve this hey-presto! with one decisive piece of legislation.

*In that same self evaluation paper, you mention in a footnote that you turned down all invitations to be an adviser to governments of transition economies but that you considered yourself to be an adviser 'in the broader sense' of conducting and publishing research and making policy recommendations as an outsider. Why did you turn down those invitations to be an advisor on the inside?*

I would like to make it plain that in my view, those serving as advisers to democratic governments, ministries and parties are performing an honourable and important task. However, it has to be acknowledged that people who undertake such functions will have to be loyal to those they are advising. If advisers disagree with something, they can convey their criticisms behind closed doors, but they cannot make their remarks public. They have to pay full attention to the political-cum-tactical criteria that guide the actions of the person they are advising.

For me, these are constraints that I cannot accept. I would like to retain my full intellectual and political independence. I normally publish my positions. If the government, some minister or some other political personage asks for my opinion or calls for my advice, I am at his or her service under suitable conditions. Such conversations have taken place on more than one occasion. Still, I think it is one thing to give *ad hoc* advice that does not commit the person presenting his opinion to giving loyal

service to the statesman or parliamentarian being advised, and another to undertake a formalized, official job as an ‘adviser’.

*One of the big surprises to economists in the 1990s was the depth and duration of the recessions that occurred in the former socialist economies during the initial phase of transition.<sup>20</sup> The enormous transformations taking place were bound to create disorganisation for a period, and Blanchard and Kremer [1997] have attempted to explain the fall in output in these terms. Was the severity of the recessions that were experienced also a surprise to you?*

Yes, absolutely. I did not expect such large falls in output. Disorganisation is certainly one of the reasons. There was for a period an institutional vacuum. The old institutions disappeared without there being adequate replacement. The new institutions had still to be created.

## **Capitalism, socialism and democracy**

*How have the people in Hungary and the rest of the transition economies reacted to the profound political and economic changes that have taken place?*

I am more appreciative about the changes than many of my fellow citizens in Hungary and the other transition countries. The man of the street, the average citizen of the country, is usually not grateful to history; he is rather inclined to look at the darker side of events. Many citizens are disappointed with the results of change. That is because most people had unreal expectations about what could be achieved quickly. They believed that once the switch from socialism to capitalism had taken place, everybody would be lifted out of poverty and into high standards of living almost overnight. So there is a high degree of dissatisfaction in the transition countries.

*Do you include Hungary among the countries where there is dissatisfaction?*

Yes, I do. The gap between expectations and reality was just too large. I think the Hungarians were expecting even more than people in some of

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<sup>20</sup> See Kornai, 1992d, 1994; Campos and Coricelli, 2002.

the other transition countries. As one who has spent half of his life studying the field of 'comparative economic systems', I had much less expectation about what could be achieved quickly. I think I understand how capitalism and socialism function, so I am not disappointed. As an economist, I know that you cannot expect a sudden jump in the standard of living to Western levels. Productivity has to rise and this takes time. I also know that capitalism is far from being a perfect system. In the Churchillian sense it is better than any of the not very good alternatives.

Although capitalism still has many faults, such as excessive income inequality and recurrent problems with unemployment, nobody has yet invented a better economic system. There was some inequality under socialism, but less than under capitalism. The inequality is now more conspicuous, because some individuals make a lot of money and it is highly visible. What I really value about the changes after 1989 is that we now have democracy and freedom of speech. That is something extremely important.<sup>21</sup> The political situation now is incomparable with the situation as it was under the rule of the Communist Party. In the economy there is now much more flexibility, much more entrepreneurship and initiative coming through. This is a great achievement. We have got rid of the endemic shortages.<sup>22</sup> It is as if many people have already forgotten what it used to be like before 1989. Seeing that the shops are full, they complain that they cannot afford to buy the goods on offer. I understand how they feel, but as an economist who spent a lot of time on analysing chronic shortages, I can see profound improvements compared to the way things used to be.

Hopefully these improvements will continue and then everyone will begin to feel the benefits of the change of system. My view is that the changes led us in the right direction, and the long-run prospects are promising. Initially, the shock of change had a negative impact on production, which painfully worsened the economic situation of many people. We also have troubles linked to widespread dishonesty and corruption. But I believe the worst is over. From the broader perspective, the positive achievements have been much more important.

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<sup>21</sup> See Kornai, 1988.

<sup>22</sup> See Kornai, 1995.

*Looking back over the political and economic events since 1989, how would you assess what has happened on the road from socialism to capitalism? What have you learned about the determinants of success?*

Before I can answer that, I need to know how you define success.

*I guess most economists would define success as when a transition economy finally gets into a situation where markets work well, leading to sustainable growth of income per capita.*

I prefer not to have such an exclusive indicator. In my mind there are at least two equally relevant success indicators. The first is freedom, the second is material well-being. If you look only at GDP per capita, you only have half of the picture. You must consider both. In fact, in my subjective judgement, freedom is more important. I cannot say that China is more successful than Russia. China has been more successful in one of these measures, the growth rate of GDP, but much less successful in establishing greater freedom.

China's success with GDP growth is in part due to the maintenance of stability in the country. In this stable political framework, with the dominance of the Communist Party, they have achieved high rates of economic growth. But they have paid a precious price for that. In China, the political regime is extremely oppressive and there is no political liberty or freedom of speech. So I do not regard China as a shining example just because it has been successful in economic growth. In making comparisons you have to refer back to your basic beliefs and philosophy.

Having experienced political repression for many years, I attach great importance to freedom. I cannot say....for me as a Hungarian or you as a UK citizen, freedom is important but that for the people in China it does not really matter, let them be content with their higher growth rate of GDP per capita. That is hypocritical. If you really think that freedom of speech is not important, then go and try your luck in a faster growing economy under the dictatorship of a Communist Party. So I am not prepared to ignore the political side of change. While Russia is not consistently democratic, it is certainly no longer ruled by a single party. There is political rivalry and elections, and there is much more freedom of speech than in

China. It is not a mature democracy, but it's a vast improvement on how things used to be.

*I take your point. Again, those of us who have lived all our lives in democracies tend to take these freedoms for granted. Related to this general issue of freedom and democracy, in your paper in the Journal of Economic Perspectives, 'What the Change of System from Socialism to Capitalism Does and Does Not mean' [2000a], you argue that... 'capitalism is a necessary condition of democracy... There has been no country with a democratic political sphere, past or present, whose economy has not been dominated by private ownership and market co-ordination'. Why is capitalism necessary, although not sufficient, for democracy?*

First let me be clear about what I mean by democracy. I follow Schumpeter's definition of democracy as a system that exhibits certain minimal conditions, namely, that governments can be peacefully changed on a regular basis by electoral methods; that no single party or ideology has a monopoly of power; there is a competitive multi-party system; and there is freedom of expression and the press. So by those criteria you cannot find one single example of a democratic socialist state. Not one. As far as I am concerned that settles the issue until someone can show me an example to the contrary.

Empirically there is no argument. Capitalism is not a *sufficient* condition for democracy because there have been capitalist systems with dictatorial political regimes, for example, pre-war Italy and Germany, and there are many post-war examples in Southern Europe, Africa, Latin America and East Asia. But there is also a logic to why capitalism is *necessary* for democracy. This has to do with the ownership question. For democracy you need freedom of the individual. People must be free to speak out, and that is not possible in a society where individuals are in all respects dependent on and at the mercy of their employer, which in a socialist system is predominantly the state.

Again, to use Hirschman's [1970] terminology, there is no exit. You need genuine decentralisation of ownership and power for democracy to develop, otherwise you are subject to common central commands. There is nothing wrong in having a certain share of public ownership, a genuine mixed economy. But to have the economy dominated by a monopoly or

predominance of state ownership is incompatible with democracy. For real democracy there must be a predominance of private ownership.

*Since 1979 China has been freeing up its economy in a gradualist way and the private sector has been allowed to expand. Given that this trend is expected to continue, what are the prospects for democracy in China?*

At some point, sooner or later, the communists will have to give up their monopoly of power. But we don't know when and we don't know how this will happen. My guess is that it will occur through a transformation of the Communist Party itself. Although the Communist Party retains the same name, it does change over time. Today's Chinese Communist Party is different from the time of Mao's.

The same happened in Eastern Europe in the 1980s. Transformations can take place in the thinking of the Chinese Communist Party. Also, once you begin to allow the private sector to grow, sooner or later the business community will desire political representation. So I am, in that sense, optimistic for the very long run situation in China.

## **European Union enlargement**

*How important is it, for the former socialist countries of Eastern Europe, to be accepted as members of the European Union?*

It poses a dilemma that Hungary, and the other Eastern European economies, have only recently broken free from the dominance of the Soviet empire and achieved national sovereignty. Joining the European Union will involve handing over a large measure of that sovereignty. That is a hard decision to make. There are trade-offs, costs and benefits. But on the whole, I give it strong support, because I think the benefits of membership will outweigh the costs over the longer term.

There are nationalistic movements in each Eastern European country that oppose membership. I am convinced that being a member of the EU will exert some discipline on the former socialist economies, both from the economic and the political aspects. This comes back again to my concern for freedom and democracy. I am not prepared to assess the merits of membership simply on the impact of such a move on GDP growth and

economic efficiency. My main objection to communism was not that it led to a poor growth performance and economic inefficiency, although these features were of course important drawbacks of the socialist economies. My main objection was against the political system and all that it implied. I firmly believe that EU membership will provide greater protection of human rights, including the rights of the minority populations in the former socialist countries, and will also give more support to democratic institutions.

## Current research

*Your current research interest is focussed on the project 'Honesty and Trust in the Light of Post-Socialist Transition', centred here at the Collegium Budapest, Institute for Advanced Study. What is the motivation behind this broad research agenda, and what are its main objectives?*

The motivation comes from the experiences we have had in transition economies. I mentioned before that many people are disappointed, and the level of dissatisfaction is much greater than can be explained by simply looking at the GDP performance of the transition economies. There has been an explosion of corruption and dishonesty. People feel that they cannot rely on other people's word. There is a problem of trust. Under socialism, the institutions of government became discredited and as a result, cheating on the state became acceptable. People would only trust close family and friends. And then came the dramatic events of 1989–1990, bringing about political upheaval. While political and economic institutions changed relatively fast, the evolution of new social norms takes longer.

*How is the project progressing?*

This particular project developed from my collaboration with Professor Susan Rose-Ackerman of Yale University.<sup>23</sup> Beginning with a preliminary planning workshop in May 2001, we have since organised a series of conferences based on the interests of the participants. Our aim was to form a

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<sup>23</sup> See Rose-Ackerman, 2001.

'focus group' by bringing together scholars from across the academic spectrum to carry out this work. Much of the research is interdisciplinary, reflecting the fact that we have scholars participating from political science, sociology, philosophy, law and economics. These scholars come from all over the world, including the former Eastern European socialist economies and Russia, but also from the USA, Mexico, Scandinavia, Western Europe and Canada. We organised the project around three major themes, all of which derive from problems connected to political legitimacy and institutional quality.

The first theme is... How can we create a trustworthy state? Here we are interested in questions such as... What are the main causes of bureaucratic corruption and what can be done to reduce it? How can we use the law to reduce dishonesty and corruption? What system of incentives can be designed to encourage public officials to go about their duties in an efficient and competent manner? How can we increase accountability and transparency in government?

The second theme relates to formal and informal cooperation. The research here looks at issues such as law enforcement, informal contacts, reputation, organised crime, state capture and networking. It is desirable in the post-socialist economies for business enterprises to develop norms of behaviour based on trust and reputation. What are the rules of the game when politicians get involved with business and vice versa? How impartial is the state? These are all important public policy issues for the transition economies.

Our third theme relates to the value that we place on honesty and trust. For example, how important is honesty and trust in successfully building a credible democracy? How has the legacy of socialism influenced people's behaviour? Do different groups within a country behave differently? We have organised three workshops around these three themes, and have just had the first related to 'Creating a Trustworthy State'.

Papers were given on many of the topics I have just referred to. We have another workshop focusing on 'Formal and Informal Cooperation' to be held in November, and a third workshop on 'The Value and Price of Honesty and Trust' in December 2002.<sup>24</sup> The current project will conclude with the publication of a book containing our research findings.

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<sup>24</sup> Details of these workshops can be found at [www.colbud.hu/honesty-trust/](http://www.colbud.hu/honesty-trust/).

Hopefully the participants will also continue their collaboration in these important questions into the future.

## The future

*How optimistic are you about the future for the transition economies of Eastern Europe?*

I am optimistic for the medium and long term, but I am making no predictions about the short term. Too many unexpected things can happen in the short run. As economists we see this all the time. I do hope that the worst of the adjustment is over. I look forward to continuing our integration into Europe. The cultural history of Eastern Europe has always been linked to Western Europe. We are by geography and history tied closely with the rest of Europe. Historically, Eastern Europe has produced many great writers, scientists and composers.

*And, might I add, many great economists...*

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