Why the Ex-Communist Countries Should Take the "Middle Way" to the Market

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ABSTRACT

The ex-communist countries of Europe as well as Soviet Union want to find a way out of the command economy to a market system. The common advice (e.g., Lipton and Sachs, Kornai) has been to go quickly "all the way" to a fully capitalist economy. The difficulties of this policy are now becoming clear.

This paper argues that a "middle way" with many socialist elements is an attractive path for these countries, for both the transition and as a long-term goal. Economic reform of ex-communist countries must be based on two core elements. First, the primacy of law and stable private property rights must be assured. Second, free markets must be the basis of economic relations.

How could reform then be a middle way? First, firms must be independent entities owned by shareholders and responsible for making a profit, but the owners can include local, provincial (republic) and national governments, workers, and social institutions providing pensions and insurance. Government ownership has not made Volkswagen, Lufthansa or Japan Air Lines economic failures.

Second, market are institutions that must be developed. It is particularly important for a society without accepted norms and laws regarding market behavior to develop them, and to evolve efficient private contracts. Government legal codes can help. Finally, regulation can provide some of the security of socialist systems and Western welfare states.

The economic case for a middle way is supported by its widespread success, including Austria, Germany's "social market" economy, Sweden, Canada and Japan. The cultural case is based on an economy's need to be reasonably consistent with its society's customs and norms. It is less of a shock for an ex-communist society to move to the "middle way" than to a purely capitalist society.

Why the Ex-Communist Countries should take the "Middle Way"

To the Market Economy

1. Introduction

U.S. economists have largely agreed on a solution to the economic problems of the ex-Communist countries: establish a U.S.-style economy as quickly as possible.[1] This paper argues that such a goal is inappropriate. Rather, these countries should find a "middle way" that is based on the primacy of free markets, but includes considerable public ownership and a strong welfare state. It is a path similar to that of Sweden in some ways, to Germany in others, and to Japan in still others.

What are the advantages of a middle way? It lets their economies be consistent with their society's history and cultural values. Such successful capitalist economies as the United States, Japan, and the Western European countries have quite varied economic institutions and these differences are related to their different historical experiences and cultural patterns (Kreps 1990, North 1990, Zald 1990, p. 90). For example, the white-collar/blue-collar dichotomy in U.S. industry has roots in firms with native white foremen and immigrant workers (Edwards 1978). So it is reasonable to take a society's culture into account when devising economic policy, just as one would take into account that society's skills, educational levels, natural resources, and factories.

The ex-communist countries have quite varied cultures, and therefore their transition to markets should vary. For example, Polish society is far more individualistic than Russian society, so reform policies favoring highly individualistic behavior patterns will be more successful in Poland. The United States can often be a model for Poland due to both societies' individualism. In contrast, the strongly authoritarian, egalitarian and conformist tradition of Russia (see, e.g., Kolchin 1987) suggest that continental models such as Germany, Austria and Sweden might be more appropriate. It is also crucial that the new value of democratic rule, has been adopted by all of these countries. Even a communist party must now try to gain popular approval.

Before turning to specific policy models, it is worth dealing with the argument that <u>any</u> intermediate policy is wrong. According to many advocates, one should "let the market work" and make adjustments only when major problems develop. The basic rationale is that competition by private firms in markets is the only efficient policy. Proponents would appeal to the neoclassical general equilibrium model or to the Chicago school supply and demand model, or to the Austrian model of entrepreneurship. None has any place for a society's culture. A secondary rationale is that the leaders and bureaucrats of the old communist system are fundamentally hostile to change and will try to reimpose their traditional methods of control using any tools available (Kornai 1990). If they are required to operate, say, rate-of-return regulation of electric utilities (a nearly universal form of government regulation of industry), they will instead reimpose the traditional command economy.

Part of the neoclassical and Chicago stories is clearly valid: competitive markets are a highly successful way to organize economies. But neoclassical theory has little to say about the organizational form of firms and nothing to say about specific property right rules and the relevance of culture. These questions are assumed away in order to model markets. Yet industrial organization and comparative economic systems do deal with property right systems and with the relationship of culture and economics. They find that a wide range of property rights systems are efficient.[2] Similarly, many divisions between the public and private sectors are efficient. In addition, there is some evidence that a property rights system can be highly efficient in one society but can fail in a society with a quite different culture. Examples include the U.S.-style system of property rights in the Philippines and the British legal system in India.

The second argument, that the entrenched communist bureaucracy will fight all change, is a serious concern: they will probably do just that if they can.[3] So there are severe disadvantages to letting any current bureaus survive. And the bureaucrats have established behavior patterns that they will follow in any other bureau. So the use of current bureaus and bureaucrats should be minimized. Yet the dramatic change from Communist Party control to democracy may convince bureaucrats that they must accept "the will of the people." Thus, policies that need bureaucrats need not be opposed per se. Rather, agent discretion should be minimized. Policies should have fixed and transparent rules that will resist manipulation. And when possible, new administrative units should be created in place of the previous bureaucracies. In this move to a rule of law, these units could follow juridical rulemaking procedures (as do most U.S. independent agencies), rather than imposing regulations by fiat as in the past.[4] Even so, the tradition of favoratism will have to be fought everywhere in these bureaucratic ex-communist societies (e.g., Telgarsky and Struyk 1990, p. 58).

2. The Necessity of Stable Property Rights and Free Markets

Successful economic reform requires two policies: stable private property rights and the primacy of free markets. These policies are also sufficient, as the details of property rules and market arrangements, as well as who owns what property, can be successfully arranged in numerous ways, including a "middle way." Thus, the core of this proposal is that firms be required to survive in free market competition. (It is presumed that the economy has a stable currency and thus a monetary and credit reform as well as reformed banking and credit institutions; see McKinnon 1991).[5]

Economic theory shows that free-market competition assures the same market outcomes under a variety of economic institutions.[6] The competitive pressure of existing firms and free entry of new firms assure that any firm that fails to provide goods at minimum cost will be driven out of business. Firms must provide goods that consumers want, pay for labor and materials, and have profits left over or they cannot survive. This result holds not just for profit-maximizing firms but also labor-managed firms (Vanek 1970, Bonin and Putterman 1987) and profit-sharing firms (Weitzman 1983, Koford and Miller 1991). The practice of capitalist economies also shows economic success for a wide variety of economic forms. One can find industries in which stock-market capitalism dominates in some countries, family firms in others, government-owned firms in some and cooperatives and partnerships elsewhere.

Markets will <u>force</u> efficiency on all types of firms, if they are free to adjust their production methods and output, and to freely enter and exit the industry. Free entry and exit is the most powerful element in the long run, while the extent of competition among existing firms is most crucial in the short run.[7]

A second reason to favor market competition is that innovation is most likely in such markets. The communists' bureaucratic control of industry failed to encourage innovation, despite immense efforts (Berliner 1976). The failure of the Soviet economy to innovate despite all efforts was the biggest single reason why Soviet intellectuals favored the radical changes that became Gorbachev's glasnost and perestroika (Shlapentokh 1988, Hosking 1990 p. 2). In contrast, innovation prevaaails where open competition and entry are permitted.[8] So the move to a market system will by itself solve the innovation problem that communist systems unsuccessfully grappled with.

The stable and assured private property rights of economics textbooks are an abstract, even impossible ideal. For example, transactions costs are never zero in the real world. Yet a reasonable approximation to such rights exists in most developed economies. Their importance is shown by the failure of economies lacking them. Economic historians, particularly Douglass North (North and Thomas 1973, North 1990, North and Weingast 1989) show that insecure property rights ensures poverty for a country. Development economists have also shown that without a stable system of private property rights, economic development of a country is unlikely (Bates 1981, Klitgaard 1990, de Soto 1988). No one will invest in a business that can easily be confiscated. And there are few benefits to learning productive economic skills in a society without protected property rights. Rather, gains come from learning to capture others' wealth (Bhagwati's DUP activities [1982]).[9]

Property rights without the free exchange of goods through markets are meaningless, so economic reform requires the combination of full private property rights and markets. The next two sections describe reforms creating property rights and markets consistent with the customs and values of the ex-communist countries. The analysis describes reforms in some detail to illustrate "middle way" market reforms and show that they are workable.

3. Creating Secure Property Rights

To create secure property rights in a formerly communist country, it is necessary to establish the rule of law protecting productive private property (Litwack 1989). And people must know that these laws will be respected by the government and the public. Democratic countries often (not always) develop respect for law, and the popular support for the government may have that effect in Poland, while the Soviet government's lack of legitimacy hinders the public's acceptance of Soviet law.[10] However, before people can know that property rights will be protected, private firms, particularly corporations, must actively exercise those rights. I turn first to the task of creating private property from state enterprises.

Virtually all of the productive assets and organizations in the ex-communist countries remains owned by the state. (The major exception is private farmland in Poland). Proponents of U.S.-style capitalism have argued that these should be quickly sold off in a Thatcher-style series of sales, or perhaps in a distribution of stock rights to all citizens.[11] However, this policy has bogged down, and it appears to face insuperable practical and political hurdles.[12]

The alternative is to begin by establishing legally recognized corporations to own the large productive enterprises. Small productive assets--shops, restaurants, small repair and service establishments--can be sold off at auction, as Czechoslavakia has recently begun to do (Economist, February 2 1991, p. 71).[13] And individuals must be free to establish new private firms and corporations as they choose. Large enterprises that are wholly government-owned can be turned fairly quickly into private corporations. The main difficulty is establishing just what a particular enterprise actually owns, what its assets are, and in particular what its financial assets and liabilities may be.[14]

Once enterprises have been defined as private corporations, they will have stock ownership (along with some bond debt). The stock in each corporation can be issued and sold to a variety of parties. A number of experts have proposed such distributions, and their conclusions are similar.[15] I will describe one specific approach, but the details are less important than the basic principle that stock distribution and sale should assure fairness and efficiency, and major social interests should not be neglected. Some stock should be sold at a low price to current workers and managers. A moderate proportion, perhaps 5-10%, should be sold at auction to the public, including foreign buyers.[16] This will create enough "outside" shareholders that a market in the stock can develop, and with it, market valuation of the firms. The bulk of the stock should be turned over to government units--national, provincial (republic), and local governments, and to national pension authorities. For example, the national authorities might receive 40%, provincial governments 10%, local governments 10%, and the national pension system 20%.[17]

Administration of most government stock should be turned over to specialists such as banks or stock fund managers.[18] Their main task will be to try to assure that the firms are run profitably. Their stock ownership gives them the ability to discipline and replace poor managers. The division of stock ownership into several hands will make it difficult for owners or managers to engage in self-dealing of the sort that is notorious of Hungarian and Polish enterprise managers (Lipton and Sachs 1990b).

Most government stock should remain in government hands for the near future. That satisfies the cultural norm that the economy should not be "given away" to people who will then be wealthy and dominant.[19] Nationalism makes foreign buyers a problem: some firms should be sold to foreign firms with special expertise or to provide investment capital, but selling firms to foreigners just to get them out of the hands of the government is less desirable. In addition, government ownership adds a social element to firms' decisionmaking. Firms will be less likely to close down plants or drive hard bargains with workers, for example. While such decisions may not maximize profits, I believe that they are deviations from profit-maximizing that most people in these countries will prefer.

Some stock will be sold to a broader public over time. Pension funds will need to sell stock to pay pensions, assuring a gradual and continuing release of shares to the public. Governments will also want to sell shares for cash, since their tax revenues will be slim and their credit ratings low. The experience of government ownership of stock in Western Europe has been mixed, with fairly poor in the United Kingdon and Italy, and more positive results in West Germany, Austria and France.[20] Some lessons from that experience are that firms will inevitably be turned into political tools, and yet some will nevertheless have excellent managements and do well. Lufthansa, Volkswagen, Veba, Electricité de France, and Japan Air Lines come to mind, along with the Swiss and French National railways and POSCO, the South Korean steel firm that is government-owned and apparently the world's most efficient.

With both firms and governments facing a continuing need for cash I expect that firms will issue new stock and governments will sell stock regularly. That assures a gradual shift of the economy into private hands. Governments will want to sell some assets quickly to reduce households' "cash overhang" but unwilling to sell a large share of assets since they greatly exceed the private sector's purchasing ability. Firms in industries that lose money in government hands will likely be quickly privatized, since governments will be unwilling to raise taxes to subsidize them. Just as unsuccessful privately owned firms are reorganized and "downsized", unprofitable publicly owned firms will be reorganized or sold to make them profitable.[21] Some declining heavy industries like steel and coal may remain under government control to avoid closing plants and laying off workers, but that is what the public would want the government to do in any case.

Creating corporations but not quickly privatizing requires far less change than full privatization, since there is no current capitalist class in these countries to sell the firms to. It also requires a much smaller <u>cultural</u> adjustment, since a new capitalist class need not be created. While the public wants rapid economic growth, few people in formerly communist societies want an artificial new class of wealthy owners of capital.[22] However, many new private firms will be established and grow rapidly as people see opportunities neglected by the established firms. So the private share of the economy will grow fast even without privatization of large existing firms.

What will motivate the managers of these partly-public firms? They will face a strict test of market profitability, since cash-strapped governments can hardly provide them with funds. In the post-communist environment, making a profit will be a challenge in itself. If managers fail to make a profit, they are likely to be replaced.

Large government-owned firms will face as strong incentives as privatized firms. Both will face severe pressure to make profits, since neither will have a ready source of additional funding. Each will be able to appeal for some government aid if failure would devastate some region--private U.S. firms like Chrysler and Grumman have received large infusions of government support. Both will face foreign and domestic competition in the long run, which will be the ultimate test of their viability.

The specific form of corporations and privatization policies should vary across Eastern Europe with each country's specific institutions and culture.[23] A quote from Soviet writer and dissident Amalrik (1981, p. 37-8), gives a flavor of the difficulties of assuming that all cultures are just like the U.S.

> As I see it, no idea can ever be put into practice if it is not understood by a majority of the people. Whether because of its historical traditions or for some other reason, the idea of self-government, of equality before the law and of personal freedom--and the responsibility that goes with these--are almost completely incomprehensible to the Russian people. Even in the idea of pragmatic freedom, a Russian tends to see not so much the possibility of securing a good life for himself as the danger that some clever fellow will make good at his expense.
>
> To the majority of the people the very word "freedom" is synonymous with "disorder" or the opportunity to indulge with impunity in some kind of anti-social or dangerous activity. As for respecting the rights of an individual as such, the idea simply arouses bewilderment. One can respect strength, authority, even intellect or education, but it is preposterous to the popular mind that the human personality should represent any kind of value.

As a people, we have not benefited from Europe's humanist tradition. In Russian history man has always been a means and never in any sense an end.

...The Russian people...have...one idea that appears positive: the idea of justice...In practice, "justice" involves the desire that "nobody should live better than I do"...The idea of justice is motivated by hatred of everything that is outstanding, which we make no effort to imitate but, on the contrary, try to bring down to our level, by hatred of any sense of initiative, of any higher or more dynamic way of life than the life we live ourselves. This psychology is, or course, most typical of the peasantry and least typical of the "middle class". However, peasants and those of peasant origin constitute the overwhelming majority in our country.

Such cultural values are sure to affect how a society can approach free markets. I now examine how cultural values affect policies toward private farming and large industrial corporations.[24]

Farming conditions in eastern Europe vary between areas suited for large-scale grain production and areas suited to small-scale fruit and vegetable production. Either family or corporate farming is technically suitable to the whole region, so in the long run private farming is the most economically efficient system. It could include large family farms in grain-producing regions. It could include either small-scale family farms or large-scale corporate farms using hired workers to produce vegetables and fruit. Current institutions affect the acceptable choices, however. The Polish people strongly desire private, small-scale family farming, and have organized most of their countryside as such. Such farms will probably prevail for the near future, even though the farms are inefficiently small. Under free markets most farmers would be driven from the land, which would be politically unacceptable.[25] In contrast, large-scale farms prevail in grain-producing areas of the Soviet Union and Bulgaria. These can be privatized as units, with the farms having the option of subdividing their land fairly. It seems that Russian agriculturists are not ready to establish family farms, so large corporate or collective farming may prevail there, and the laws for privatizing Russian farming should reflect that possibility.[26] Family-sized fruit and vegetable growing seems preferred everywhere, so the privatization of such farming could be carried out under standard "land reform" rules: low prices, family farms, and limited resale rights for several years.

Large western industrial firms have numerous plants spread across a number of countries; such firms export a large share of their output. They must meet world quality standards to export successfully and meet import competition. Communist firms have not faced these conditions. Exports were rarely determined in competitive markets but were set bureaucratically. So were the location of plants and the size of firms, making most firms national monopolists.

These conditions will now break down. The the open economies of Hungary, Czechoslovakia and Poland, will fare differently from the closed Soviet economy. The former are close enough to Western Europe, and small and open enough that trade with Western Europe is critical. The Soviet Union is so large and distant from Western Europe, international transport is so difficult, and the Soviet economy is so closed, that international trade will likely be a secondary factor. In Eastern Europe, merging with (or more likely, selling out to) foreign multinationals should be the quickest way for firms to increase efficiency. Countries must decide whether to allow such mergers and sales. They must also decide whether to protect their industries from imports. Both a country's industrial efficiency and its nationalistic feelings are important in this choice. Hungary seems most open to foreign influence and competition. Since its firms have been partially free for decades, they are more able to compete successfully (Kornai 1990). Also, Hungarians are relatively willing to accept foreign ownership of industry and are comfortable with close association with Austria and Germany. So Hungarian corporate law should allow foreign ownership, mergers and takeovers under a broad set of circumstances. Government approval of majority ownership of large firms by foreigners might be desirable until the public reaction to foreign takeovers becomes clear.

Poland's economy has been near collapse in recent years and the public is ready to take drastic measures to improve things. And entrepreneurs have been trading heavily with the West for years. There is rather strong Polish nationalism that will oppose external control from Germany and the Soviet Union. (Control of local firms by U.S. multinationals or Polish emigres would be acceptable). This implies some government veto power over foreign takeovers. Support for workers' rights is strong and has been reinforced by the Solidarity trade union. Finally, in recent years, workers have gained strong legal rights over firms' decisions. Poland is an excellent candidate for a double board of directors along German lines, that can accommodate strong worker influence in one board while maintaining stockholder ownership in the other board.

The Soviet Union's current political conflicts make it hard to predict politically appropriate policies. But some general principles can be described. Russians seem much more hostile to foreign control than Eastern Europeans, even though the chance of foreign domination seems slight. They are unfamiliar with the management of firms along capitalist lines, and would be shocked at the "ruthlessness" of profit-maximizing managers (Lewin 1988, p. 140). The Soviet Union is the best candidate for firms owned by cities, provinces and republics, and constrained by them from pure profit-maximizing objectives. The size of the country and its enterprises reduces scale-economy gains from foreign mergers. But foreign firms could enter and shake up the Soviet economy through new capital investments and the purchase of individual factories.

Some ways to establish private property have been described. How can these rights be defended by the rule of law? Three levels of legal rights are needed. First, constitutional protections must assure that laws will not be changed arbitrarily. Often, a sufficient guarantee in practice is that democracy gives a stable political equilibrium assuring basic property rights. However, since that is not assured in recently democratized countries, such constitutional protections as prohibiting the taking of private property without just compensation are essential.

A second guarantee establishes a formal legal structure protecting property rights, including contracts, torts and corporate property law. Former communist countries do not have such detailed laws, and they take many years to develop. Even eastern Germany, which just adopted West German law in toto, has had great difficulties in fitting existing institutions to its new legal system. Yet the job must be done, as quickly as possible. The most efficient way to obtain such a legal system is to copy one that already exists and works well. Thus in the 19th century Japan adopted German legal institutions (Stafford and Robinson 1990). A continental legal system is most appropriate; the German legal systema is a good one to examine.[27] All continental legal systems are consistent with the generally administrative approach to law of communist governments and the earlier institutions of Eastern European countries.

The independence and impartiality of the judiciary are critical to any legal system, particularly after its distortion by communist control. Every country will need to recruit new judges and remove many communist appointees. Election of local judges, as in the U.S., might be an attractive option.

The third element of a property rights system is public acceptance. At its best, the public actively supports the law--notifying the authorities of theft or embezzlement, for example. At the minimum, the public might passively accept private property. But if many of the public attack or steal some types of private property, that property will not be viable. Private property belonging to "speculators" and "profiteers" in the Soviet Union has often been attacked; the government must consider the public's view of the legitimacy of such property rather than just deplore such attacks.[28]

In each former communist country, there are grave doubts about the legitimacy of new enterprises that may have "stolen" public assets or that may be taking advantage of "shortages." It is desirable to keep firms from gaining that reputation. Establishing publicly owned corporations and including workers among the owner should help avoid this sense of illegitimacy. Small firms should have their assets sold to the public at auction and have their inputs (food, building materials) available on free wholesale markets.[29]

4. Culture and Creating New Markets and Market Institutions

Certain markets can operate without much institutional structure. People inspect the goods, pay cash, and take the goods away with them. Farm produce and much retailing can work this way. Other markets develop a contract structure that is effectively an institution. Following Eggertsson (1990, p. 175), cultural variations can be defined in terms of contracting costs. Past experience leads to institution-specific knowledge, which imply quasirents in firms and institutions. Following Becker and Stigler, people may develop tastes for institutions that they are familiar with and understand well. So different countries have low costs for different institutions: that is, essentially, "culture".

Most large Eastern European firms do not require specific laws to enforce their contracts, so they can develop new forms of contracts from scratch without government aid.[30] But governments can influence these institutions by passing appropriate laws. Governments could signal that bribery of public officials is strongly prohibited. Governments could also discourage private kickbacks to workers at other private firms, to reduce the general acceptance of corruption in society. Finally, enforcing private contracts between firms should be made easy, while unilateral breaking of contracts should involve full compensation for harm. Recently in communist economies the expectation has been that contracts are points to begin bargaining from, not final agreements. That is not acceptable in an economy of independent firms, and that expectation must be broken down.

Labor markets always need an institutional underpinning, whether of custom, labor unions, or laws. Customary practices have been inefficient and unfair in communist states, while labor unions have had real power only recently in Poland. Laws seem needed to develop new institutions. In the past, workers had few effective rights except to avoid hard work (Berg 1990). Managers had few means of gaining effective cooperation.[31] The relative rights of workers and management involve complex issues in disparate fields that nevertheless must be consistent. For example, safety regulations, union shop rights, and workers compensation all deal with the same problems of efficiency and safety; each approach affects the others. Therefore, it seems best to copy the laws of a country with a successful system of labor law. Workers' rights should be strong regarding unfair dismissal, to accord with socialist values. But they should not be so strong that firms cannot fire malingerers or troublemakers or cut down money-losing operations; these are all major problems that firms must be able to confront effectively. So while Dutch law very effectively protects workers from dismissal, a poorly motivated labor force could take advantage of it. German labor law may have the best combination of fairness toward workers and a recognition of the need for efficiency and flexibility. Austrian and Swedish institutions emphasize bargaining between "peak" organizations of workers, firms and the government; in countries with a strong sense of solidarity among elites, such as Czechoslovakia, this model may be useful (Calmfors and Nymoen 1990, Jackman, Pissarides and Savouri 1990). For laid off workers, Sweden has had an effective (but controversial) combination of high benefits and strong incentives to find new jobs (Flanagan 1987, Johannesson 1981). The German laws regarding unions might be appropriate for Poland or Czechoslovakia, but where real popular unions do not yet exist weaker rules are appropriate. Since workers are familiar with the current rules, a reasonable beginning is actually to enforce the current laws, until their defects become clear. This applies particularly to the Soviet Union, where workers are quite unfamiliar with western concepts of labor law but have sometimes tried to have their own labor laws enforced.

The transition to markets may require some intermediate steps in the country that is most autonomous from the Western European economy, the Soviet Union, and perhaps in the Balkan states. Prices and output levels are very far from their long-run equilibrium levels. Therefore, there is a good chance that when prices are freed, they would shoot up (or down), and quantities could easily change drastically. Firms could easily be bankrupted when caught by whipsawing prices, even though eventually they would be profitable. The IMF/World Bank/OECD/EBRD recommended that some Soviet prices, particularly housing, energy and utility prices, be controlled for a number of years (1991, Volume 2, p. 10).

This problem can be solved by allowing prices to adjust in a constrained fashion, controlling the aggregate price level or a sectoral price level, while letting individual prices adjust consistent with that constraint. MAP--the Market Anti-inflation Plan, is such a mechanism devised by Abba Lerner and David Colander (1980). Similar systems controlling wages have been used by Hungary over the past decade including its recent recent price reform and in Poland's "big bang". They are proposed by the IMF/World Bank/OECD/EBRD (1990, 1991) to stabilize the Soviet economy: "incomes policy seems indispensable at least for the transition" (1990, p. 2).[32] MAP and related sectoral policies allow for adjustment in prices toward their equilibrium level, while in effect taxing such changes. That reduces the size of price changes, but allows prices to move toward their long-run equilibrium. Equally important, these mechanisms can assure that the aggregate price level, or some sectoral price level such as consumer durables or energy, stays at a set level, while allowing efficient removal of price distortions for either the whole economy or within the specific sector.

Traditional incomes policies discriminate against workers, by constraining wages but not returns to capital. That may be politically as well as economically inappropriate. MAP, which controls value added, is unbiased and so is a fairer and more efficient policy tool. Incomes policies constrain an individual firm's wages, so a firm facing a shortage of workers is largely unable to adjust. MAP lets such a firm raise its wages if it pays another firm with a labor surplus to reduce its average wage. Price controls cause similar problems for firms; again MAP creates a market in the right to increase prices, letting a firm raise <u>its</u> prices if other firms are willing to reduce their prices by an equal amount (Koford 1987).

A related mechanism sets a constraint on aggregate output of a category of good, such as trucks, while allowing for adjustment of the number of individual types of trucks. Again, firms that cut back output of all sorts must pay other firms to expand. This allows flexibility in adjusting to demands while still assuring that the overall industry continues to produce. As individual prices and quantities adjust under this mechanism, markets will approach their long-run equilibrium and the aggregate constraints can be adjusted (Koford, Miller and Colander 1990). These policies can also be used to assure long-term price stability and a stable aggregate GNP level.

Finally, the Eastern European countries nearest the West can just let capitalist market institutions freely enter the country. This gives them directly a set of efficient and fairly compatible institutions. Hungary and Czechoslovakia are the most likely to accept Austrian or German institutions. How might they do so? Firms need various of types of insurance--fire, casualty, workers' compensation, product liability. Rather than set up their own regulations, the governments could allow insurance from neighboring countries to be offered freely. Then those countries' rules and formats would be adopted immediately. Similar principles apply to the full range of legal institutions, perhaps even allowing legal issues to be determined by their neighbor's courts.

5. A Middle Path: Summary

This paper argues for a move to market-based economies that preserve elements of a socially conscious society, and thus is a kind of "middle way" between pure capitalism and socialism. The proposal has a "big bang" for establishing private property rights and market competition immediately. But full private ownership of large firms is deferred. Instead, governments create strong incentives for firms to operate profitably and efficiently. Governments sell stock when they want the revenue or believe that private ownership would increase a firm's efficiency. Society then can choose to move to the sort of market-based economy that its public prefers. Before full privatization, it should develop full legal institutions and the socially conscious regulations that the society wants. People in different countries have quite different preferences on government ownership and the strength of a "social" market economy. This proposal leaves each country free to choose.

In developing markets, the critical policy is to assure that the markets operate freely. Yet markets require some institutional framework that organizes that freedom. This proposal favors the rapid creation of markets and so the adoption of successful institutional rules from other countries. At the same time, each country must look to find or develop rules consistent with its culture, past institutions, and aspirations.

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Endnotes

1. See, e.g., Lipton and Sachs (1990), Nordhaus (1990), Sachs (1991) and comments by Hewett (following Nordhaus) and Kornai (following Lipton and Sachs). I have heard numerous verbal statements from, e.g., Ed Hewett, Herb Levine, Richard Ericson. Editorialists have applauded the big bang approach and Vaclav Klaus' Friedmanite ideas, while criticizing those favoring slower change (e.g., Applebaum 1990, Economist 1990, p. 13).

2. For example, both the English common law and the continental "Napoleonic Code" seem able to protect private property and allow free transfers. See generally, Demsetz (1967), North (1990) and Tullock (19), and more specifically Pryor (1971, esp. Chapter 9) and Eggertsson's (1990) impressive review.

3. Even when the Hungarian elite largely agreed on the need for marketization, their short-term practical decisions, which reflected immediate self-interest and also traditional problem-solving, led to an extension of central controls (Richet 1988).

4. Wilson (1989, pp. 160, 337) shows how bureaus can cope well with straightforward, routinized tasks. He also shows how they can develop a strong and well-motivated cadre if given an appropriate mission. Unfortunately, the existing bureaucracies in former communist states rarely seem to have such values, so only newly instituted agencies might do a good job.

5. It is clear that effective banks will take many years to develop. Credit-worthiness standards must be learned and developed, and loan officers must gain experience. Firms must develop a credit history, first with small short-term loans. Thus, banks cannot play a major role in providing finance to these economies.

6. See, e.g., Estrin and Perotin (1991), and Eggertsson (1990, Chapter 5). The extent of innovation, however, will vary.

7. Even when entry and exit are not free, but some entry and exit are possible, markets should be workably competitive (Murrell 1991). Most European and Japanese firms are not free to lay off workers, close plants, or even shut down in bankruptcy, and markets there are arguably far from perfectly competitive. Yet most observers regard those markets as reasonably close to the competitive ideal.

8. Nelson (1981) has an eloquent discussion. The market need not be even close to perfectly competitive (see Scherer and Ross 1990). Freedom of entry is probably the most important condition, but even regulated monopolies have been innovative (e.g., AT&T and electric utilities).

9. It is only fair to point out that the communist countries turned in very rapid growth rates for many years, contrary to the arguments of economic theorists.

10. Smith (1990) describes how Soviets enjoy breaking laws, playing a "cat and mouse game" with the authorities. Much of Gorbachev's effort has gone to developing more respect for law, but he has not been very successful. Ioffe (1988, pp. 14, 55) describes the Soviet legal system as backward.

11. See Lipton and Sachs (1990b). Vaclav Klaus (1991) has been the strongest Eastern European proponent of such a policy.

12. These obstacles include the lack of sufficient capital among citizens to buy the assets, the complete absence of any idea of their value when the economies are freed up, the complexity of any sale, auction or distribution of claims to assets, and the distributional question of whether some people should receive some assets as a matter of right (workers, for example). The IMF/World Bank/OECD report (1990, p. 17) describes these issues for the Soviet Union and concludes that the most rapid privatization of large-scale assets "is likely to be protracted". Kornai (1990, p. 91) favors gradual privatization, despite a desire to move as rapidly as possible, since rapid privatization would lead to severe political and economic difficulties. Dhanji (1991, p. 326) shows how Poland's "big bang" failed to make rapid progress in privatization, and is now becoming a gradual privatization due to the obstacles noted above.

In Eastern Europe where previous owners of real property demand its return, uncertainty regarding ownership will continue until these claims are resolved politically.

13. Poland has now leased or sold over 100,000 small private shops (Gultekin 1991).

14. It is fortunately <u>not</u> necessary to define the overall legal rules, regarding, say pollution, while defining each corporation's individual ownership. Nevertheless, deciding workers' rights in corporations will be a difficult and protracted political decision in Eastern Europe (Lipton and Sachs 1990b).

It is not clear how difficult it will be to define each corporation's property rights. All communist enterprises nominally have owned their real property, although the military may own some factories that are leased to firms, (as the U.S. military does). Larger difficulties arise over financial assets and liabilities and contractual obligations. Loan renewal terms have not been spelled out. Conditions of foreclosure do not exist, either in general law or in specific contracts. Obligations to provide workers with health and recreation facilities are real but vague. Warranties and product liability are unclear, even for such large interfirm contracts as rolling mills, mining equipment, computers and aircraft.

15. See, e.g., McKinnon (1990).

16. The proportion to be sold to the public depends partly on the size of the "ruble overhang" of liquid savings available for investment.

17. A uniform rule permits a large number of firms to be dealt with at once. Ongoing Polish experience suggests that the moderate sized firms can be dealt with this way, but that the very large firms must be treated as special cases.

18. This reduces the problem of finding able board members. Bulent Gultekin (1991) points out that with 8000 firms to privatize in Poland, perhaps 120,000 board directors must be appointed, which is a major task in itself.

Political patronage dispensed through Italian and French government-owned firms has been a major problem. An administrative level separating firms from government would reduce patronage but not prevent open political policy decisions.

19. The plans to give stock to "everyone" in Poland and Czechoslovakia necessarily require setting up some kind of holding companies or investment trusts. Their supervision of thousands of firms that they own stock in is certain to be more theoretical than real. That will provide managers of these firms with the opportunity to run their firms as they please, so long as they do not need to borrow.

20. Canada's (and Quebec's) experience also appears to be relatively favorable.

21. Italian and UK experience might contradict this optimistic view.

22. If Hungarian and Polish experience is a guide, the public is happy with entrepreneurs who become wealthy from innovations, such as computer software or Rubik's cube. But they are very suspicious of those who gain wealth from firms based on former government property. Kornai (1990) emphasizes this opposition to new wealth as a major political obstacle to be overcome.

23. Some useful references on cultural values in the Soviet Union include Hosking (1990), Lewin (1988) (on the values of the new educated urban elite, compared to the previous peasant culture), Petr (1990) (on the thinking of Soviet liberals), Shipler (1989), Shlapentoch (1986, 1988) (on the thinking of the Soviet elite and public).

Tismaneanu (1988) describes well the state of mind of Eastern European intellectuals, one that is strongly anti-Stalinist and anti-authoritarian, and quite strongly disillusioned by the experience of communist ideology. The Bulgarian liberal economic reformers of Club "Economics 2000" noted (1991, p. 22) that for workers "the attitude toward the state as the only benefactor and defender of people's interests has remained unchanged...in solving unemployment problems...3.5 percent [recognize] the role of firms, but 60 percent give the highest rating to the state."

One can also overemphasize the importance of culture in a society, and neglect the specific situational factors that actually may create apparently "cultural" behaviors. Wildavsky argues that there are a variety of cultural preferences in every society; it is the relative mix that varies.

24. Urban land policy should also be addressed, but I am too ignorant of this important subject even to attempt some comments.

25. Presumably, when these facts sink in, Poland will adopt some subsidy system for farmers comparable to that adopted in the U.S. or the EC.

Possibly, most small farmers could take jobs in local factories and farm as a part-time occupation. But there are not currently enough rural factories for this to succeed.

26. Some farmers would like to have their own land, but most are quite concerned about their loss of security (Smith 1990 pp. 226-9).

27. The French legal system might also be appropriate. I know little about other continental systems. It is striking that the Czechoslovakian parliament wrote

its own economic laws rather than copying German or EC laws because the latter were to detailed to enact readily (Dyba and Svejnar 1991, p. 187).

28. The Soviet trading cooperatives were closed due to these attacks, even though they were performing a highly useful service (Smith 1990 p. 289).

Shiller, Boycko and Korobov (1990) present survey evidence that Soviet citizens do not have very different values regarding speculation than do Americans. But their evidence shows that Soviets are more favorable to government action against speculators.

29. The latter was the Soviet objective in establishing markets for wholesale trade.

30. Contracts will develop even if governments don't enforce them, maintained by the need for continuing relationships. But long-term contracts for, say, gas pipelines, will need government support. So will contracts involving patentable products.

31. Granick (1986) discusses the customary rights of Soviet workers.

32. The specific mechanisms adopted recently by Poland and the Soviet Union to control wage increases have severe technical flaws.