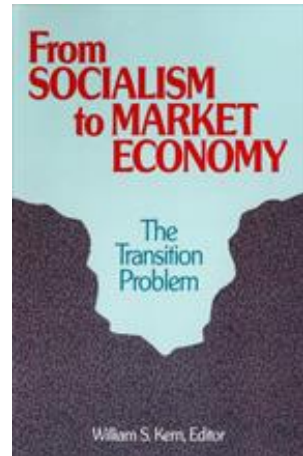




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Roadblocks to Changing Economic Systems in Eastern Europe

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The eight “socialist” or former socialist countries of Central, Eastern, and Southern Europe can be divided into two groups of four nations: those in which the body politic has made a *seemingly* firm commitment to become a market economy (the German Democratic Republic, Czechoslovakia, Hungary, and Poland); and those in which the body politic has not (or not yet) made such a commitment and still believes that some kind of a third way of “market socialism,” a system that combines central planning and the market, is feasible (Bulgaria, Romania, Yugoslavia, and Albania). To be sure, Yugoslavia is difficult to classify since Slovenia and Croatia have a strong preference to join the first group, but the other republics are not willing to go along with their choice. The USSR would belong to the second group, although there too not all republics see eye-to-eye on this issue.

This essay is about the nature and problems of the transition faced by the countries that appear to have made a commitment to become full-fledged market economies. (Why their commitment is dubbed “apparent” will be explained later.) The next section identifies the three main models of successful market economies. It is important for those of us in the West who wish to advise policymakers in Central and Eastern Europe on transition to a market economy, and for policymakers in those countries working on transition problems who wish to learn from

the experiences of successful market economies to recognize that in different historical, social, political, cultural, and economic environments, alternative institutional arrangements and policies can be successful. This suggests caution in seeking to duplicate some particular feature of another country's economic system.

After focusing on the differences between market economy systems, the essay identifies and discusses briefly those system features and causal relationships that successful market economies appear to have in common. Assuming that the factors identified are the right ones, I venture the hypothesis that successful transition programs in Central and Eastern Europe will be those that can duplicate just those system features and policies that seem to account for the successes among the market economy countries, irrespective of the economic, social, cultural, and political differences among them.

Next, I examine the economic legacies inherited by the new governments in Central and Eastern Europe, following the framework presented in the previous section. The purpose is to try to identify the nature and size of the gap between what is and what should be, a gap that transition programs should attempt to close. On each set of issues I discuss the main policy options and make recommendations.

The concluding part of the essay offers some thoughts on the strategy of transition, calls attention to the immense intellectual, economic, and political difficulties of transition, and speculates about policy implications for the United States and the West.

Models of Successful Market Economies

As I see it, there are three main models of successful market economies: the West European social market economy, the U.S. consumer market economy, and the Japanese corporatist market economy. Let me describe briefly the main differences among them.¹

Although there are vast differences even among the countries of Western Europe, the successful European paradigm is best exemplified by the *social market economy* of Germany. There is an unquestioned

commitment to the predominance of market forces and of private property; "social market" simply means a recognition that an unbridled market has imperfections and that it is the state's responsibility to rectify them. The state is responsible for sound monetary and fiscal policies (a task that successive German governments have met in particularly exemplary fashion), allowing relatively free foreign competition on the domestic market (with agriculture being the most notable exception); efficient infrastructure, some attention to the environment; adequate health care, education, and the right of just about all citizens to decent (which in some cases means subsidized) housing; job security for the large majority of the workforce (that has parallels with the U.S. Civil Service); and substantial government programs to help the unemployed and the poor.

The basic idea of a social market economy is making capitalism more humane in order to sustain political support for the system, but not to interfere with market forces so much as to lose the efficiency gains of capitalism. The line between what the private sector provides via the interplay of market forces and what the state provides as a matter of political right is, to some extent, blurred. Germany's economic performance (as well as that of the other West European countries) has been helped by the willingness of its people to save and to work hard, traits that to a degree are culturally determined.

In Germany, as in the other countries of (especially Northern) Europe, the social and business infrastructures are excellent, the cities are generally more livable than those in the United States, and there exists only a relatively small underclass of "have not" persons. But it should not be forgotten that these achievements came relatively recently, not early in the period of postwar reconstruction and expansion. Behind the success is decades of painful sacrifice, initially including high unemployment. Furthermore, Europe's property rights under the current system are much less entrepreneurial and adaptive than property rights under the U.S. system. The most revealing evidence for this is their highly disparate rates of growth in long-term job creation. To be sure, Europe's problems are being addressed by the 1992 process

of economic integration, which borrows some of the best features of the American system.

As an aside, note that the difference between a German-type social market economy and the “market socialism” ideas in Eastern Europe and the Soviet Union is fundamental. Although there is no precise or fully agreed to definition of market socialism, its advocates believe that the introduction of *limited* market forces can help preserve an economic system in which the means of production should remain predominantly nonprivate, the government should play a substantial role in directing economic activities, and the distribution of income and wealth should be relatively egalitarian. Market socialism often entails giving workers a substantial role in management. Advocates of market socialism are suspicious, often for ideological reasons, of capitalism and of markets; market socialism is their terminal of retreat in the face of the proven basic faults of a centrally planned economic system.²

The U.S. model, termed a *consumer market economy*, assigns a powerful role to the pull and push market forces (and only a minor role to the government) to promote economic growth through adaptation. The entrepreneurial spirit is vigorous and the mobility of the factors of production, including labor, is high. The efficiency of the market is praised and government interference is criticized (although reality is not as extreme as the image). To be sure, long-run market efficiency is probably impaired by the often short-term horizons of corporations, the get-rich-quick schemes chased by many entrepreneurs, and by the inordinate amount of litigation and financial manipulation that are also a part of the system. Government regulation (and deregulation) typically targets as the beneficiary the consumer rather than the producer. Social pressures and government policies promote private consumption over saving. This preference is reflected not only in individual and corporate behavior but sometimes also in irresponsibly large deficits in the government budget.

Critics note that the U.S. paradigm excessively promotes the virtues of short-term market efficiency and individual consumption over long-term growth, equity, and addressing social problems. There is an underprovision of social investment. America’s infrastructure has been

deteriorating. And a large underclass, with no stake in the prevailing economic and social order, has emerged and is being perpetuated.

Japan's paradigm, termed a *corporatist market economy*, is a particularly successful blend of features rooted in Japan's own environment and traditions.³ One of its main features is intense competition for greater market shares rather than for short-term profits. This has led to long-term thinking and continuous improvements in efficiency, productivity, and cost-competitiveness, even though the domestic market has been sheltered—often for long periods, until domestic firms in an industry have matured fully—from foreign competition. Most Japanese firms have a strong commitment to employment security, but not to the preservation of the specific jobs of individual workers. This, in turn, has justified large corporate expenditures on retraining programs and relocation. Together with Japan's rapid rate of growth and the downward flexibility of wages, these features have contributed to its enviable record of full employment, flexible market adaptation, and spectacular economic success.

Perhaps no factor is more important in the Japanese model than its promotion of an extraordinarily high level of voluntary savings and investment. These are prompted by the pressures as well as opportunities of its economic system, by its government's policies (providing large incentives to save and a stable financial framework), as well as by the traditions of the Japanese culture. There is a close working relationship between the government on the one hand and business and labor unions on the other. The bureaucracy has maintained and uses skillfully its authority over the private sector, mostly by assisting producers rather than consumers or labor.

We should not forget that Japan's spectacular success is of relatively recent fruition; in the later 1950s, its level of development was measured to be on par with those of the USSR and the countries of Eastern Europe, on average. Japan has achieved what it has today by sacrificing consumption over a long period; by working extremely hard, including the sacrifice of leisure (an attitude that is instilled in early childhood); and to some extent also by neglecting a bit its infrastruc-

ture, the environment, and (until recently) the global burdens shouldered by other large and economically successful nations.

The newly industrialized countries of Asia (e.g., Korea, Taiwan, Hong Kong, and Singapore) have much in common with Japan's paradigm, although no two countries have fully identical economic policies and systems.

Common Causal Factors in Successful Market Economies

Although there are major variations in the economic systems and policies among even the successful capitalist market economies, the economic systems and policies of such countries appear to have shared, to a greater or lesser degree, the following essential features.

1. *Private Ownership.* The means of production are predominantly privately owned. State-owned enterprises, in some cases accounting for as much as one-third or more of output, have played a more important role during the early stages of reconstruction and development, when unemployment was still high and voluntary savings still low, than subsequently. State enterprises tend to be more efficient when they function in a competitive environment than when they are insulated. In a competitive environment, state ownership does not automatically mean gross inefficiency if the firms receive no subsidies or the subsidies are given in ways that do not cancel the pressures and rewards of market forces for the firm. However, since the operation of state-owned firms is difficult to insulate from political and bureaucratic pressures, practically all the industrial countries have implemented programs of privatization in recent years.

2. *Competition and Trade.* The single most important feature of a well-functioning market system is strong competition. Countries whose domestic markets are large enough to accommodate more than a handful of firms in each industry, such as Japan, could afford to be protectionist and still maintain strong competition. However, countries that are small or medium-sized must open up to import competition

and eventually direct foreign investment. Full competition requires sound and predictable rules and regulations in all areas of production and trade. It is the government's responsibility to establish and enforce them, unless industry or trade associations can do the job as well or better.

3. *Sound Currency.* One of the essential functions of government is to provide a sound currency. This means a low rate of inflation and full convertibility as soon as practicable. The rate of inflation can be kept manageable only with sound monetary and fiscal policies (for which there are general guidelines but no precise recipes); the same is also a precondition for meaningful convertibility. A low rate of inflation and the expectation that inflation will not get out of hand are necessary to motivate business firms—as well as households as savers and providers of labor services—to take the long view and to focus on real economic activities instead of devoting their energies to hoarding, speculation, and other kinds of manipulation to protect the value of their assets. Convertibility is essential to link the domestic economy with the world economy; it facilitates the efficient cross-border flow of goods, services, and people. No meaningful import competition or trade along the lines of comparative advantage is likely to take place without the currency being convertible.

4. *Savings, Taxation, Financial Intermediation.* An adequate-to-high level of savings and efficient financial intermediation of the incomes saved by households (the most important source) and businesses into productive investments are essential common features of sustained good economic performance. Efficient investment in physical and human capital is the engine of technical progress and productivity improvements. In the long run, all countries must rely on domestic savings to finance an adequate level of domestic investment. Net borrowing from abroad can assist a country only temporarily and only on the margin.

Countries that have reached a certain level of development need a reasonably sophisticated and competitive banking system. This means a system that is largely private, with investors risking their own money and seeking profits. Savers and investors must have at their disposal an

array of attractive financial instruments (e.g., savings accounts, stocks, bonds and the like).

The rate of taxation, direct plus indirect, on business profits and personal incomes must not be prohibitive, that is, it must not be so high as to act as a disincentive to putting forth a strong economic effort by investors, entrepreneurs, managers, professionals, and workers. There is no precise figure on what threshold level of taxation begins to seriously inhibit economic effort; that depends in part on a country's economic circumstances and its culture. But a tax burden that is greater than 50 percent is certain to be constraining; some believe that the threshold rate is considerably lower.

5. Infrastructure and the Environment. A sound infrastructure (e.g., a well-functioning system of telecommunications, an adequate network of transportation, good schools, hospitals, and housing) is needed both for the sake of business efficiency and as a vital contribution to a decent standard of living. In addition, people increasingly want the government to help protect the environment. Businesses and people are generally willing to pay for these benefits through some combination of user charges and taxes.

6. Opportunities for Individual Fulfillment. Human beings want opportunities to seek personal fulfillment. This means, first and foremost, the political and economic freedom to pursue goals as investors, entrepreneurs, farmers, professionals, and wage- and salary-earners. A pluralistic and relatively stable political system provides the most supportive political environment; economically, the previous paragraphs summarized much of what is needed. In addition, people want a proper and well-managed workplace; an equitable system of personal compensation and a reasonably fair distribution of income and wealth; some degree of employment security; and a back-up system of minimum income maintenance in case of dismissal, old age, or ill health. And since more and more of the simple jobs are being automated (except in the poorest countries), both future employability and personal fulfillment require broad and affordable opportunities for a good education, including continuous upgrading of skills and retraining.

The factors just enumerated are strongly interdependent. For example, competition is not likely to be strong and investment efficient if the means of production are not predominantly private. The voluntary savings needed for investment are unlikely to be forthcoming if the currency is not sound and the taxes are excessive. Foreign competition and integration into the world economy are essential; to achieve them, a convertible currency is needed. These are just a few examples; the list of linkages is extensive.

Legacies of Socialism, Transformation Operations, and Recommendations

To judge what it would take to transform the economic systems and policies of the countries of Central and Eastern Europe into systems that would sustain good economic performance, let us look at the economic legacies inherited by the new governments, using the preceding framework. We also highlight the options and problems of transformation, and make recommendations.⁴

Much of what these countries have inherited in the economic realm, and also their options for transformation, is similar, but certain differences will be noted. The German Democratic Republic, of course, stands out as the country whose absorption into a unified Germany simplifies, first, the intellectual problems of transformation (in terms of not having to spend time searching for an appropriate kind of economic model) and, second, financing its huge costs, which will ease some or much of the pain.

1. *Ownership.* There are not proven ways to develop efficient and fully competitive markets and to motivate producers toward efficiency, customer satisfaction, and innovative behavior in economies where most of the means of production are state-owned. In Central and Eastern Europe, state- or worker-owned enterprises and large cooperatives that function similarly account for much of production (agriculture in Poland and Yugoslavia is an exception) and own an even larger share of productive assets. Privatization is, therefore, a cornerstone of the

transformation. As yet, none of these countries has put in place the full complement of laws and policies that set out firmly the scope, the speed, and the strategies of privatization.

Privatization faces a number of major constraints.

(i) In Yugoslavia, Hungary, and Poland earlier reforms have transferred some of the (not always clearly defined) ownership rights to workers or their elected representatives, in the mistaken belief that this would improve efficiency. Workers often oppose privatization or object to terms of the sale that would be acceptable to a private owner. The two main policy options are to continue to allow workers a say in privatization or to “renationalize” such enterprises, returning to the government all rights of ownership. The latter appears to be the preferred solution on economic grounds, but it is politically exceedingly difficult because it appears to be a step backwards.

(ii) Most businesses will require considerable restructuring before or after privatization because they are typically overstuffed, lack modern production and marketing expertise, and cannot raise sufficient capital in their present state. The arguments for restructuring *before* privatization are that it would be politically more acceptable for the government than for private (especially foreign private) owners to do it, and that revenues from the sale would be greater. The argument for restructuring *after* privatization is that the state may not have the political will or know-how to do the job. My view is that the approach must be country-, sector-, and enterprise-specific.

(iii) There is insufficient accumulated domestic private wealth to find buyers for more than a small fraction of the enterprises to be privatized. Those who have capital often have acquired it in ways the population does not consider legitimate. The main options are (a) to gear the scope and speed of privatization to the availability of private domestic and foreign capital; (b) to give every citizen a share in every enterprise, via holding companies; (c) to finance a portion of the equity acquired by nationals of the country with a special line of credit; and (d) to make large sales and/or placements to pension funds, mutual funds, local governments, insurance companies, nonprofit foundations, and like

organizations. Each solution has advantages and problems; some combination of (c) and (d) would seem to be the best strategy.

(iv) Many sectors of production and distribution are dominated by monopolies or oligopolies. Therefore, it is necessary to consider the effects of each privatization on competition.

(v) How should state property offered for sale be valued? One problem is that costs, prices, and the accounting system are arbitrary; a more fundamental one is that private investors are typically willing to pay only a price warranted by the firm's *existing* level of efficiency and earnings, while the population, the press, and most local politicians would like the investor to pay for *future* earnings expected after the improvements. This is as much a political as an economic debate. Many are against privatization, whether because of ideology or envy, and they use economic arguments to support their criticism. A further problem is that in some of the countries, "sweetheart" deals have been consummated between management and buyers through "spontaneous" privatization deals. The recommendation of most experts is that the only way to assure a fair price is to establish, publicize, and enforce fair, competitive, and transparent privatization procedures, and then let the market determine value.

(vi) Should foreign investors receive the same, preferential, or dispreferential treatment as domestic investors? Most experts agree that "national" treatment makes the best economic sense, although simultaneous preferential and dispreferential treatments in certain areas may be justified, some perhaps on a temporary basis.

(vii) Who should get the proceeds and how should they be used? The most basic issue is how much of the purchase price should go to the state and how much should be invested in the enterprise itself? If all proceeds went to the state, would investors be able to pay also for the cost of restructuring? Would that not reduce too much the incentive to bid? But if all or most proceeds went to the enterprise purchased, the investor would then "buy itself" and the state would get little. It seems that no generalized solution can be recommended. The government's revenues from privatization (outright sale, down payments, and debt service) should be used mainly to reduce the government's domestic

and foreign debt; a modest share should be contributed to a revolving fund to provide credits for the start-up and expansion of private business ventures.

In sum, privatization faces immense economic and political dilemmas. There are many additional and extremely difficult issues we did not even touch upon, such as handling of the liabilities of an enterprise when only some of its assets are sold, the issues of compensation to owners expropriated after the war, and the privatization of land and housing. All privatization issues are extremely sensitive politically. Most political positions can be justified with economic arguments, some more sound than others. It is worth noting that while the privatization experiences of market economies can offer helpful insights, in Central and Eastern Europe the process has to take place on a much larger scale and in an environment in which much of the capital and many of the essential supporting institutions are inadequate or nonexistent.

2. *Competition and Trade.* In the Council for Mutual Economic Assistance (CMEA) countries, central planning has replaced the market as the main mechanism of resource allocation. The markets that remained or have emerged, mostly in certain consumer goods and services, are functioning inefficiently, especially in the countries where central planning is still pervasive. The chief problem is market segmentation. In some countries most goods and services, in other countries many, are distributed at state-controlled prices and are in short supply. Consequently, all kinds of nonprice mechanisms of allocation have emerged. Therefore, the markets that do operate typically embody large “spillover” effects. This means that the “free” prices on those markets are often much higher than would normally be justified because the money that cannot be spent on the many goods and services that buyers would really have liked to purchase “spills over” into demand for those goods and services that happen to be available. Even in Hungary and Yugoslavia, where past reforms have made planning and the market theoretically coexist and jointly determine resource allocation, the new governments have inherited situations in which the

bureaucratic direction of the economy has remained dominant, even if the instruments used are not those of direct central planning.

The quick freeing of the prices of most goods and services is hampered by the high degree of monopolization of the domestic markets, because norms of fair competition are not well defined, by the almost complete absence of import competition (except in Hungary since 1989 and Poland since 1990), and the prevailing mechanism of intra-CMEA trade.

Creating and maintaining competition requires that the following steps be taken, more or less simultaneously.

(i) Adopt a program of deconcentration (coupled, whenever possible, with privatization) that breaks up those monopolies where technical and economic considerations allow it and where import competition is weak or absent.

(ii) Promote the establishment and growth of small and medium-sized enterprises.

(iii) Establish sound competition policies and institutions, based on freedom to acquire property, for the business firms to enjoy unrestricted entry into and exit from the market, and for labor to freely migrate within the country. Adopt transparent norms of unfair competition, with effective mechanisms for enforcement.

(iv) Create an economic, financial, and legal framework that promotes the development of market forces. Especially important is the creation of efficient capital markets.

(v) Announce a program and timetable for reducing most subsidies. In the enterprise sector, this should be coupled with imposing greater financial discipline on firms and exposing them to domestic and international competition.

(vi) Reform the system of wage determination. One legacy that is highly problematic is that up to one-half of an average wage-earner's total compensation has been paid in the form of free or subsidized goods and services. If subsidies are to be reduced and real incomes are not to decline precipitously, wages and salaries must be adjusted upward. This complicates the problem of wage determination (which is already troublesome because of the absence of real owners to resist

unjustified demands for wage increases; their place is taken by bureaucratic regulation). When can wages be allowed to be fully market-determined and whether and how to create a level playing field of wage-setting between state-owned and private firms are two of the many difficult strategic issues of transition.

(vii) Change the existing mechanisms of intra-CMEA trade and finance because a system in which governments direct enterprises in what to export and import is not compatible with a market system, nor is the settlement of transactions in transferrable rubles (TR). In June 1990, the Soviet Union abrogated its network of bilateral agreements to settle its transactions in TR and proposed switching to dollars. This change will almost certainly be introduced next year. Much more difficult is delegating trading decisions to enterprises. Given the Soviet Union's prevailing system and growing economic crisis, it is not inclined to alter the existing arrangements. While in principle it is possible for an East European government to tell its domestic enterprises that they must sink or swim on their own in trading with the Soviets, the impact of such a change on the volume and composition of trade would be very uncertain. To be sure, the economic crisis in the Soviet Union and elsewhere in the CMEA, and the pressures to reorient a significant part of intra-CMEA trade to the world market are, in any event, causing huge shocks and uncertainties for these economies, irrespective of what happens to their system of trading. It is paradoxical that while changing the system of trade would add new uncertainties and burdens in the short run, such a change is in fact unavoidable if a country wants to respond effectively to the crisis in intra-CMEA trade.

(viii) Import liberalization of convertible-currency trade must be the centerpiece of programs creating a competitive economy, allowing prices to be market-determined, promoting exports, and improving the gains from trade. The existing system of mostly implicit quotas and other administrative restrictions must be transformed into tariffs and exchange rate-based "controls" on imports. Import liberalization will be easier in countries like Hungary and Yugoslavia that, over the years, have introduced significant reforms in foreign trade by weakening and eventually disbanding the state's monopoly of foreign trade and by

granting foreign trading rights to a growing number of business entities.

3. *Sound Currency.* One of the legacies of a socialist system is pervasive shortages, which means repressed inflation. Shortage is caused by two distinct phenomena. One is the unavailability of goods and services in the right quantities or assortment, or at the time or place needed, i.e., poor matching of demand and supply at micro levels because markets function so poorly. This kind of shortage is largely the result of the economic system. In certain countries, especially in Yugoslavia and Hungary, the reforms introduced in the 1960s were able to reduce shortage but not eliminate it.

The more traditional source of repressed inflation is the result of excess money and credit creation *cum* price controls. The pace of money and credit creation is a policy decision that is not linked closely to the economic system. In recent years, policymakers in Poland, Yugoslavia and the USSR have sinned the most and consequently, by 1990, have come to face the most difficult dilemmas of what to do. If inflation—whether repressed or open—is high, that causes severe damage to the economy for reasons that are too well known to be listed. But wringing out inflation is exceedingly difficult, economically as well as politically, since it involves some combination of large though temporary price increases and restrictive monetary and fiscal policies which cause bankruptcies and unemployment.

Poland has implemented a drastic policy of stabilization. The Balcerowicz program, introduced January 1, 1990, opted for: the rapid elimination of the budget deficit through large cuts in subsidies and other kinds of spending; a very tight monetary policy, initially involving large interest rate increases to restrain credit demand and to create incentives for saving; the closure of unprofitable enterprises, thereby abandoning job security; restricting wage increases to a fraction of the rate of inflation; the virtual elimination of all price controls (except energy and housing); and introducing resident zloty convertibility.

At the time of writing (July 1990), it is too soon to give a definitive assessment of the Balcerowicz program. The economy that the new government had inherited was in such a deep crisis that something

drastic had to be done, so shock therapy was perhaps unavoidable. But is obvious (by hindsight as well as foresight) that in Soviet-type economies, inflation is even more difficult to control than in market economies, and for several reasons.

(i) Commercial banks in a Soviet-type economy do not respond to tight monetary policy the way banks do in a market economy. One legacy of the system is that banks do not, as a rule, push enterprises into bankruptcy if their loans are “nonperforming.” When the commercial banks were established (in most countries during the last few years, by separating out a part of the former monobank that performed both central and commercial banking functions), they were given an arbitrary portfolio of assets (outstanding loans to enterprises) and liabilities (enterprise deposits) without sufficient reserves to write off the bad loans. And the authorities cannot afford to push into bankruptcy the handful of banks that do operate in these countries.

(ii) The alternative, that of the banks foreclosing on enterprises, is also not practiced. Given the arbitrary nature of costs and prices and the state-imposed supply responsibilities on producers, firms that are loss-making or illiquid are not necessarily those that are truly the worst performers. Even in countries such as Hungary and Yugoslavia where the problem of arbitrary pricing has been improved substantially by reforms, many enterprises are in a monopoly or oligopoly situation. They claim, perhaps with some justification, that their production is essential for supplying the domestic or convertible-currency markets. Given the precarious status of these countries’ balances of payments, the threat that their production will be replaced with imports unless they shape up is not credible.

(iii) The way enterprises get around tight monetary policy is “credit queuing.” When firms cannot obtain direct financing, they sell to each other on credit. The second enterprise may be unable to pay as well because it is *de facto* bankrupt or because it has itself given pseudo credits to other enterprises, and so on down the line (or “queue”). In a market economy, where enterprises have real owners, there are economic incentives for a creditor to force a nonpaying debtor into bankruptcy, or for the debtor to voluntarily declare himself bankrupt. In a

socialist economy, nobody has an economic interest in bankruptcy, or cares if unsound business practices further dissipate the value of an enterprise's assets.

(iv) The only way around these problems (before real owners are found and market institutions are created, which will take time) is for the authorities to institute draconian measures and to let the chips fall where they may. This is what Balcerowicz has done in Poland. But enterprises—not being accustomed to such pressures and not having much experience in how to be flexible, cut costs, and find and adapt to the requirements of new markets—tend to be paralyzed. In the lingo of economists, their supply response is weak. In the meantime, production declines precipitously and unemployment jumps.

The problems just enumerated are not just those of Poland and the countries that must deal with a large stock of excess money and credit. These are problems for all countries during their early stages of transition to a market economy. They too are finding (or will find) it difficult to control the strong inflationary pressures that are generated by:

- reductions of subsidies and the freeing of prices in an economy where producers face insufficient competition;
- increases in nominal wages (including the substitution of subsidies by money wages);
- depreciation of the real exchange rate;
- having to finance the terms of trade losses with the USSR as the CMEA moves to convertible-currency settlement;
- servicing large foreign debts, which reduces domestic supply; and
- increased inflationary expectations.

Thus, it is easy to say that sound money is needed for an economy to perform well, but realize it is very difficult as pressures for substantial price inflation increase and are notably difficult to control.

Although the policy dilemmas are somewhat different in countries where inflationary pressures are very large versus those where they are most moderate, the essential policy question is still whether to try to get inflation out of the way quickly by a more or less once-and-for-all increase in the price level (bunching together as many as possible of the factors that account for inflation), which involves a willingness to

suffer the political price and run the risk that inflation may get out of control altogether, or restrict prices to increase more gradually, which makes the process more protracted and the medicine perhaps less effective.

In either case, it is essential that no time be lost by the authorities in creating or strengthening those monetary, banking, and financial institutions and instruments that are essential for monetary policy to be effective.

Sound money also means a convertible currency. There are many different kinds of convertibility: for residents and nonresidents, for the enterprise and the household sectors, and for current- versus capital-account transactions. Most important, I believe, are (a) that domestic enterprises be able to buy the foreign currency to pay for imports; (b) that foreign investors be able to convert their local earnings and repatriate the capital invested; and (c) that foreign tourists could readily obtain the local currency at a single exchange rate and that the inflow be channeled (via the authorities or via a foreign exchange market) into imports and debt service rather than into the mattresses or foreign bank accounts of currency speculators.

Should the exchange rate be fully market-determined by letting it float; should the authorities fix the rate and try to maintain it; or should they opt for an intermediate solution, such as frequent but small adjustments?

The main advantages of the floating rate are that the authorities need not maintain large reserves and that there will be a single exchange rate in the economy. Its disadvantage is that under conditions that typically prevail in these countries during the early stages of transformation, the market will assign an extremely low value to their currencies relative to their purchasing power. This makes not only exports but domestic assets also very cheap to foreigners. That, in turn, creates or exacerbates the political problem of foreign investment and also feeds inflation.

The advantage of a fixed exchange rate (depending on where the rate is set) is that it mitigates the above problems. Its disadvantage is

that fixed rates are not possible to maintain without economic policies that support them, and without adequate reserves.

Poland, as part of its program of economic stabilization and liberalization, decided on a very substantial devaluation, eliminating the huge difference between the official and grey market rates, and then trying to keep the rate fixed. Hungary also has a fixed exchange rate regime, periodically adjusted for inflation differentials, but its official rate values the forint significantly higher than the rate prevailing on the parallel (grey) market, so it has a *de facto* multiple exchange rate system.

4. *Savings, Taxation, Financial Intermediation.* One legacy is the very large share of the German Democratic Party that is channeled through public coffers—60 to 65 percent—which of course has to be covered by taxes. Extensive redistribution in the form of transfers and subsidies to and from enterprises and households is the main reason why the share is so high.

The net voluntary savings of households (the sector that throughout the world provides the bulk of savings) is much lower in socialist economies than in market economies for the following reasons.

- The share of personal income in the total income of the population is low because too much is distributed centrally.
- The share of personal income saved is also lower than in comparable market economies because, until now, governments have provided full pensions, free education and health care, and job security. International studies of what motivates household savings show that the precautionary motive (the individual's desire to weave a personal safety net) is the most important. Therefore, one reason that governments in Central and Eastern Europe need to substantially reduce their cradle-to-grave systems of support is to encourage voluntary savings; another, of course, is that many of those programs are dysfunctional and too costly to be affordable without imposing prohibitively high individual and business taxes.
- In some of the countries the level of household debt is very high because automatic entitlements to subsidized loans for housing have created the incentive to assume the largest possible mort-

gages. In Hungary, for example, housing subsidies alone (mostly on the interest rate) consume 15 percent of the central budget.

- Real (or perceived) interest rates on household savings have been negative until recently, in all the countries; it is still the case in some of the countries.
- The absence of opportunities to buy stocks, mutual funds, and other financial and real assets has reduced the incentive to save for investment purposes.

In such systems, much of the economy's large savings is generated by way of very high direct and indirect taxes. For example, Hungary today has a 53 percent payroll tax (43 percent paid by the employer and 10 percent by the employee), a 50 percent marginal income tax rate, a 40 percent corporate profits tax, a value-added tax of up to 25 percent, plus many additional specific excise taxes. The government then decides, politically and bureaucratically, how to allocate its large revenues. This helps explain why these economies have such notoriously low efficiency of investment.

The main objective of fiscal policy during the transition should be to reduce significantly the tax burden on producers and households while, at the same time, balancing the budget. To encourage capital formation, retained earnings should be taxed at significantly lower rates than distributed earnings, and savings and capital gains should be granted preferential tax rates. Other exemptions should be reduced and the tax systems restructured to conform to international standards.

There is an urgent need in all these countries to strengthen the financial system by allowing much greater scope for competing private financial intermediaries, including foreign-owned ones. Private financial intermediaries are essential for improving the efficiency of investment allocation. There is a role for governmental institutions and programs, but they too should be run in a businesslike fashion.

5. Infrastructure and the Environment. Two areas where the all-powerful governments of the socialist countries should have outperformed their counterparts in market economies are building and maintaining infrastructure and protecting the environment. How paradoxical that especially in these areas all the centrally planned

economies governments have performed so disgracefully poorly. The extent of environmental degradation is immeasurably worse in Eastern than in Western Europe. This is explained partly by the priority placed on development of mining, metallurgy, the chemical sector, and other heavy industries, and partly by simple inattention. Infrastructure has also been neglected. One reason for the worsening crises in these economies is that by now they have “used up” much of the infrastructure inherited from before the war.

It is urgent that environmental regulations be tightened and enforced and that a long-term program of clean-up be adopted and financed, partly from external sources. Practical considerations suggest that infrastructure should be opened up to foreign investment since the budgets of these countries are simply not in a position to devote the resources needed to develop and maintain infrastructure at the desired level of efficiency.

6. *Individual Fulfillment.* It was already mentioned that one of the legacies is a cradle-to-grave system of social programs. This seemingly attractive public aim has turned out to stifle personal responsibility and to generate a large bureaucracy and many regulations, with a great deal of corruption and waste. The transformation must begin with a recognition that governments cannot fulfill people’s lives through pervasive interference, however well-intentioned. Governments’ responsibility is to create a stable economic and political environment and the confidence-inspiring institutions that permit individuals to fulfill their own lives.

Although it is up to each country to adopt the kind of social support systems it wants and can pay for, the direction of the needed changes includes the following.

- Subsidies for consumer goods and services should be reduced or eliminated.
- Housing, which in most countries represents a huge and unsustainable drain on the state budget and causes serious distortions in fiscal and monetary policies, needs to be privatized and much of it commercially operated. Unsustainable terms of outstanding mortgages must be changed.

- Only a minimum level of pension should be compulsory and operated by a government agency; private pension systems should supplement it.
- Retirement ages should be adjusted to reflect demographic realities, the country's labor force needs, and ability to pay the state's pension obligations.
- To improve the efficiency of health care delivery, the cost of routine medical services and related prescription drugs should be reimbursed only in part, except for patients with very low incomes. Privately operated health care should be allowed to compete with socialized health care as an incentive to provide high-quality service at affordable prices (more or less the Canadian system).
- The above-recommended changes in programs, together with the elimination of job security for all, will require the establishment of a new kind of social safety net which should rest on two pillars: unemployment compensation and assistance to the needy.
- The systems of education as well as training must be changed, for the sake of better individual fulfillment and also to prepare the kind of labor force their economies need today and even more in the future. In all these countries, access to higher education is much too exclusive and restricted. The proportion of young people in secondary and especially in tertiary education is much lower than in the Organization for Economic Cooperation and Development countries and it must be raised. Today's curriculum (in education as well as in training) tends to prepare for skills that are defined too narrowly and are often obsolete. The curriculum must be broadened, putting more emphasis on basic skills, interdisciplinary studies, communications, and greater individual choice of courses and flexibility of thinking.

Conclusions and Implications for Western Policy

Transition involves changes in the economic system, strategic economic decisions, and economic policy choices.

The most important strategic decision is the sequencing and speed of transition. In countries that face an unusually large macroeconomic disequilibrium, the highest priority must be given to stabilization. This may require what in popular parlance is known as shock treatment. Immediate attention must be paid also to introduce those reforms in the institutional framework that are needed to make stabilization policies effective.

One of the great unknowns is whether it is possible to significantly improve economic efficiency as long as most enterprises remain state-owned and partly worker-managed. The only option is to try, since there is no easy and quick solution to privatization. The key must be to design and then hold firmly to a program, with a timetable, that introduces greater competition and eliminates the hope for case-by-case state support for the enterprises that are failing.

Concerning the pace of systemic transformation, the place for caution is at the policy deliberation phase, weighing the alternatives, the likelihood of achieving intended and unintended consequences, sequencing choices, and modes of implementation. Measures should be packaged into large bundles because the economy operates as an organic whole and not as an unrelated collection of bits and pieces. Packaged into large bundles, the linkages in the system can be relied upon to effectively enhance every other action.

Moving rapidly also makes political sense: to prevent a consensus that forms immediately after the elections from dissipating before a large package of measures is implemented and results become evident—probably a minimum of two to three years. Any large program, such as privatization and foreign economic liberalization, will take years to implement, even at maximum speed.

Agreements with the international and regional organizations, such as the International Monetary Fund (IMF), the Group of 24, and the European Community, can help a government sell a tough program

domestically by holding out the promise of such economic benefits linked to program implementation as, for example, some type of association with the European Community. International agreements can also enhance the government's credibility that its program will be implemented.

Credibility also means not raising unrealistic expectations. If government policies lack credibility, are hesitant, are full of unworkable compromises, then managers and individuals will refuse to change their behavior to fit the new policies. This, itself, can undermine transformation. For certain countries, such actions also undermine international creditworthiness.

Tremendous obstacles stand in the way of governments following the suggestions outlined in this essay. In some countries, the first problem is that of insufficient credible and mobilizable expertise to design good programs. Even in countries where the requisite expertise can be found (e.g., in Hungary), there is this question: will the experts—many of whom have cooperated with the previous and rather liberal Communist governments and/or are associated with one of the opposition parties that is not a member of the governing coalition—be listened to by the authorities or be pushed aside as “politically unreliable”? There are signs that this is happening, which is a great pity. None of these countries has a second set of first-rate experts waiting in the wings, as there are in the industrial countries.

The most fundamental constraints are political. Throughout the region, the population has high expectations that changing the political system will bring about quick economic improvements. Democratic elections, with new and old parties competing for power, tend to reinforce these expectations with promises that are unrealistic. In some cases the promises are made because politicians do not understand the situation, in others out of sheer demagoguery. To make matters even more difficult, there are many politically influential persons who still believe in their heart of hearts that some kind of a third road is a viable option and behind the scenes are pushing the policymakers to take it. Not infrequently, such persons hide behind market economy slogans.

Newly elected politicians in all these Central and Eastern European countries face an extremely difficult and unpleasant situation. They have inherited the sorry legacies of the previous regime. These legacies require the new governments to take a series of tough actions. Most have unpleasant consequences for the economic well-being of the population, and thus for political stability in the short run. The fruits of those actions will ripen only years later, perhaps after the next, or after the next-to-the-next, election. It is realistic to expect that wise statesmen are (or will soon be) governing these countries? This essay began with a statement that the body politic in four of the countries has made a *seemingly* firm commitment to become a market economy. Yes, they genuinely want to become like the social market economies of Western Europe. But this does not mean that they are also willing to take the tough steps that will lead there.

I have only a single thought concerning Western policy toward these countries. We should give them substantial economic help, but tie our assistance to tough and internationally well-coordinated conditionality. Some energy should be devoted to public education that explains the requirements and pitfalls of transformation and the rationale of conditionality. Although the United States does not have much money to offer, it should rely on its intellectual and political leadership to direct a Western consensus on these issues.

Governments in Central and Eastern Europe should be expected and nudged to make the tough economic changes that experts agree are needed. Otherwise they will not and should not last long, and western assistance will have been wasted.

NOTES

1. The distinction among the three models derives from my discussions with and the writings of the distinguished Canadian economist, Sylvia Ostry. See, for example, her *Governments and Corporations in a Shrinking World: Trade and Innovation Policies in the United States, Europe, and Japan* (New York: Council on Foreign Relations, 1990) and her co-authored article in the May 1982 issue of the *OECD Observer*.

2. The idea of market socialism was first put forward in the 1930s by theoreticians in the West, such as Lange and Taylor, largely in response to the Great Depression. Next, it was revived in a

rather special form in Yugoslavia (socialist self-management) in the early 1950s as an alternative to the Stalinist model. Then it was resurrected in the 1960s by reform economists in Poland, Czechoslovakia, and Hungary. Perhaps the fullest expression of market socialism was the blueprint of Hungary's New Economic Mechanism, much of it introduced in 1968. Until the late 1980s, reform economists in all the Communist countries were politically constrained from advocating any system change more radical than market socialism. Today, as the political constraints have lifted in many of the former Communist countries and as negative experiences with models of market socialism accumulate, a growing number of specialists, including the author of this essay, have doubts that market socialism is a viable economic system. In some cases, market socialism refers to the temporary economic system that will be in place during the period of transition to a genuine market economy, when state-owned enterprises will still be dominant and the government will have to play a central and pervasive role in managing the transition.

3. For further details, see Masaru Yoshitomi, "Micro- and Macro-Foundations of Japan's Economic Success," in Andras Koves and Paul Maret (eds.), *Foreign Economic Liberalization of Hungary and the CMEA and International Experiences* (Boulder, CO: Westview Press, forthcoming). I have also benefited from discussions with Seiichi Masuyama of the Nomura Research Institute (London) about Japan's economic system.

4. From here on, this essay relies extensively on the findings and recommendations presented in *Hungary in Transformation to Freedom and Prosperity: Economic Program Proposals of the Joint Hungarian-International Blue Ribbon Commission* (Indianapolis and Budapest: Hudson Institute, 1990).