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Übergang zur Marktwirtschaft am Ende des 20. Jahrhunderts

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Transition to a Market Economy at the End of the 20th Century
Übergang zur Marktwirtschaft am Ende des 20. Jahrhunderts

Eleventh International Economic History Congress
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Edited by Ivan T. Berend

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PREFACE

The last two decades of the waning 20th century have been characterized by the spectacular world-wide victory of a self-regulating market economy. The system which was aggressively challenged at the beginning of the century and seemed to be buried under the ruins of a devastating war and depression in the interwar decades, was triumphantly reborn after World War II in the Western core countries. The Central and Eastern European, Asian, African and Latin American peripheries, however, stronger than ever, turned to alternative models. Modernizing dictatorships emerged: the state had a strict control over the economy and, in several countries, also owned a great part of it. More than one third of the world introduced some kind of planned economy with an overwhelming state control and ownership. The prophecy of Joseph Schumpeter at the end of the 1920s regarding the decline of capitalism and its transformation into a victoriously spreading socialism seemed to be the reality in a great and, between the fifties and seventies, growing part of the world.

From the mid to late seventies on, however, the international trend was not only halted but sharply and spectacularly reversed. The successful model of the Western core became the admired, praised and recognized pattern to follow all over the world. The *Zeitgeist* dramatically changed and irresistably penetrated even the birth place of the former alternative model, the home land of planning and state-ownership, the (former) Soviet Union and the state socialist countries in Europe, Asia, and the other peripheries and continents. Market transformation and privatization characterize the economies of Latin America, Africa and Asia. The world economy is in flux.

What happened? Why did it happen? What were the causes and what are the main characteristics of this transformation? What is even more important to analyze: what are the consenquences? What kind of economic and social cost have to be paid for such a transformation? Was the chosen model of a self-regulating, laissez-faire market system adequate? What are the lessons of the first chapter of transition, and do they challenge the universally accepted model of the eighties and early nineties?

These are crucial questions which require a proper answer by experts, scholars, policy makers and governments. Although these questions are burning practical-political issues of the present and future, and initiate economic, social and political analyses, a proper understanding is hardly possible without an interpretation of economic history.

This world-wide intellectual-political challenge initiated the decision of the Executive Committee of the International Economic History Association in 1990-91 to offer a special session on the topic at its XIth Congress in Milan in 1994. The task to prepare Session A/3 at the Milan Congress, which I was asked to undertake, was a great honor and also a similarly great burden. Fortunately, I gained the help and received the contributions of an excellent team, composed of members of the international community of economic historians and economists from Central Eastern Europe, Western Europe, the United States, India and Australia. Most of all, the enterprise was immediately recognized and highly sponsored by the *Südosteuropa-Gesellschaft* (Munich), and personally by its Managing Director, Dr. Roland Schönfeld, which made it possible to organize an excellent preparatory conference in the attractive

Nymphenburg palace of the Carl Friedrich von Siemens Foundation in Munich, in March 1993, and to publish this volume before the Milan Congress.

I hope very much that this volume and the session which will be based on it may contribute to a better understanding of a historical, and historically unprecedented, process which directly influences the life of millions and even billions of people, both those living now and those who will be born. A better understanding of the present exciting and highly debated historical transformation may contribute to influence historical trends – a goal and service of scholarship for the society.

Los Angeles, May 1, 1994. Ivan T. Berend

Ivan T. Berend

End of Century Global Transition to a Market Economy

– Laissez-faire on the Peripheries? –

Introduction

"Despite the fact", stated Giovanni Sartori in 1991, "that...a majority of the 175 countries...in official existence do not qualify as even minimal democracies, the *Zeitgeist* admits one and only one legitimacy, namely, that power derives from, and is bestowed by, the people. In today's modern world there is but one 'rightful government': freely elected government."[1]

The same could be said of free market economies. Although very few countries have a genuine free market economy, the *Zeitgeist* admits one and only one ideal legitimate economic system: a *laissez-faire* market economy without state interference, protectionism and public ownership.

After the fall of the Berlin Wall, the symbol of the division of Germany and the entire world into two opposing and confronting systems, an extreme though typical expression of the *Zeitgeist* was Fukuyama's vision of an 'end of history' which suggested the ultimate victory and unchallenged existence of a single, triumphant paradigm: liberal free market parliamentary democracy. Indeed, the entire world is on a spectacular march towards an 'ideal-type' *laissez-faire* system as described in textbooks by the Chicago School of Economics. Countries which had turned towards strong state interventionism, built a huge public sector and instituted centralized planning during the postwar period, now dramatically revised their policy and introduced privatization. Marketization became a leading trend through deregulation and the elimination of obstacles to free trade set up during the postwar decades.

What is the explanation of this historical trend? To understand the ongoing transformation, one would have to analyze the road which led to the present change.

1. Economic Models During Post-World War II Prosperity

Karl Polanyi's historical analysis "shows that never before our time were markets more than accessories of economic life...Where markets were most highly developed, as under the mercantile system, they throve under the control of a centralized administration which fostered autarchy...Regulation and markets, in effect, grew up together. The self-regulating market was unknown"[2] and first emerged in Great Britain during the 19th century.

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[1] G. Sartory, "Rethinking Democracy: bad polity and bad politics." *International Social Science Journal*, August 1991. No.129. Blackwell Journals UNESCO. p. 437.

[2] K. Polanyi, *The Great Transformation. The Political and Economic Origins of Our Time*, Beacon Hill, Boston: Beacon Press. Fifth printing. 1964. p. 68.

"[A]s the transition to a democratic system and representative politics involved a complete reversal of the trend of the age," added Polanyi, "the change from regulated to self-regulating markets at the end of the eighteenth century represented a complete transformation in the structure of society...[I]t demands...the institutional separation of society into an economic and political sphere...Such an institutional pattern could not function unless society was somehow subordinated to its requirements." [3]

Though it triumphed as an aftermath of the British Industrial and French Revolutions, the self-regulating *laissez-faire* economic system enjoyed short-lived success and was consistently challenged from the early 20th century on.

Of course various attempts were made to replace free market economics with fascist state-regulated and state socialist non-market systems in the interwar period; but special attention should be placed on the fact that the self-regulated market was successfully restored after World War II by the United States and (thanks to Marshal Aid) some of the "core" countries of Western Europe. This definitely played a determinant role in what has turned out to be unprecedented postwar prosperity.

The second half of the 20th century was the scene of the most rapid economic growth in modern history. During the quarter of a century following postwar reconstruction, the world economy achieved a 3.8% average annual growth rate. No single economic model has, however, been responsible for this economic success.

The United States, Canada and some countries of the European Community possessed market economies based on policies of large-scale private ownership and free trade. But several European countries achieved the same or even better results by means of the creation of a state-regulated and partly state-owned mixed economy. France, Italy and Austria, for example, developed a huge state-owned sector comprising between 25% and 50% of industry. State planning was also introduced in France, and Austria based its socio-economic system on a so called *Sozialpartnerschaft*, which was an institutionalized agreement system between the state, entrepreneurs and trade unions.

The Asian countries followed strong state interventionist policy combined with autocratic and, in several cases, even dictatorial political regimes. These modernization dictatorships have been among the most successful actors in the international economy. Though developing a democratic system, India adopted essential elements of Soviet-type planning and economic policy. Latin America has been characterized by dirigist modernization dictatorships and pronounced state domination of the economy, including the creation of huge public sectors and a controlled market. Similar patterns were followed by most of the newly independent Third World countries of Africa.

The backward, peripheral countries were highly impressed by the Soviet model of modernization based on central planning, state ownership and forced industrialization. This blueprint, an explicit antithesis of *laissez-faire* capitalism, conquered nearly one third of the world. It was adopted and imposed in Central and Eastern Europe but also in other continents, first of all in Asia (the most important examples being China, North Korea and Vietnam) and also in some African and Latin American countries.

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[3] *Ibid.* p. 71

Thus, various models existed in the postwar world economy, and they have competed vigorously with one another. Although these models were rather different, and, in a way, almost every country represented a special case, some generalization is still possible.

Taking a broad-brush approach, we may distinguish two major types: market and non-market models. According to this interpretation, the former may include the types of market economies that utilize state interventionism and often have a state-owned sector of the economy as well as some kind of planning. In these cases, however, state interference serves the market and counterbalances its shortcomings, rather than working against it. Countries employing regulated-market mechanisms sometimes have authoritarian or dictatorial political regimes as well. Hence, in addition to the classic *laissez-faire* countries, most of the European mixed economies and Asian state interventionist modernization dictatorships would fit into this category.

The second group consists of those countries where the market was destroyed, or where state intervention worked against the market, attempting to replace it with state activity. Beside the Soviet Bloc's central planning system, several Latin American, some Asian (for example India) and a number of African countries applied to this model.

Though there is some validity for distinguishing between these two basic types of economies, a differentiation among three models can offer a more accurate picture and a better understanding.

The author thus prefers to categorize the different countries into three models. In addition to non-market economies, a form which dominated one-third of the world in the 1980s, one may differentiate between two, somewhat different, types of the market economies:

- the *laissez-faire*, self-regulating free market economy, which is, as Karl Polanyi defined it, "an economic system controlled, regulated, and directed by markets alone...[N]o measures or policy must be countenanced that would influence the action of these markets...[O]nly such policies and measures are in order which help to ensure the self-regulation of the market by creating conditions which made the market the only organizing power in the economic sphere." [4]
- the regulated (often mixed) market economy, which is characterized by strong state interference and regulation. While the self-regulating market "subordinates the substance of society itself to the law of the market," [5] a regulated market is an "economic system [that is] absorbed in the social system." [6] A centralized administration influences the flow of money as well as supply and demand; and labor and land, meaning the society and its "natural surroundings," are often not subordinated to the laws of the market. In this model the economic system is controlled, regulated and directed by both the state and the market. State regulations assist as well as replace the market mechanism which is often incomplete.

After postwar reconstruction, in a quarter of a century, the non-market models enjoyed enormous success and a rather good reputation. Angus Maddison's calculations

4 *Ibid.* pp. 68–69.
5 *Ibid.* p. 71.
6 *Ibid.* p. 68.

offer a broad view of the results and reflect the simultaneous success of the different economic models. Between 1950 and 1973, the Central and Eastern European planned, non-market economies achieved their best performance, an unprecedented 3.9% average annual per capita growth of their GNP which surpassed not only their previous rate of development – which had averaged 1% between 1913 and 1950 – but also the rapid growth of the market economies: the non-European "core" countries, including the United States and Canada, had an annual average growth of 2.2%, while the European "core", including several countries with the so-called mixed economies, reached 3.8%.

The highly 'statist' and regulated Asian market model's success was characterized by its 3.7% annual growth. Dirigist-regulated Latin America could boast a less impressive 2.5%, and the African countries 1.7%. Centrally planned Central and Eastern Europe almost quadrupled its interwar growth rate and began to catch up with the West during the most rapid growth period in history. According to Paul Bairoch, these countries attained a level that represented 66% of the European average per capita GNP in 1950, and 83% in 1973.

This brief survey may illustrate the fact that no one single model was responsible for the exceptional economic growth, and that the various models were indeed highly competitive. Hence, the lessons of post-World War II economic history do not reflect the unquestionable triumph of *laissez-faire* capitalism. On the contrary, different types of market and non-market, *laissez-faire* and state-interventionist (for or against market), social democratic, Soviet-type, Peronist, Keynesian and Asian-type, planning and public ownership dominated the economic arena in most parts of the world.

Thus, the roots of the recent victory of *laissez-faire* free market system are not very deep. They go back only as far as the major structural crisis of the 1970-80s.

2. Technological Revolution and Structural Crisis in the Last Third of the 20th Century

The structural crisis which became manifest after the Oil Crisis in 1973, followed by a similar jolt in 1980, was generated by a gradually-emerging and dramatically-expanding technological revolution which transformed the world economy. The change of the old technological regime began immediately after World War II. Its first milestones were the first mainframe computer (with its 18,000 vacuum tubes), invented in 1946 at the University of Pennsylvania, and a transistor that was able to magnify electronic messages, a product of the Bell Laboratory in 1947. Parallel to this communications revolution in the making, the service branches, which utilized computers, expanded with extraordinary speed. Automobile and air transportation, television and an endlessly-booming tourist industry accelerated a process that was already between fifty and seventy years old that had fostered the emergence of a broad lower-middle class, professional, white-collar society.

A historic turning point occured in 1956, when the United States, the world's most advanced country, was the first to reach the point where white-collar workers outnumbered blue-collar workers. As was often maintained, industrial society – the child of the Industrial Revolution – had ended, and a new age had begun.

It would take some time before the practical application of the new technologies and industries achieved a certain critical mass and could impact on everyday life. Indeed, as Daniel Bell observed, the new age actually opened only in the 1970s. At the beginning of this decade, the microprocessor, the "brain" of modern computers, was developed in the Silicon Valley, and this had both symbolic and practical importance, opening the road to further and further miniaturization and an increase in capacity. As a result, the cost-per-bit of computer memory decreased by 28% annually from the mid-1970s. The age of computerization had arrived. Until then, there existed only large computers owned and utilized by government, large companies and universities. But now microcomputers became popular and widely used. Further refinements of this new technology made it possible to link personal computers to large units, as well as to create data bases. Networking, together with a new variety of telecommunications technologies such as teleconferencing, cable television, teletext and videotext were the great new inventions of the seventies. "The technical advances in microelectronics that occured in the 1970s and 1980s," sums up Everett Rogers, "have spurred the Communication Revolution." All this was connected with an emerging new "high-technology industry..., one in which the basic technology underlying the industry changes very rapidly." [7] The most important high-technology industries, such as electronics and its sub-branch, microelectronics, centered on semiconductor chips, whose application was the main driving force of a new age of technology that included biotechnology, aerospace, advanced instrumentation and pharmaceuticals. Modern communications and computers penetrated virtually every sphere of the economy. According to some calculations, by the mid-1980s, roughly one-quarters of the American jobs were connected with computers as primary work tool. As a result, industrial employment continued to decrease in the United States. By 1980, only 2% of its active population worked in agriculture, and 22% in blue-collar industrial jobs.

The new technological revolution was characterized not only by new inventions, new technology, and new branches of production, but also by an entirely new industrial environment. To mention only some of the most important emerging new factors, the technical revolution was distinguished by an unparalleled complex of installments and production systems, coupled with a newly-refined division of labor. As one expert stated: "Refinement is perhaps the first apprehendable, moreover, measurable characteristic of those instruments, which are transforming the world. We are assessing the technological parameters of the electronic circuits, whose capacities are permanently increasing, in microns and fractions of microns. This is the determinant factor of their...fantastic capacity of storing and processing as well as speed... There is a permanent struggle for fractions of microns. Microns and ractions of microns characterizing modern processing technologies, the preciseness of machine tools, the interlocking of surfaces..." [8]

Another element of refinement is the quality of materials. The impurity of materials is measured by hundredth or millionth of percentages. Special alloys represent

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[7] E. Rogers, *Communication Technology. The New Media in Society*, New York, London: The Free Press, 1986. pp. 14–15.

[8] T. Vamos, *Alamerult alepitmeny* (The Submerged Substructure), Budapest, 1991. (manuscript) p. 3. I am summarizing the following main characteristics of change on the basis of this paper.

connections of critical precision and require even higher quality standards. These demand the highest standards of hygiene within the industrial environment as a whole, a new requirement is, for example, the number of fragments larger than 1 or 0.1 micron allowed per one unit volume of air.

Complexity is the other most striking technological characteristic of the new technology. Recent electronic circuits already contain more than one million previously independent elements. A car or an airplane has several thousands, and tens of thousands, of components respectively. There are quite a number of products whose technological documentation is as heavy as the product itself. Huge international systems, such as telecommunications, air-transportation, or energy concerns, have an immensely-complex operational mechanism. The software for a new electronic trip-circuit may contain several million orders, and several hundred thousands machines can operate within one computer network. Complexity is even greater in production processes. A traditional product was easily processed if miniature measures and special tidiness were not required. Increased standards create myriad additional requirements. A half-size measure, a two-times refined surface, or two-times tidier product often require the fulfillment of five to ten times more factors. Several co-factors which might be neglected for the production of a traditional product would have to be counterbalanced. Production procedures are becoming much more complex; integral circuits have more than hundred working phases. The unparalleled complexity of the new technology characterizes the division of labor and demand rather than narrow specialization.

All these are immeasurably connected with a highly developed human-technological civilization and a new and advanced infrastructure of the information society. Since the highly complex system is in a permanent state of change and transformation, its interrelationships require a maximum flexibility. To adjust to this new environment and remain competitive implies thousands of social, organizational, infrastructural and technological prerequisites in all their complexity.

This "entire set of technological changes" led to the decline of previous technology and the branches which were based on it, while generating new leading sectors. This is what Schumpeter calls a "structural crisis" with its "creative destruction" comprising severe temporary turmoil, decline, or stagnation and other frightening symptoms of a sick economy with high unemployment, inflation and declining standards of living. In the late 1970s and early 1980s, the world had to face an unprecedented situation: stagnation combined with inflation ("stagflation"). Very few of the rich "core" countries remained immune, and most suffered temporary 10% to 12% unemployment with 10% to 20% inflation while the growth rate declined.

The relatively backward peripheries had a much more difficult time. Besides the painful experience of stagflation and increasing unemployment, they had to face an ever deepening debt-crisis and, in several cases, hyper-inflation.

In 1983, Brazil and Mexico accumulated debt of nearly \$100–100 billion, while Argentina, India and Indonesia amassed roughly \$30–30 billion. The unstoppable decline is reflected well by the fact that, in the late 1980s, Mexico had an annual trade deficit of roughly \$20 billion. The total amount of debt in Brazil, Mexico and Argentina surpassed the level of their exports by three to five times, and the annual debt service consumed between 50% and 62% of their export incomes in the late 1980s.

Poland, Hungary, Romania and Bulgaria accumulated huge amounts of debts, varying from $10 to 30 billion. The net value of debts in the region as a whole increased from $6 to $79 billion between 1970 and 1980. Indebtedness became a self-generating process from that time on, and the 1980s led to a hopeless and devastating galloping of debt. By 1990 Poland accumulated $41.8, Hungary $20.3 and Bulgaria $9.8 billion of net debts, and indebtedness of the region jumped to $110 billion. At the end of the 1980s, Hungary's total debt was just over two times higher than its export earnings, while the corresponding figures in Bulgaria and Poland were three and even five times respectively. Additionally, most of the new credits served as repayment for the old ones. From the more than $20 billion that made up the Hungarian debts, only about $4–5 billion was invested into the economy. Most of the Central and Eastern European countries, as well as several other peripheral countries with a non-market system, were caught in the indebtedness-trap. Several countries of these regions, such as Argentina, Yugoslavia, and Poland, could not avoid an annual rate of hyper-inflation of between 1,000% and 1,300%. By the late 1980s, economic collapse was unavoidable.

Moreover, the structural crisis outside the advanced world became more acute and long-lasting than that of the "core" countries, lasting throughout the second half of the 1970s and the entire 1980s. Where the OECD countries, the most advanced of the "core" nations, achieved 3.6% growth between 1986 and 1989, and where Asian reached an annual average of 3.7% between the entire period of 1973–1987, and while the United States, after the severe recession of the late-1970s and early-1980s, experienced an unprecedented new boom later, the countries with non- or limited market economies were unable to cope with the crisis.

State socialist Central and Eastern Europe was strongly hit. According to World Bank figures, Hungary, which had an annual growth of 6% until the late-1970s, suddenly dropped to 1.6% and 0.0% in 1979 and 1980. Closely-connected with its political crisis, Poland witnessed a -10.0% and -4.8% decline in 1981 and 1982. Yugoslavia declined to 1.2%, 0.6% and -1.1% rate in 1981, 1982 and 1983 respectively. There was no recovery to come. In the crucial years of 1986–89, Hungary achieved mannual growth of 0.9%, with Poland putting on 0.2%, Yugoslavia 0.5%, and Romania 0.7%. East-Central Europe's growth, dropped to 1.9% between 1973 and 1987, less than half of its previous annual per capita rate of development.

Latin American, African, Indian, and other restricted market economies shared the same experience: African growth, slow as it already had been between 1950 and 1973, declined from an average of 1.7% in 1973 to 0.3% in 1987, while Latin America's growth decreased from 2.5% to 0.8%.

The crisis-ridden peripheral economies applied mostly non-market models, and their severe economic turmoil was thus a predicament of both the relatively more vulnerable peripheral economies and the non-market systems that had ceased to promote the "catching-up" process. Hence, once again, the gap began to grow dramatically.

The failure of the non-market systems was most spectacularly illustrated in the fact that the gap between Central and Eastern Europe and the United States increased from 1:3 to 1:4 between 1980 and 1989. In this single decade, the disparity between the region and the European Common Market doubled. Previously underdeveloped South

Korea, which could claim only one-half of the average per capita income of Central and Eastern Europe in 1980, had closed the gap by the early-mid 1990s. Concluded Eva Ehrlich and Gabor Revesz, two analysts of the process: "The development model of East-Central Europe, which aimed to catch up with the economically advanced countries, not only failed to realize this basic goal but led to an opposite consequence, the increase of the existing gap." [9]

There was, however, not only the question of the rate of growth and its evolving trends. The real and major difference was that the crisis occured in Central and Eastern Europe and in other non-market economies without a real adjustment and restructuring. Destruction, therefore, was not accompanied by creation.

In analyzing the reasons of their failure, one has to stress the somewhat complex coincidence of several factors: the non-market economies were not only traditionally peripheral, backward and subordinated to the "core", but had also sought to achieve a breakthrough through strong protectionism, by shielding their markets from international competition and attempting to create national or regional isolation. Additionally, several peripheral non-market countries heavily militarized their economies, in acts of aggressive confrontation or self-defense.

Protectionism and isolation from the world market definitely helped foster industrialization and rapid growth in the postwar world economy during its first quarter century. But when the harsh structural crisis made basic technological transformations manifest, and radical restructuring based on new technology became the most important requirement of the age, a country's isolation from the world market became a major obstacle to transformation and adjustment. The more militarized and protectionist the regimes became, the less able they were to adjust to the new situation.

The technological revolution and structural crisis of the last one-third of the century might serve to highlight the importance of a highly-flexible economy with market acting as an incentive and highly-motivated entrepreneurial interests prevailing. The advanced market economies were far better suited to the new economic environment than were the almost non-reactive, rigid and centralized bureaucratic regimes. In the age of the information-communication revolution, not only had the relatively backward peripheral economies lost their previous advantage to generate rapid growth but they were also incapable of crisis management and adjustment, in addition to being handicapped by obsolete infrastructures and policies of protectionist isolation, heavily controlled by a bureaucratic state or possessing a strong or dominant and protected state sector, and characterized by the complete lack of market interests.

3. The End of Prosperity – End of Leading Theories

The end of the unprecedented postwar boom that shattered the world economy undermined not only the peripheral economies and their tremendous efforts of catch up, but also called into question all the concepts and theories that dominated the academia and had influenced policy makers from the 1940s on. According to John

[9] E. Ehrlich-G. Revesz, *Osszeomlas es rendszervaltas Kelet-Kozep Europaban* (Collapse and change of the regime in East-Central Europe), September 1991. (manuscript) p. 103.

Kenneth Galbraith, in one of his lectures in Oxford in 1980, "nobody could gain a Ph.D. at Harvard in the 1930s who did not accept Say's law, while, similarly, nobody could gain the degree if did accept it from the 1940s on." Indeed, the ruling economic *Zeitgeist* of the 1940s in the West was a triumphant Keynesianism denying an almighty market-automatism and the validity of Say's assumed market equilibrium, which suggested that supply itself creates demand, and that every sale is potentially a purchase since the supplier and seller receive the income to satisfy their own demands. Smith's "invisible hand" creating and assuring a permanent market equilibrium was replaced by Keynes with an interventionist state, which itself was to create "additional demand." This was necessary, Keynes maintained, because the market was unable to guarantee harmony, given the fact that supply and selling does not always create demand, particularly when over-saving diminishes the total value of demand compared to supply. In contrast to the classical school of economic thought, Keynes and his followers stipulated that demand creates supply, and thus a force outside the market, the state, has to create extra demand by stimulating employment via public investment and consumption.

Several peripheral countries, however, went much further than this, copying Soviet-type planning which sought not only to correct and improve the market mechanism, but to destroy it entirely. They did so by banning or strictly limiting free enterprise (the main actor of a free market economy), by introducing central planning, fixing prices, and creating inexorable defense barriers against world market competition.

The leading competing paradigm of market capitalism, the economic concept of so-called Marxism-Leninism, the Stalinist version of Marxism, that was widely applied in a gradually expanding 'Socialist world system' which, in the end, dominated more than one-third of the world throughout the European, Asian, Latin American and African continents, and represented the most vigorous challenge. Several of its elements were adopted in non-socialist, peripheral, Third World countries as well.

But all these dominant postwar theories which seemingly worked in the 1950s and 1960s, clashed head-on with the changing realities of the 1970s. The emerging crisis thus became a predicament for these previously victorious theories as well. Keynesianism did not offer an antidote for stagflation, and the state socialist planned economies did not have the means and mechanisms to promote rapid adjustment to the changing technological regime and swift structural transformations of the economy.

In the critical period of a transforming world system when historical trends suddenly changed and traditional values suddenly questioned, one important factor had a profound impact on the theoretical and policy reorientation. This was a historical coincidence: the more backward a country was, the more its economy was characterized by state interventionism and a negation of the market. This was evident since these peripheral countries had sought to find an alternative model which would help them catch up without getting involved in futile competition with an overpowering "core". An inevitable outcome given the logic of peripheral backwardness, was that these countries and regions suffered the most during the structural crisis of the 1970–80s, and, as was illustrated above, they declined into a complex and endless depression. Poor and backward countries are always much less able to demonstrate the necessary flexibility to react adequately to major structural changes. What happened in the 1970-80s was thus yet another example of a well-known pattern in modern economic history: advanced economies react better and more effectively in historical turning points than do backward economies, and consequently the gap between them is further widened to a dramatic degree.

In spite of this fact, the failure of the peripheries was more often interpreted as a consequence of their 'statist,' anti-market policies than as an outcome of their limited peripheral abilities. In other words, the much deeper crisis of the peripheries was widely interpreted as regime- rather than region specific.

On the other hand, the much greater flexibility of the advanced "core" to react to the structural crisis by adjusting to the new technological era and its structural requirements was coupled with a successful propagation of free enterprise, market-orientation and *laissez-faire* ideology.

Hence, Keynesianism and the Marxist-Leninist Soviet model were effectively compromised, and a triumphant neo-classical liberalism replaced them as the predominate trend. Unable to find the ways and means themselves, and disillusioned with their own ideals, a desperate elite of crisis-ridden peripheries, began to believe that all the problems and all the economic turmoil had originated from a mistaken model. There was no resistance any longer: the Marxist-Leninist Soviet model was buried alongside with Keynesianism and social democracy in a huge mass grave.

The new *Zeitgeist* was determined by a jubilant Chicago school version of free market ideology. John Mynard Keynes was defeated by Milton Friedman who dominated the air-waves advertising his "freedom of choice," posing before television cameras comparing Hongkong with Red China and 'explaining' the difference between them by contrasting their policies and the models they had adopted. Leonid Brezhnev, Gustav Husak, Peronist-type Latin American generals and Mengistu-type African dictators were all easily thwarted by Ronald Reagan and Margaret Thatcher. The 'Reagan revolution' or 'Reaganomics' successfully promoted *laissez-faire* ideology and free market policies, offering the unparalleled American upswing that was taking place by the early- to late-1980s as an example to be emulated. Reaganomics was presented as a simple and quick solution to the world's complex economic ills. Similarly, Thatcherism offered a "vaccination" against the *Sozialpartnerschaft* and social-democracy, and initiated instant privatization in Britain.

The relatively successful adjustment of the "core" to the new technological and structural requirements of the 1980s, thus led to a triumphant vindication of free market ideology.

Although this victory was partly generated by several mere coincidences, the superiority of free enterprise was clearly not a mirage. In the epoch of an information, communications and service revolution which radically transformed the infrastructure and structure of production, the former declined dramatically alongside the spectacular rise of new leading branches, and the more flexible and reactive market mechanism that were the sign of affluent market societies proved to be much more effective than the non-market economies. Small-scale, highly market-sensitive firms played an outstanding role in most of the success stories. Market information is indispensable for orienting both investors and entrepreneurs. Consequently, state control and interference, let alone bureaucratic central planning, often proved to be counter-productive, for the state was simply unable to react fast enough. It is thus true that models that had worked relatively well and served a catching up process in the postwar decades were now rendered obsolete in the face of new realities.

The image of a free market system that is almighty and is the ultimate key of economic success, as well as the fact that it had indeed worked in some "core" countries and proved to embody an impressive potential for flexibility and an ability to react, influenced policy-makers, governments and international institutions to a great degree, creating an atmosphere of an almost dogmatic or religious belief in a single valid, uniform and universal model of an idealized *laissez-faire* system.

This ideology, combined with formidable technical and monetary skills, was conveyed by a group of Western economic advisers taking on the role of modern 'crusaders.' Dynamic, knowledgeable, ambitious, driven with a definite sense of mission and convinced of a single formula for economic success, these advisors arrived on the scene and quickly prevailed. As Alec Nove passionately noted: "Extremist neo-conservative think-tanks send missionaries to expound the gospel: roll back the *laissez-faire* is seen as the answer..." [10]

Moreover, one should not speak only of an intellectual atmosphere and a general *Zeitgeist*, because the impact was more direct when wielded by such powerful international institutions as the World Bank, the International Monetary Fund and several United Nations-related organizations. These, as well as the American administration and several other governments of the so called G-7 group of the most influential advanced countries, shared and represented an ideological belief in free marketism and suggested its application in all the crisis-ridden peripheral countries as a replacement for their previous statist models. Their 'suggestions' were much more than merely the friendly advise of senior partners. These governments and international institutions were the ones these countries were forced to turn to for aid and credit, and accepting these "suggestions" soon became a question of life and death, the only hope for survival. These governments and organizations were in the position of mandating the abolition of Cold War tariff barriers and restrictions. They could encourage private banks and companies to invest, partly by providing certain guarantees for investors. These were the powers who forgave debts and allowed a country's inclusion in the European Community.

The highly indebted peripheral countries, in several cases suffering from macroeconomic chaos, a lack of stability and hyper-inflation, sought any means to accommodate their potential saviors. Moreover, the World Bank and IMF, did not hesitate to prescribe conditions based on their ideological principles. Countries were practically forced to apply them, since this made it possible to stabilize their economies and encourage foreign investors. But, most of all, they believed they were paying an entrance fee to the European Community by accepting its conditions.

As Beverly Crawford rightly noted: "In 1989...the Commission of the European Communities was given the authority to direct and oversee bilateral assistance to Eastern Europe from EC members. In order to receive assistance from EC members, recipients were required 'to have pluralistic political systems...[and] to make rapid movement toward free market economies...and furthermore, 60 per cent of its lending

[10] A. Nove, *Economics of Transition – Some Gaps and Illusions* (manuscript), Berkeley, 1993. pp. 4–5.

is earmarked for private sector projects, directing capital away from the hands of the state. Conditionalities favors the radical over gradualist model of transition..."[11]

Indeed, as Mira Muc, head of the Slovenian privatization office stated in the early summer of 1993: "We gave our word to the World Bank for privatizing 400 firms in 12 months...without that there are no credits."[12] The international financial institutions represented a rigid stand regarding social policy and welfare programs. They always subordinated the social issues to "economic rationality," and pushed the governments to this direction. Governments of the countries of the region were forced to keep the budgetary deficit under 5% of GDP and cut social expenditure in a drastic way. In the fall of 1992, the newly appointed Prime Minister of Poland, Hanna Suchocka had to face crucial decisions since the IMF suspended credit to the country because its budgetary deficit surpassed the prescribed limit. Decreasing the deficit from 7.5% to 5.5% of the GDP, in accordance with the conditions of the IMF, pushed governmental policy toward harsh social conflicts in the summer and fall of 1992, which undermined the government. This policy of the international financial institutions led to a lack of social sensitiveness of governments which directed transformation. "Society...cannot be permitted to go bankrupt," stated Polish Deputy Minister Piotr Mierzewski, "because of health expenditures."[13]

"The actual economic programs of the governments," reported Federigo Argentieri, an Italian expert of the Central and Eastern European transition, "are more dictated by the International Monetary Fund than anybody else, leaving not too much place for maneuvering, except for nationalist and populist demagoguery."[14]

It would be, however, one-sided and unfair to condemn the IMF and World Bank and speak about an imposed blueprint of transition. These plans were relatively well-received by the new political elite, and they confused local economic experts.

There was, undoubtedly, a certain amount of logic in the advanced countries' advise, since the new governments were struggling with the difficult legacy of a bankrupt state-owned economy and therefore sought to replace it as soon as possible. To achieve this, a 180-degree change apparently seemed to make sense. A psychological approach may also shed some light here. In fighting against state socialism, and after years of analyzing and denouncing its structures, the former opposition emotionally bonded to the total negation of its legacy.

Moreover, the newly established parties and freely elected governments began to compete with each other in demonstrating their determination to follow the American-led Western world. The applause in the West that immediately followed was encouraging. The shock therapy definitely became the greatest propaganda success achieved by the former state socialist countries. The West awarded Poland with an

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[11] B. Crawford, *Market, States and Democracy: The Transformation of Communist Regimes in Eastern Europe and the Former Soviet Union* (manuscript), Berkeley, 1993. (Crawford cited the U.S. Government Accounting Office's publication: *Eastern Europe: Donor Assistance and Reform Efforts.* Washington DC: US Government Printing Office, 1990; and A.Vanik, "A Forced March to Capitalism." *World Press Review*, February 1991.)

[12] *Napi Gazdasag*, June 5, 1993.

[13] *Rzeczpospolita*, February 22, 1993.

[14] F. Argentieri, "Hosszu gyotrelmes ut." (A long, painful road) *Nepszabadsag*, August 8, 1992. p.17.

unique and unparalleled gesture: it forgave 50% of Poland's official debt in April 1991, while the American administration took the spectacular step of reducing Poland's American debt by 70%.

"I understood the difficulties that we faced because of the Balcerowicz Plan," quoted Tadeusz Kowalik the statement of Bronislaw Geremek, one of the most influential Solidarity leaders, "but at the same time I knew that this was the only way that could secure the chances for Poland of getting place in the European economic order. In other words: without...a very painful renunciation...we had no chances to overcome the distance separating us from the threshold allowing us to start the process of integration. I was also aware that we must move very quickly...because Europe had frankly no intention to wait for us."[15]

The 'demonstration' effect of the shock therapy was strong. In competing for foreign aid and for easy access to the European Community, which was seen as a realistic possibility after the historic year of 1989, the Central and Eastern European governments became free-traders and anti-state interventionists to a degree surpassing the countries that were classic adherents of that policy. The new elite thus became the world's most ardent advocates of free trade ideology, and they followed it with neophyte bigotry and orthodoxy. Anyone who questioned this policy fell under suspicion and was arbitrarily accused of harboring nostalgia for the collapsed regime or of attempting to preserve certain elements of it.

4. Global Transition Towards a Private-Market Economy

In the midst of a devastating structural crisis and revolutionary technological and structural transformation, the North Atlantic community took the lead in conducting a successful adjustment. The new governments of Margaret Thatcher and Ronald Reagan launched an all-out attack against state interventionism, state ownership, social partnership, and cooperation with labor unions, while openly shifting the burden of the transformation to the lower strata of the society by means of radically-altered tax policy. Ideological hegemony was accompanied by the demonstrative practices of these governments.

'Reaganomics' was a massive, ideologically based commitment and action against both the legacy of 'big government' and the Democratic Party's traditional 'tax and spend' policy. Dramatic tax reductions and the withdrawal of the state from established responsibilities went hand in hand with contracting out, i.e. privatizing, key public services.

Although public sector agencies, having faced difficulties in performing key services because of labor shortages during the decades of the postwar boom, occassionally turned to private sector firms to undertake work which previously was entirely done by the public sector, it began to do so at unprecedented levels during the 1980s in several advanced countries. After the Conservative electorial victory of May 1979, several services previously covered by the Ministry of Defense and particularly the National Health Service (in its 2,000 hospitals) were contracted out in Great Britain.

[15] B. Geremek, *Rok 1989*, Warsaw, 1992. p. 365. Cited by T. Kowalik, in this volume.

From the early 1980s on, the Thatcher government initiated the privatization of state-owned industries. By 1985, nearly a dozen previously-nationalized firms had been sold to private investors. The sale of part of the stocks of British Petroleum began a process that led to the transfer of control to the private sector of North Sea Oil licenses, the majority of assets of British Aerospace, Associated British Ports, and British Telecom. The Jaguar car manufacturer, British Gas, Amersham International and other companies were entirely outright to private investors, while Hoverspeed and the National Freight Corporation were purchesed by their own work force. In all, some 400,000 jobs were transferred from the public to the private sectors during the first half of the 1980s, and the value of the assets amounted to more than 5 billion pounds.

Britain's Conservative government privatized those firms that were nationalized by previous Labor governments particularly during the early postwar years. Other European countries had a longer tradition of state ownership and a mixed economy, though, and they too saw a massive outbreak of privatization thanks to the ideological triumph of *laissez-faire* economics.

The most interesting case was definitely France, where the tradition of a dominant state was not only due to socialist influence but to a kind of national tradition which spanned from Colbert through to De Gaulle. The latter, who nationalized Renault to punish Louis Renault for collaborating with the Nazis by producing tanks and army vehicles, carried out a major nationalization: "For reasons which are psychological as well as economic and moral," stated De Gaulle in November 12, 1947, "there was a need after the liberation of France to pursue a nationalization policy in the area of coal, electricity, and credit. This is what I have done." [16]

Until the early 1980s, therefore, France had a mixed economy with a strong state sector comprising 94% of energy industries, 83% of the telecommunications industry, 46% of the transportation industry, 44% of banking and 6% of other industries.

Unlike in the United States and Britain, France voted socialists in 1981. Francois Mitterrand became president as a result of the May elections while parliamentary elections the following month led to the formation of the Socialist government of Pierre Mauroy. Clearly, France was swimming against the tide.

Not only the United States and Britain but the entire advanced world, including Germany, Italy and Japan, were moving towards deregulation and denationalization. Germany privatized the Veba conglomerate and two dozen state-owned companies, while the Italy's IRI, the public holding company founded by Mussolini, privatized Alitalia, Autostrada, the Italian toll-roads, Elsag and nearly a third of Banco di Roma, altogether roughly one dozen major firms. The advanced "core" countries shared the values of neo-liberal economics.

Within twelve months, though, the Socialist government of France, had nationalized eleven major private companies and the remaining private banks. After this new wave of nationalization, 53% of the fixed assets of all French companies was held by public firms, which employed nearly one quarter of the nation's work force. In the energy, railroad, telecommunications and tobacco industries, the private sector entirely disappeared.

[16] Ch. De Gaulle, *Discours et messages*, tome 2. Paris, 1970. p. 154. quoted by B. Jacquillat, *Nationalization and Privatization in Contemporary France*. Hoover Institution-Stanford University, 1988. p. 16.

This proved to be, however, a short-lived trend in France. From the mid-1980s on, the Socialist president and the new Socialist government, led by Fabius, discontinued the previous policy and the country gradually and – after the electoral victory of Chirac – radically turned to the 'de-statization' formula of the other Western countries. The parliament enacted two privatization bills in July and August of 1986, and privatized thirteen major firms in a period of nine months. Within eighteen months, almost all of the nationalizations of the early 1980s had been re-privatized, along with some token companies of the traditional public sector.

The triumph of free market economy, deregulation and privatization in Europe was greatly assisted by the collapse of the South European dictatorships of Franco, Salazar and the Greek military junta. Coincidentally, these events all occurred during the the second half of the 1970s, when both the outbreak of an international structural crisis and, as a reaction, a general shift towards a private-market economy became characteristic. The new European democracies in the last stage of the Cold War were soon accepted by the European Community and began to adjust their political and economic regimes.

Although in Spain, a private economy began to flourish under Franco's political dictatorship, especially from the 1960s on, it was a strongly state-controlled and partly state-owned, mixed, dirigist economic regime. Similar to Mussolini's Italy, Franco's Spain also established its public holding institution, the *Instituto Nacional de Industria* (INI) in 1941, introduced centralized price and wage controls and also controlled all private business. The established public sector dominated the coal, electricity, transportation, ship building and telecommunications industries, and was also important in textile, as well as chemical and automobile productions. Roughly 20% of all assets were in the hands of the state until the end of the 1970s. Three major state conglomerates controlled the commanding posts of the economy: INI had a share in 700 firms, holding a majority of shares in 250 of them, where 210,000 workers were employed in 1984. INH controlled the majority stocks of thirty-one companies of the energy sector, and the Direccion General del Patrimonio del Estado, among others, monopolized the tobacco and telephone industries, and held a strong position in textiles.

In post-Franco Spain, the abolition of the dictatorial regime went hand in hand with the deregulation and liberalization of the economy. Price and wage controls and state regulations were abolished. As part of a national program of restructuring that was adopted in 1984, a major privatization campaign began to eliminate the state sector from the mid-1980's on. Within two years, a consortium of seven private banks liquidated or sold 350 state-owned industrial firms and 92 banks of the Patrimonio group. In 1985–87, two financial groups privatized the INI, including the holding company's crown jewel, the SEAT automobile factory, with its 23,000 workers, itself 6% of those employed in the public sector. In 1986–87, the privatization of the Patrimonio group took place in two stages.[17]

[17] *Les privatisation a l'etranger, Royaume—Uni, RFA, Italie, Espagne, Japon*, Paris: Etudes coordonnées par J.-J. Santini, La Documentation Francaise, Paris, 1986.; K. Asher, *The Politics of Privatization. Contracting out Public Services*, Macmillan, 1987.

Simultaneous to that taking place in the Western world, and, in some respects, in post-dictatorial Southern Europe, a market transition also gained ground in Latin America. One of the pioneers of the process was Chile, where marketization and privatization was also linked with the change of the regime. After the suppression of Aliende's socialist government, Pinochet's military regime began a vigorous privatization campaign from the mid-1970s, transforming the economy according to the concepts and personal advise of Milton Friedman.

A crisis-ridden Argentina, Mexico and Brazil soon followed. The governments declared a market transformation in the late-1970s and early-1980s. The public sector of the three countries had a 20%, 29%, and 34% share respectively of fixed capital formation (i.e., productive investments).[18]

Although privatization in Argentina already began under President Alfonsin in the mid-1980s, the process gained real impetus only at the end of the decade: between 1989 and 1991 the national telephone company, eight previously militarily-managed petrochemical firms, the national airline, power plants, two television stations, coal mines, 28 secondary oil fields, the port authority, the postal service and the Buenos Aires subway system was privatized. With just under $12 billion generated in the sales (and debt conversion) and a more than $11 billion guarantee of private investment, the significance of the rapid changes is clear.

Likewise, in the mid-1980s Mexico saw the beginning of a modest first wave of privatization under President de la Madrid, but it gained momentum only at the end of the decade: the national airlines, the Cananea copper mining company, the controlling interest of the country's telephone company, the leading steel plants and seven commercial banks were all sold. The state's petroleum monopoly subcontracted the exploration and development of promising oil fields, and, from early 1992, the privatization of privately-farmed but communally-owned land began as well. The fact that over $8 billion was generated and nearly $16 billion of investments were pledged showed how important this transformation was.

In Brazil a slow start in privatization in the 1980s – with the selling of six state-owned manufacturing firms for $500 million – was followed by an upswing from 1990 on. In two years four leading steel mills, fertilizer and petrochemical firms, heavy engineering companies and a shipping firm were sold for $3.2 billion, and the process was intended to continue until the end of 1993, generating projected revenues of $13 billion.

India's transformation was definitely one of the milestones of the international marketization process. With the introduction of a planned, mixed economy under Jawaharlal Nehru's Bombay Plan, India must likely possessed the most consistent non-market economy outside the communist world. The Industrial Policy Resolution of 1956 established a dominating state-owned economic sector, with only a subsidiary

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[18] R. Floyed, C.S. Grey, and R.P. Short, *Public Enterprise in Mixed Economies*, Washington DC: International Monetary Fund, 1984.; T.J. Trebat, *Brazil's State-Owned Enterprises: A Case Study of the State as Entrepreneur*, Cambridge: Cambridge University Press. 1983. p. 122. (Cited by L.E. Armijo, *Policymakers' Motives to Privatize, with Illustrations from Recent Experience in Argentina, Mexico, Brazil, and India*, Paper prepared for the XVII International Congress of the Latin American Studies Association, Los Angeles, September 1992. p. 22.

role for private economy. While the commanding heights of the economy were in the hands of the state, private business was allowed in certain fields, though strictly controlled and guided. Private investments were regulated by a strict licensing system, and were thus allowed only when it suited government priorities. State regulation and licensing directed not only investments into newly-founded firms, but also in the expansion or diversification of existing ones.

Additionally, in certain areas, only small-scale private firms were allowed: 863 industrial items were reserved for small private business. Foreign capital investments were strictly limited by exchange regulations, limiting their possible share to 40% of equity capital and restricting their activities to certain fields of trade and commerce. The share of the public sector in domestic capital formation was 20% in the early 1980s, and almost the entire infrastructural network, including railroads, waterways, electricity generation and distribution, communications, and trade distribution networks, etc, were in the hands of the state.

Although Prime Minister Rajiv Gandhi was committed to market-oriented reforms and encouraged private business by granting it an "open general license," and though he had liberalized foreign investments into India's automobile industry by the second half of the 1980s, a marketization breakthrough occurred only, as in the Latin American case, at the end of the decade, and particularly in the early 1990s. The government of Narasimha Rao opened a new chapter after the spring of 1991, instituting, as B.V. Rao described it, "a dramatic U-turn from earlier planned strategies" in Indian economic strategy. The policy change was clearly marked by the government declaration on the New Industrial Policy of 1991, which replaced the one established in 1956, when it stated: "many of the public enterprises have become a burden rather than being an asset to the government."[19]

Deep in economic crisis and firmly in the indebtedness trap, India accepted the International Monetary Fund's assistance and conditions (a substantial IMF assistance was already offered in 1981, but was at that time rejected by the government). Following IMF and World Bank prescriptions, the country began major trade liberalization and deregulation. Import liberalization was initiated by allowing exporters to import up to the value of 30% of their exports and by reducing import duties. Within two years (in early 1993) and in two stages, India introduced full convertibility of its currency. Price and quality controls were lifted, licensing of private investment was abolished and foreign investments were encouraged with policies that included allowing foreigners to hold a 51% and, in some cases (sectors of strategic importance), 75% share of Indian industries. The government declared the beginning of privatization by disinvesting 20% of its equity capital in thirty-one state-owned industrial firms.

In Africa, the model-country which has followed IMF and World Bank reform programs first and most consistantly since 1983 on, is Ghana which gradually decreased import restrictions, ended most price controls, introduced tax reform and begun privatization by selling (or closing) roughly fourty state-owned companies.

Mosambique, Uganda, Benin, Malawi and Tansania joined the reforms but the initially optimistic forcasts on a five-seven year transformation have now been replaced by a much longer-term prediction, in some cases 15 years.

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[19] B.V. Rao, in this volume.

In Turkey, another country with a mixed economy characterized by a huge state sector (35% of total manufacturing capacities and two thirds of bank assets were in state-owned companies) and five-year planning (introduced in 1963), the civilian government of Turgut Ozal initiated a transformation program to create a genuine market economy in 1983. The program, which had already been prepared in early 1980, envisaged the reduction of state intervention, and stipulated the removal of different regulations, the introduction of free market pricing and the liberalization of foreign trade. The government immediately began the privatization of state-owned industrial firms and banks and, as a consequence, nearly 500 major private joint-stock companies, or 3% of the firms, controlled 80–85% of all assets in the country.

Turning towards privatized free market economy was thus a global phenomenon which began in the late 1970s and continued throughout the 1980s and into the 1990s. Most of the advanced Western countries which had preserved mixed economies, those South European countries which were under dictatorial governments and had a state controlled economy until the mid-seventies, as well as the Latin American continent, India, Turkey and several other countries, began to privatize and abolish state regulations and protectionism and turned towards free trade, foreign investments, and the liberalization of prices and trade.

Although this process clearly began in the mid- to late 1970s, it remained in most cases relatively moderate until the end of the 1980s, gaining momentum mostly in the early 1990s. The reason for this is closely connected to the collapse of state socialism in Central and Eastern Europe and the Soviet Union. Their profoundly anti-market model represented an extreme alternative to *laissez-faire* capitalism and, as was documented above, this influenced several peripheral countries in most continents.

The death-blow to all non-market and mixed economic models was thus launched by the spectacular failure of the Marxist-Leninist alternative economic system based on isolationism and centralized planning.

Market-oriented reforms appeared already in the mid- to late-1960s in Czechoslovakia and Hungary, while the Hungarian reforms were radicalized in the 1980s and were accompanied by similar reforms in Yugoslavia and Poland. But, under Soviet control and one-party rule, all of these reforms remained half-measures.

The new governments of Central and Eastern Europe that emerged as a result of the *annus mirabilis* of 1989 inherited the legacy of a declining, bankrupt economy. The situation was characterized by stagnation spanning a decade and a half, a decline of the GNP, a deterioration in the standards of living, inflation, indebtedness, in some cases hyper-inflation and insolvency, and most of all a hopeless structural crisis and lack of adjustment.

The first freely elected governments, however, had a great advantage compared to their predecessors: besides their vile heritage, they enjoyed the overall sympathy of the population, were offered assistance by the advanced Western countries and commanded an internal legitimacy. Ideological taboos collapsed and Soviet domination disappeared, no longer hindering drastically-needed reforms in the various countries of the region.

Besides the urgent need for a macro-economic stabilization, the new governments immediately initiated the transformation of the centrally planned, state-owned economy. The lesson of the collapse of state socialism was that an economy must have market flexibility to be capable of adjusting to rapidly changing technologies and constantly transforming economic structures. Market prices thus had to be restored to reflect market requirements and assure a spontaneous measuring and selection based on market criteria. To achieve this, consistent deregulation was needed to sweep away all legal and institutional obstacles inherent to central planning and state regulations. A new legal and institutional framework was also needed, while the previous institutionalized isolation from the world market was to be swept away. The liberalization of imports and an opening of the domestic economy to international competition was the central issue from which to start.

The nucleus of marketization and "de-statization", however, was a steadfast privatization of an economy that was almost 90% state-owned or state-controlled and owned. Such a dramatic transformation towards a market economy had never happened before. The Central and Eastern European transformation to a private-market economy thus deserves special attention – and a more detailed description and analysis – as the most dramatic and important factor of the global transition process at the end of the century.

Because of her peaceful 'refolution', Hungary was the only country in Central and Eastern Europe to enter into the new era with well developed market reforms and a prepared plan to radically transforming its economy. In the summer of 1988, a large network of six specialist committees began to work on detailed long-term plans for a new economic strategy, including institutional and ownership reforms. Preparations for a transition towards a mixed market economy were led by the legendary reformist and "father" of the economic reforms of the sixties, Rezsö Nyers, Minister of State in the first post-Kádár government of Károly Grósz.

Working Committee No.1 was responsible for presenting a complex short-term program of transition between 1990–92. The 162-page plan, which, in the words of the head of the Committee in the introduction of the published program, was "not partial, weakened by compromises, over-gradualist in that it does not touch the foundation of the economic system, and not moderately corrective in aiming for a too long period of realization...but a complex, consistent reform which radically transforms the basis of the economic system,"[20] was on the government's desk in the early spring of 1989. The "half-market economy," asserted the program, cannot spontaneously develop into a proper market economy without a consistent process of reform. It has to include a drastic reorientation of foreign economic relations to make the Hungarian economy able "to develop according to the requirements and as a part of the world economy," by eliminating the differences (among them the different price systems) of the three existing markets – domestic, Comecon and Western. The plan also proposed "an immediate start of widespread privatization of property and a long-term leasing of state property, assisted by low interest credits"[21], the "attraction of foreign capital", the foundation of the Stock exchange and a whole set of deregulating measures.

[20] See the introductory remarks of the head of the Committee and editor of its published suggestions: I.T. Berend (ed.), *A Gazdasagi Reformbizottsag Programjavaslata 1990–1992* (The program suggestions of the Economic Reform Committee, 1990–1992), Budapest: Kozgazdasagi es Jogi Konyvkiado. 1989. p. 11.

[21] *Ibid.* p. 160.

A three-year plan of import liberalization (of about 80% of imports) and a plan of monetary stabilization were also parts of the program. The last reformist government of Miklós Németh adopted and began to implement the transition plan; thus the freely elected Antall government inherited not only a plan but also an advanced process of transformation.

The government received a 'present' of another transformation plan, completed by a joint Hungarian-International "Blue Ribbon Commission." Its stated goal was to present a program of transition for the newly-elected government. Indeed, an ambitious plan, based on the Western pattern, was ready in April 1990 and was already on the new government's desk by the time it was formed.

The strategy of continuing what was already a long-established reform process was not questioned in Hungary. There were no advocates of "shock therapy" in this country, since it was evident that, based on the previous results of the reform and the major changes of 1988–89, a transition in certain basic spheres might be completed in three or four years.

In addition, the Hungarian Democratic Forum, subsequently the leading party of the governing coalition, had a somewhat ambiguous concept on economic transformation after its foundation. The first convention of the Forum in March 1989 stated that its goal was a "third road" between Capitalism and Socialism, and declared that "a strict market-based economy would only enrich a narrow group and impoverish the majority." Even the second convention in October 1989, which adopted a more detailed program, reformulated the typical populist third-road concept. "The Forum did not endorse total privatization," summarized a report, "and by privatization it did not mean ownership by individual private citizens...[T]he entrepreneurs...would not be individuals but groups." [22]

On the other hand, an uncompromising liberal opposition turned towards free market capitalism, but it did not challenge "gradualism" either, which in the Hungarian case did not mean over-cautiousness and delay. The newly-formed coalition government followed reform measures which did not lack the required "critical mass" for a fundamental transformation. Within two years, therefore, a market price system was practically complete, while subsidies were mostly abolished for industrial and agricultural products and substantially decreased for services. Marketization was established along with import liberalization between 1989–91: respectively 36%, 60% and then 86% of imports were liberalized during these years.

The retreat of the state and the advance of the market were closely connected to the development of a modern monetary system. The monopoly of the National Bank as the single creditor had already been eliminated in 1987, and thirty-six commercial banks were functioning in the country by the end of 1991. The 1991 law on the National Bank continued "de-statization" by reestablishing the bank's autonomy from the government. In the place of the previous monopoly of one single insurance company, two were in existence in 1986 and nine by 1990, with nearly one- third of them in foreign hands. Moreover, the role of middle-sized and small-scale banks are rapidly increasing.

[22] *Radio Free Europe Research.* Vol.14. No.48. December 1, 1989. Part IV of 4 parts. pp. 23–24.

The most radical change in the Hungarian reform process occurred with the privatization of what was basically a state-owned economy, which was one of the key elements of the transformation. The change of the system led to a dramatic breakthrough regarding privatization. The freely elected Hungarian parliament rejected reprivatization, i.e. restoring properties and firms to their genuine owners (or to their heirs), and has instead pledged to pay a certain (moderate) amount of compensation. The exception was forcibly-collectivized land, which was to be restored to the former owners, as well as schools and Church property (except landed estates). De-collectivization, which had been a particular focus of the Hungarian reform process since the mid-1960s in a rather successful attempt to combine private and collective farming, is now being drastically pushed further, with the new government predicting that private farming will, by 1993–94, be the dominant form. Property rights and the legal framework for unrestricted private enterprise, including unlimited foreign ownership of entire companies, had been granted already in 1988–89. Since private capital accumulation already had a decade-long history in Hungary, grassroots privatization, and the foundation of new small – and medium-scale firms, gained momentum from 1989 on. More than 40,000 private firms (with legal entity) have been established since that time, while the number of private enterprises without legal title (mostly small-scale companies) more than doubled between the end of 1988 and 1992. Their number reaching 532,000, according to a report of the Statistical Office. Moreover, according to several estimates, private firms are producing between 40% and 50% of the country's GNP. Some 40% of private business is engaged in trade, roughly one-quarter in manufacturing, and nearly 40% in services.

Foreign companies and joint ventures add up to more than 13,000 (compared to 1,332 in 1989), and invested capital totalled $2 billion in the summer of 1991 and surpassed $4 billion at the end of 1992. According to the Research Institute of Privatization, the share of foreign ownership in Hungarian firms in the middle of 1992 was more than 8%, a clear sign of foreign interest. With its earlier start, relative stability and more advanced market relations, Hungary has attracted more than one-half the Western investments into Central and Eastern Europe. The government, though, expected between 25% and 30% foreign participation; this has not been realized. Except for a few big multinationals, such as General Motors, General Electric and Suzuki, most of the investments have been small. In 1989–90, 90% of investments with foreign participation represented less than $130,000 each.

The most difficult part of privatization is the selling of big state-owned companies. Hungary decided to follow a gradual privatization plan and sell the companies piece by piece. The supervision of privatization is conducted by the State Property Agency, *(Allami Vagyonugynokseg)* which had been established in February 1989. As a prerequisite, state firms are first transformed into share holding companies. The Stock-exchange was reopened in Budapest so as to launch a domestic capital market. Though still in a somewhat embryonic state, it has nonetheless created a necessary institutional foundation. In 1991, the value of transformed companies was ten times more than it had been in 1990. Most of these firms, however, remained in the hands of the state. In March 1992, over 86% of the assets transformed to joint-stock companies remained in the hands of the State Property Agency, while only 2.5% belonged to private Hungarian investors and another 8% was purchased by foreign investors. The exact share of privatization thus did not surpass 10–13% of the former state-owned companies. Whereas in the early stage of a privatization 'gold rush', large established companies of the West were rarely attracted, investors with a small financial base were. (The average investment in foreign-owned companies or joint ventures has been $100,000). They hoped to withdraw with quick profits and in most cases had no interest in reinvesting. A significant portion of the investments was channeled into real estate and retail trade chains, fields that do not contribute directly to the creation of a competitive economy.

The car industry, however, emerged as a symbol of change. General Motor's open-field investment in Szentgotthard and cooperation with Rába led to the beginning of car production in Hungary. In March 1992, the first Opel Astra rolled off the assembly line; fifteen thousand will follow annually. Although only the assembly and painting is done in Hungary by fewer than 500 workers, and though all its parts are delivered from GM's other European plants, the enterprise still embodied a promising message. Even more exciting was the launch of Magyar Suzuki in August 1992, producing 60,000 cars per annum in its newly built factory in Esztergom, and employing 1,500 workers. Initially 40% of the components of the Swift cars will be Hungarian-made, but this might increase to 60%. With a total of 100,000 cars estimated to be built, the Magyar Suzuki plant would cover the demand of the domestic market.

In spite of its important results, the privatization process is rather slow. The State Agency has determined which companies would be sold (in the first round, twenty firms were put on the market) and has prepared every single case in typically centralized fashion. There were two reasons for doing this. First, the new political elite wanted to block what could be called spontaneous self-privatization and which received a great impetus in 1989–90, in order to prevent the former managerial elite from exploiting their positions to becoming part of the new capitalist class. In some cases, this type of privatization was accompanied by corruption, with the old managers selling the state company at an extremely low price to a private firm of which they were the co-owners, or to a foreign company that guaranteed them top management posts as part of the deal.

Hence, the government's plan to privatize about half of the state-owned companies in four or five years will definitely not be realized. According to the most recent projections, the government is planning a decade-long process. Based on its program, the state's share by the end of the 1990s would decline to 25% for banking and 20% overall.

The economic transition plans revealed certain similarities in Yugoslavia, another former pioneer of market-oriented economic reforms. Based on previous partial reforms, the government of Ante Marković a planned radical reforms in order to bring about real changes. The Croatian reform economist had already proposed a program of "new socialism" in January 1989. This aimed to combine workers' self-management with a proper market environment. Having been appointed in March, and witnessing the collapse of socialism in the neighboring countries, Marković a radicalized his plan even further. He presented the new program in December 1989 with the promise to build "a new economic and political system." The Federal Assembly passed seventeen laws from a package of 24 proposed by Marković a Six of the remaining seven were approved as "provisional measures" in December of that year.

The new reform was thus introduced and linked with a radical stabilization of the currency. At that time, Yugoslavia was suffering a bout of hyper-inflation. In March 1989, the inflation rate was 346%, and by December it had jumped to 2,600%. Macro-economic stabilization and marketization were closely linked. The new Dinar (which was equal to 10,000 old ones) was introduced on January 1, 1990, the aim being to reduce inflation to 13% by the end of the year. For the first time in Central and Eastern Europe, a stabilized currency was made convertible by being firmly tied to the West German Mark (1DM = 7YD), and this served to push marketization even further by automatically implementing the world price system. At the same time, domestic price controls were also removed on almost 85% of all commodities (only the prices of certain basic services, raw materials and energy sources remained under control). Moreover, wages were temporarily frozen. Marketization was intended to be combined with a "pluralism of ownership", i.e. a mixed-ownership structure which would include private, public and mixed property as well as a uniform, and modern taxation system.

One week after the reforms were announced 900,000 workers went on strike. This included a 30-minute general protest strike in Belgrade in December 20. Their demand was wage increases of between 50% and 400%. But even more significant was the fact that the Serbian president, Slobodan Milosević, opposed the Marković government. The Slovenian Assembly also resisted any kind of centralized federal economic policy and offered several proposals for a new constitution. Yugoslavia was, however, soon engulfed in a civil war, and the peaceful transformation was smashed.

Transition followed a different pattern in Poland and Czechoslovakia. The catastrophic Polish economic situation, with hyper-inflation of 740% in 1989, an inability to pay back foreign credits, along with a severe shortage of food and consumer goods, required desperate measures; the new Solidarity government, which took office in September 1989 sought to adopt the most drastic transformation, a process that came to be known as "shock treatment" or shock therapy. The government took advantage of its popularity and strongly-based legitimacy, and was courageous enough to realize harsh and painful proposals. Radical reform economists who had already offered reform programs in the latter years of the Jaruzelski regime, now called for immediate change. The "Balcerowicz Plan", named after its initiator and the deputy prime minister of the Mazowiecki government, with the help and advise of the Harvard economist, Jeffrey Sachs, hurriedly prepared a combined macro-stabilization and marketization plan which was received by the International Monetary Fund with the greatest enthusiasm. Western governments and journals praised the shock therapy as the most appropriate measure and definite proof of the regime's determination and courage, while the advocates of the policy became international celebrities seemingly overnight. The plan was implemented by Januar 1, 1990. Subsidies on basic foods, housing and energy which accounted for more than 30% of budgetary expenditures in 1989, were cut to 15%. Expenditures on health and education were reduced. Strict wage controls implimented, pegging increases to between 20% and 60% of the inflation rate (based on the previous month, with a 500% penalty tax on those exceeding these limits). These were combined with a policy of comprehensive price liberalization. Consumption declined by almost 35%. "It is not surprising...that Balczerowicz," stated Andrzej Kozminski of Warsaw University, "wanted Polish society to swallow such bitter medicine as quickly as possible before the massive popular support for the new government evaporated and foreign help was diverted towards other Eastern European economies starting the transition process."[23]

The austerity policy was combined with monetary stabilization. The Polish Zloty was tied to a number of convertible currencies, and the exchange rate was kept relatively stable. The Polish currency was made partially convertible, which enabled enterprises and individuals to buy and sell currency on the domestic market. This caused the "black" exchange rate to disappear. Besides its financial impact, this helped link the domestic market to the world market and encouraged import competition, and internal marketization. Hyper-inflation was curbed, and the increase in consumer prices dropped to 250% in 1990 and to 70% in 1991.

Creating a market economy was, of course, inseparably linked to privatization. Grassroots privatization and the establishment of new private enterprises gained impressive momentum. Over 51,000 new private firms (with legal entity) were established, while the number without legal entity reached 1.5 million. By the end of 1991, in addition to agriculture, which was already in private hands, private industrial sales comprised 22% of the total, while private construction reached 44% and transportation more than 16%. Some 80% of the private firms dealt with trade, especially imports, and services.

The privatization of state-owned retailing networks (by open bidding) was relatively rapid; at the end of 1991, more than 85% had become privately-owned. The decisive question was, however, the privatization of large state-owned industrial firms, which, even in 1992, were producing nearly 70% of the country's industrial GNP.

Interest in purchasing these firms was almost non-existent. A total of twenty-six state concerns was sold in the first two years, while a number of surveys reported that only an additional 3–4% of the assets of state companies might find domestic buyers. Foreign investments also remained disappointingly limited. The first year was fairly promising: the number of joint ventures jumped from fifty-five (in 1988) to 2,480 (in 1990). The number of foreign-owned companies and joint ventures continued to increase and topped 5,000 by 1991, but the amount of invested capital reached only $353 and $670 million in 1990 and 1991 respectively, which was less than a third of the foreign capital invested in Hungary – itself somewhat limited.

There were a few major investments, such as Unilever's decision to buy 80% of the shares of Pollena Bydgoszcz, the leading Polish detergent producer. As part of the multinational empire, the company which was renamed Lever Polska, doubled its production with the help of a four million dollar investment. In addition, Pepsi-Cola announced a new $60 million investment in Poland. Most of the foreign or joint companies, however, represented a very small amount of investment. In 1990, some 66% of them had investments of between $50,000 and $60,000, while a mere 0.5% surpassed $3 million. Privatization, assisted by foreign participation, thus reached a dead-end, and further development promised to be slow.

[23] A.K. Kozminski, "Transition from Planned to Market Economy: Hungary and Poland Compared." *Studies in Comparative Communism*, Vol. XXV, No.4. December 1992. p. 320.

In June 1991, to accelerate the process, the government proclaimed the extension of shock treatment to the privatization strategy. In the framework of a Mass Privatization Program, the government announced the distribution of vouchers or investment certificates to all the country's adult citizens as a universal free citizenship grant. At the same time, the government set up a national investment fund which would manage the privatized firms. Each state-owned company selected for privatization by the government would allocate 60% of its shares to the funds and, in this way, to the public at large. An additional 10% of the shares would be distributed among the company's employees with 30% to remain under state ownership. The plan envisioned that Polish mass privatization taking about two years, with shares being made available only in 1994. Simultaneously, a secondary market of investment certificates and shares would be opened at the Warsaw Stock Exchange, since most citizens would, it was thought, prefer to cash in their vouchers rather than becoming share holders. It might take years until real, concentrated private ownership emerges in Poland.

Although the term "shock therapy" was linked with the Polish road of transition, the Czech government followed an even more consistent "Big Bang" strategy especially in its privatization drive. On January 1, 1991, after one year of preparation, Vaclav Klaus, the Minister of Finance and a free market ideologist, introduced radical marketization by liberalizing prices and imports. The first shocking effect was an almost 50% price increase in January and another in February, even though price increases did slow to between 2% and 5% during the spring. Consumption immediately declined by 37%. The market transformation, though accompanied by harsh criticism, continued unabated.

The Czech privatization schedule was even more radical. In October 1990, the Federal Assembly passed a law on restitution. Unlike those adopted in other countries of the region, the law guaranteed that those private properties which numbered about 70,000 units, that had been confiscated between 1955 and 1961 were to be returned to their former owners. In the same month, another law implemented so-called small privatization, which stipulated that 100,000 state-owned stores, hotels, and restaurants be auctioned to private bidders starting in January 1991. In the first round, 10,000 units were sold for $330 million. The overall calculated value of small businesses on sale was about $6.5 billion.

Grassroots privatization was highly successful for, by June 1992, there were 1.2 million private firms in the country.

In November 1990, the government also approved a draft law on large-scale privatization of about 3,000 large state-owned companies, which were first to be reorganized – the larger units being broken up into smaller ones – and then transformed into joint-stock companies. Their privatization was initially on a voucher scheme basis. Accordingly, each adult citizen was offered investment vouchers worth 1,000 points each for a nominal fee equal to $80. This authorized the citizen to buy thirty shares (since each share initially was priced at the same number of points) of state companies via the Stock Exchange, which opened in 1991.

By May 1992, the shares of 1,400 firms were already on sale, and the auctions of assets to a net value of $9.3 billion began. Some 8.5 million Czechs and Slovaks participated and, 56% of the shares on offer were allocated. The rapid realization of the program was unique in the region. "Almost overnight," reported The World

Bank's bulletin, "Czechoslovakia will boast the biggest private sector in Eastern Europe – and one of the highest rates of individual share-holding in the world."[24] A secondary market of shares was created almost immediately. In December 1991, a private investment fund (Harvard Capital and Consulting Fund) offered ten times more than the genuine nominal value for voucher points. Other investment funds followed. About 5.7 million people opted to sell their voucher-booklets, which resulted in the accumulation of about two-thirds of total voucher points in the hands of 420 private investment funds. By August 1992, the third round of auctioning had begun.

Although foreign capital is not a central factor in Czechoslovak privatization, some landmark investments may have a great long-term impact. In November 1990, 40% of the famous Sklo Union, the state-owned glass company and an important exporter, was bought by the Japanese-controlled Belgian Glaverbel. The following month, Volkswagen bought 31% of the shares of Skoda, the single most important Czech industrial firm, for $333 million. According to the terms of the agreement, Volkswagen will invest $6.3 billion (!) into Skoda over the next seven years, thereby acquiring between 70% and 75% of the stock. The transaction, if fully realized, would be the largest cross-border investment in European history, which may change the whole industrial environment of the region and, indirectly, the country as well. In two years, in September 1993, however, as Reuter riported, Milan Smutny, the spokesman of Volkswagen, declared that the company canceled the biggest chunk of its investment program and will not build the planned engine producing plant but accomplish only an assembly work in Mlada Boleslav. The investment project was cut nearly a half of the original one.

Although following different roads, the three pioneering countries of transition – Poland, Hungary, and Czechoslovakia – have achieved important results in the transformation towards a private market economy.

The Balkan countries, however, partly because of their later start, and partly because of a different political environment, have followed a more cautious and slower road in the same direction as their central European counterparts took, especially during the first period of transformation. Price liberalization and some sort of privatization were debated and introduced between 1990 and 1991.

The National Salvation Front in Romania initially had a definite Third Road concept. In the summer of 1990, Silviu Brucan, one of the leading ideologists of the front, argued that "Romania has a lot to learn from the example [of South Korea] if it wants to avoid becoming an exhausted half-colony of the West." This strategy, he argued, offers both "a great opening to Western investors and joint ventures, while maintaining a strong state sector and thus efficient control over development." He also advocated the combination of the South Korean with the Austrian models, especially the "social policy of Austria."[25]

President Iliescu himself often stressed the danger of copying foreign models and advocated for some special Rumanian road, labeled by some Western experts as "post-communist communism." In later months, however, the post-Ceausescu leadership of Romania turned towards Western social democratic concepts.

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[24] *Transition. The Newsletter About Reforming Economies*, The World Bank. Vol. 3, No. 5. May 1992. p.3.

[25] D. Ionescu, "Quest of a Model: Development Strategies under Discussion." *Radio Free Europe. Report on Eastern Europe*, Vol. 1, No. 39. September 28, 1990. p. 28.

The Government Commission for the Transition to a Market Economy, which was set up in January 1990, presented its report in May of that year. The core issue was gradual price reform. According to the report, price liberalization implemented in three stages would take two years to complete. In other words, it would be in place by June 1992. The program was launched and subsidies were gradually cut. In September 1992, prices of staple foods doubled. As with the marketization process all over the region, Rumanian price liberalization led to a 228% price increase between June 1991 and June 1992.

In the summer of 1991, the government implemented a partial privatization of both the agricultural and non-agricultural sector of the economy. This was based on the idea of creating a mixed economy. For, the government intended to privatize 53% of the state's assets, about 6,000 "commercial" companies retaining the balance which were what were termed "strategic sectors" such as mining, transportation, armaments, and communications in a framework of reorganized, autonomous state-owned companies. The plan called for privatizing the "commercial" companies within seven years, partly by distributing "property certificates" or vouchers among adult citizens. Each voucher would comprise 30% of the assets, while the remaining 70% were to be sold by the newly established State Property Fund, by minimum 10% allocations each year on the market. But various limitations persisted, and even grassroots privatization had strong ideological restrictions placed upon it. Although the establishment of private firms was allowed in trade, services and tourism, the number of employees was to be limited to twenty. Thus, of the firms set up during the first eighteen months, 115,000 out of 145,000 were one-person family-run businesses.

Meanwhile in Bulgaria, the government opened the round-table talks of March 1990 by presenting an over-cautious plan for gradual marketization, which was opposed by those urging shock therapy. In October of that year Prime Minister Andrey Lukanov presented a program to the parliament entitled, "Accelerated Transition to a Market Economy." This program proposed that privatization begins in 1991. The government promised to devise a special plan for small-scale privatization by November.

Continued economic decline and an accelerated political transformation led to a stepping up of the transition process. In February 1991, a radical reform package was accepted, prices were liberalized on everything except energy products, the exchange rate was standardized and the currency floated on the free market. Liberalization of foreign trade also contributed to the establishment of a speedier marketization process, together with the elimination of the state monopoly on foreign trade. Persistent price adjustments to the world market resulted in a high inflation rate, generating a 120% increase in the month of February alone. The total price increases for 1991 was 334% although the rate of inflation did slow down in the spring and summer. A number of new laws were enacted to accelerate privatization. Reluctantly, Bulgaria reverted to radical measures: a restitution law guaranteed the return of residential, industrial, commercial, and landed properties that had been nationalized or confiscated after 1947 to their previous owners. This uniquely-radical step was the most important element of Bulgarian privatization: by June 1992, some 3,600 shops, along with 2,600 houses and apartments, 600 industrial sites, and 130 restaurants had been returned to their former owners, as had 85% of all eligible land.

The establishment of new private firms was also initiated and, by the end of the year, nearly 180,000 new small businesses had been registered, most of these in the trade and services sector. In June 1991, the government completed the first auction of state-owned shops and gasoline stations. Another 1,500 units were immediately prepared for a second round of sell-offs. Consequently, the role of the private sector in the Bulgarian economy rose from 5% to 25%.

The law of April 1992 regulated the privatization of large state companies. The Privatization Agency is responsible for selling the shares, and the employees of the companies have the option to buy 20% and 30% of them. In August 1992 the privatization of 65 enterprises began and was slated for completion by the end of the year. By early 1993, however, almost the whole of big industry, a total of 96% of assets, was still in state ownership. In contrast to the three hundred firms which had been prepared for privatization, the government sought to sell off 1,200 that is, one-third of state-owned companies in 1993. This extremely slow privatization process is partly connected with the fact that foreign capital inflow is almost non existant. Compared to the nearly $5 billion invested in Hungary, Bulgaria has received only $100 million in three years.

The history of the past three years in the former Soviet Bloc was essentially repeated in the Soviet Union after the failed coup in the summer of 1991 which was followed by the collapse both of the Union itself and the state socialist regime. An agonizing and chaotic political transformation in the successor states has been coupled with the dramatic collapse of a sick economy and an emerging hyper-inflation as well as an indebtedness crisis. Russia, still a great power in terms of its nuclear military capability, was seemingly incapable of consolidating itself without major foreign assistance, and prepared to follow the shock treatment approach. President Boris Yeltsin and Deputy Prime Minister Yegor Gaidar, in an entirely different political, economic and historical environment, attampted to follow the Polish path based on the advise of Western advisors such as Sachs and Aslund.

Hence, though facing tremendous political opposition and mass dissatisfaction, a market transformation based on the already-established Polish-Hungarian-Czech blueprint began throughout East-Central Europe, including the vast former Soviet empire and tiny Albania. Its progress, however, was not only relatively slow but also contradictory and ambiguous.

Although the future of the Russian and East-Central European transformation is far from clear, it is unquestionably true that the Soviet model of a non-market regime, along with its numerous variations on the theme, had collapsed completely. The alternative and compelling model which dominated one-third, and strongly influenced another one-third of the world through to the 1980s was now in ruins. The collapse of the model's East European stronghold led to an inevitable chain reaction: it breathed life into market transition and free-market ideology throughout the world, having a peculiar inpact in the peripheries, such as Latin America, Asia and Africa. As Richard Sklar stated:

"By the end of the 1980s, when Leninist one-party rule collapsed in Europe, its economic rationale for Africa had entirely disappeared. The avowedly Marxist-Leninist regimes of Angola, Benin, Congo, Madagascar, Mozambique, and Zimbabwe had become receptive to the logic of capitalist development long before their leaders finally embraced multiparty democracy, in each case between 1989 and 1991. Their basic economic practices were ideologically indistinguishable from those of other African regimes..."[26]

As the reforms that have taken place in China demonstrate, most of the Asian state socialist regimes are in rapid transition towards a classic Asian-type market-based modernization dictatorship, taking their cue from the most successful postwar models, the Japanese, the South Korean, the Taiwanese and so forth.

After reviewing the global trend towards a market transition based on a triumphant free market ideology, one has to address the most decisive question of our times: will global acceptance of the free-market ideology, and the new economic world system that is in the making, lead to a more effective catching-up process in the backward peripheries? In other words: will the replacement of the failed model with the economic formulae and ideals of the most advanced "core" satisfy the nations in transition?

This is the central issue of the age and will be that of the twenty-first century, since the history of the twentieth century has shown there to be a continuous revolt at the peripheries. The world has experienced nationalist upheavals that have unleashed the bloody forces of devastating world and civil wars, as well as attempts at rearranging borders and the world system, building or destroying empires, eliminating and replacing existant dominant powers. Major revolts and revolutions have erupted to destroy *ancien regimes.* Left-wing and right-wing rebellions have attacked the status quo, and powerful ideologies – Fascism, Nazism, Communism, as well as populist, nationalist, and religious fundamentalism – have risen and declined, only to re-emerge again.

In an unstable, strife-riven peripheral world, economic success and an emerging sense of well-being would be a miraculous weapon against self-destructive and internationally-explosive rebellion. As national decline (even in relative terms) and frustration unleash various types of devastating and revolutionary forces, a successful consumer society, as Eugen Weber once formulated consumes revolts and revolutions as well. Rising economic and consumption levels, as well as what might be called the 'middleclassization' of former class societies might serve as a solid basis for a new world order.

Will marketization, privatization, and the adoption of free market ideals unleash adequate market forces and sources at the peripheries to promote an effective adjustment to transforming technologies and economic structures?

It is of course too early to evaluate and generalize. We are in the middle or, rather, the beginning of a developing new trend, the opening of a new chapter in history. All forecasts and prognoses are uncertain and mostly biased. To envision a future for the peripheries based on the success of the free market economies in the "core" or the spectacular rise of some of the Newly Industrialized Countries, might be as mistaken as supposing a continuation of decline in the transforming economies that characterized the early years of the bumpy road to transition.

An historian could find ample reasons not to even try to analyze this process, maintaining that it is "not yet history!" but, sharing the view of Marc Bloch, there is no real reason to exclude the present from history. It is only a transitory point at the end of the

[26] R.L. Sklar, "The Future of Socialism in Africa. The Failure of Economic Statism." In: M. Cohen and M. Kilson (eds.), *Africa: Crisis and Change. Dissent.* Special Issue. Summer, 1992. pp. 399–400.

endless line of history and thus would be ununderstandable without the interpretation of the *longue duree* of the historical trends that produced it. Additionally, history *in statu nascendi,* in other words, a new chapter of history in the making, always provides an excellent opportunity for discovering some primery characteristics and determinants of the emerging new developments.

5. The Experience of Adjustment: Free-Market Versus Regulated-Market Models

What are the major economic lessons of the difficult years of the recent structural crisis and of the attempts made at adjustment? As illustrated above, some countries became, on the face of it, relatively successful in the wake of the stagflation of the mid-to late-1970s and the recession of the late-1970s to early-1980s. The increased prosperity of the 1980s in the United States, and in some other countries, suggested an end of the structural crisis in the developed world. However, the repetition of the recession in the early-1990s throughout the advanced world clearly shows that an adequate adjustment has not yet taken place. The "Reagan boom" was more a product of temporary phenomena than a successful structural adjustment. The $4 trillion deficit, accumulated mostly in the 1980s, one-quarter of which originated from foreign sources, demonstrates without a shadow of a doubt the bogus character of this past prosperity which went on to become an obstacle for future recovery.

In spite of repeated recessions, slow growth and high unemployment, as well as the eergence of hitherto unknown new economic phenomena such as 'stagflation' in the late-1970s and early-1980s, and the 'growth without job creation' in the early 1990s, the adjustment process of the "core" countries are definitely making progress.

Although some of these countries may decline and thus drop out of the "core" as a result of their not being able to adjust adequately, most of the affluent countries are going through the process of, to use Schumpeter's term, "constructive destruction." While suffering from the decline and collapse of some of their leading sectors, they are building up new branches based on the most modern technology. The slow-growth period of adjustment is thus pregnant with the promise of new prosperity.

The economic turmoil of the "core," as has already been noted, was accompanied by a far-reaching crisis in the peripheries. From the late-1970s on, decline in output, hyper-inflation, high rates of unemployment, and indebtedness crisis have had powerful impact within what have become the former state socialist countries, and well as in other peripheral economies. According to Angus Maddison's calculations, the critical period 1973–1987 reflect a slower growth rate of 3.4% (compared to the 5.1% achieved between 1950 and 1973) in the world economy, these figures being based on thirty-two countries from the various regions. The 'world' average, however, included below-average growth rates in the "core," with the OECD countries coming in at 2.4%, while Latin America was growing at 2.9%, and the Soviet Union at 2.1%.

The only region which achieved a continuously rapid growth was Asia, which registered a 5.9% increase. South Korea, Taiwan, and China put on 7.9%, 7.8%, and 7.5% respectively. In the 1980s, China achieved annual growth of more than 10%. "In Asian countries," writes Maddison, "the acceleration of economic progress in the golden age was even more marked. Eight of them achieved better (generally very much better)...growth rates than in the...earlier phases."[27]

Indeed, the average rate of GDP in the Asian countries at constant prices was only 1.7% in the period 1900–1913, 1.3% in 1913–1950, and then 5.4% from 1950 to 1973. Thus the highest rate (5.9%) was achieved during the recent structural crisis. Indeed, the IMF reported surprisingly high rates of growth in some of the 'developing countries' in the early-1990s, which reached 5% a year. China, with its reformed state socialist economy, recently achieved a record 12%.

While almost all "core" countries, as well as most of the peripheries, are suffering from the damage brought by the structural crisis, the Asian modernization models proved to be the most successful.

The Japanese government's five-year plan for the second half of the 1970s defined precisely the structural changes that needed to be made to the Japanese economy to enable it to adjust to the new requirements of the period. The state plan gave strong preference to the required percentage increase in the high-tech and aerospace industries, and guaranteed incentives and assistance to the strong market forces that were to help foster restructuring.

China has successfully combined consistent market reform, a rather special form of 'privatization' and structural changes based on political stability. Whereas the government has given the green light to private business, including foreign investment and joint ventures, and contributed to creating a more flexible market and export-oriented private sector within the state socialist economy, it has made no effort to privatize the state-owned economy.

The right to sell state-owned assets is still highly constrained, noted Andrew Walder, the Harvard expert on China. "[L]and, factories, and other enterprises are not freely bought and sold...and still generally remain under the de facto ownership of territorial-defined government agencies."[28]

The reforms, however, radically changed property rights by promulgating a "widespread downward reassignment of use rights within government hierarchies, and at the grassroots, from government agencies to households and individuals. The most dramatic such reassignment took place in the dismantling of collective agriculture."[29] The same principle was applied to collectively-owned assets in industry and trade. The lease-holder received the right to manage, along with increased autonomy. Victor Nee speaks about "informal property rights" in the reformed Chinese economy. As a result of these rights being delegated to managers, state-ownership became similar to that of modern share-holding companies, one fundamental aspect of which is precisely the fact that the running of the company is in the ends of an appointed management.

Between the state and the relatively small private sectors, the most characteristic intermediate sector which has increased dramatically since the late-1970s is the so-

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[27] A. Maddison, *The World Economy in the 20th Century*, Paris: OECD. 1989. p. 37.

[28] A.G. Walder, Corporate Organization and Local State Property Rights: The Chinese Alternative to Privatization. In: V. Milor (ed.), *The Political Economy of Privatization in Post-Communist and Reforming Communist Systems*, Chapter 2. p. 11, (under publication).

[29] *Ibid.* p. 8

called collectively-owned sector in the rural areas and townships. This marketized, freely operating sector, which was owned by the local community and never belonged to the central state authorities became the main actor in the 1980s, absorbing nearly 60% of the increase of the labor force and achieving an annual 20% growth rate, which meant that its output doubled every three or four years.

Both the small size of the operations and the fact of non-exclusive property rights are linked with Chinese traditions. Since Western-style landownership never existed in the country, individual ownership was always constrained, property rights were complex, and small family-size firms traditionally dominant in the Chinese economy.

The Chinese reform model also embodies a cautious combination of domestic market protection and export orientation. The huge and very poor domestic market itself offers unlimited growth potential and the government is continuing to protect this market for domestic output.

This deliberate, far-sighted export orientation, however, has created special zones and forms, has attracted foreign capital, technology and expertise, and continuously has developed the export sector of the Chinese economy. The competitive export branches are being aggressively promoted. As a consequence, foreign trade increased five-fold between 1978 and 1988, and more than doubled its share of the country's GDP. It should be added that roughly one-quarter of exports are produced by the above- mentioned collective sector.

The entire market-oriented transformation of the economy was thus guided by the state, which also guaranteed political stability. Interestingly enough, the new impetus of reform and the high growth rate in the early-1990s was assured in the wale of the bloody Tienanmen Square massacre of 1989, when a mass demonstration and upheaval for democratic reform was ruthlessly suppressed by the use of tanks. As Andrew Walder argues, the Tienanmen Square events represent a turning-point in post-revolutionary Chinese history: in spite of using the traditional communist terminology, China is gradually turning out to be a classic Asian modernization dictatorship.

The future of China's reform, however, is still uncertain. Although it has been very successful and is generating not only astonishing economic growth but an equally impressive increase in consumption and living standards, including housing, the regime might ultimately be challenged politically and may even collapse. The country might disintegrate and decline into civil war. The major question is whether the inherent political stability of a dictatorship will survive marketization reforms.

Independently of a possible political disaster, however, the near decade-and-a-half of transition and rapid growth have, without a doubt, paved the road for a historically-rare market transformation and opportunity for catching-up.

The most successful example of adjustment to the new technological and structural requirements of the world's economy as well as the most spectacular example of catching-up, during the structural crisis in the last one-third of the century has thus undoubtedly been Asia's regulated-market economies. (China, which is gradually reforming away from state socialism into this latter category of Newly Industrialized Countries of Asia, is producing the strikingly smooth transition from a non-market, publicly-owned towards a mixed, regulated-market economy.)

The high degree of flexibility, combined with cautious and strong state participation aimed at overcoming the problems typical of an incomplete market and the lack of a market society has resulted in an increasing role for "new-style" Asia in the changing world system.

Replacing its traditional method, the United Nations published new calculations that counted the Gross Domestic Product on the basis of Purchasing Power Parity – calculations that shocked the world by proving that the assumed domination of the "core" countries was declining: rather than representing nearly three-fourth of the world's output, they actually had only a 54% share, at the expense of the rapidly-developing Asian countries. According to these new figures, China now has the second-largest economy in the world. Although calculations based on PPP are open to question, there is still a clear need to correct measuring techniques based on exchange rates. However, one cannot ignore the enormous and consistent advance and rapidly-growing importance of the Asian "success" countries such as Japan, South Korea, Taiwan, Honkong, Malaysia, Indonesia and, last but not least, China.

6. *Anni Miserabiles in Central and Eastern Europe: a Laissez-faire System in the Periphery*

Central and Eastern Europe, however, followed a different path after its *annus mirabilis* in 1989. As the most climactic and radical example of end-of-the-century market transformation in the world economy, its implications deserve special attention in this analysis. As was documented above, the region adopted the free market ideology of the Western "core" and began to rebuild its institutional and legal system, to reform ownership structures, and its economy based on the self-regulating free market model and property rights. Such an historic transformation, however, was bound to have unavoidable negative side-effects.

Closing down obsolete, non-competitive branches of the economy, ending subsidies to deficit-producing firms, or shedding part of the work force of over-staffed institutions are unavoidable steps in the transition process. The negative side effects are the decline in production and an increase in unemployment.

Adjusting to world prices and liberalizing imports is creating competition for heretofore protected and insulated Central and Eastern European economies, yet this is a prerequisite for market adjustment and introduces international market incentives. On the other hand, though, it is destructive for the obsolete branches and firms since it causes a loss of market, decline in output and an increase in bankruptcies. In an age of technological change and structural crisis, adjustment inevitably generates "creative destruction" as we have seen in the case of the advanced "core."

New and unfavorable external economic factors worsened the difficult transformation of the region. The complete collapse of the Soviet Union and the former Comecon market, a mini Gulf oil crisis in early 1991 and a severe recession in the United States followed by the Western world in general in 1991–93 has had negative repercussions on, and create additional barriers to, Central and Eastern Europe's transition.

Hence, the over-blown expectations and over-optimistic forecasts and promises inevitably came into collision with the harsh realities. Hope for a short, one- or two-year decline followed by a discernable recovery and real prosperity in four, or five years, was not well-based. Repeated government predictions of an imminent upturn in the national economy proved to be mistaken in 1990, 1991, 1992 and, in most of the cases, in 1993 as well. Official forecasts of a moderate, transitory decline in industrial output and domestic production, and calculations of a temporary increase in the rate of inflation and unemployment, have turned out to be grossly inaccurate. In the end, the deterioration of the economy has been much greater and has lasted much longer than originally expected.

The most educative case of instant market transition was that of former East Germany. The economic unification of East and West Germany was realized on July 1, 1990 with the elimination of the Ost-Mark, which made the West German DM the general official currency. A common German market was also created as a result of the removal of all the trade barriers between the two states, which were politically united on October 3 of the same year.

Seemingly overnight, the East German economy which had, up to that time, been managed along strictly orthodox, non-reforming central planning lines, had been a member of the isolationist Comecon, and had delivered the majority of its output to the Soviet and Central and Eastern European markets, became a part of the *laissez-faire* market economy of the Federal Republic of Germany. Drastic re-privatization was announced. Pre-communist ownership was legally restored. This was undoubtedly history's most uncompromising transition to a market economy, a shock treatment *par excellence.*

As a consequence, during the first three years of transition, East German production was cut to half its 1990-level, and 40% of all jobs disappeared. Describing the West German 'Economic *Blitzkrieg*' in East Germany, Roland Schoenfeld concluded: "East Germans are disappointed..., treated as second-class citizens... their life long endeavors failed and their economy – once eleventh among the world's industrial nations – in shambles."[30]

The total collapse of the former East German economy, once without a doubt the strongest and most developed in Central and Eastern Europe, might be taken as a test case. This is particularly apposite, since this part of the former Soviet Bloc received far more from external sources during the early years of its transition. The report of the Bundesbank in the spring of 1993 revealed that there had been a transfer of $250 billion from West to East Germany between 1990 and 1992. Nonetheless, instant marketization ruined the economy and the livelihoods of the majority of the adult generations of East Germany. It is significant that, in the early 1990s, a few – very extreme – but nonetheless relatively typical ideas emerged, calling for the de-industrialization of the *Ost-Länder* to make it into a tourism and recreation area. The belated and partial re-emergence of the post-war Morgenthau-plan, paradoxically enough proposed by the Germans themselves on this occasion, also typifies many of the gloomy forecasts made about this area, many of which maintain that the Eastern territories will be the 'undeveloped South' of a rich Germany.

One explanation for the collapse would certainly begin with the legacy of a vast but non-competitive, technologically and structurally-obsolete East German economy,

[30] R. Schönfeld, in this volume.

whose "principal industries," continued Schoenfeld, "were concentrated in 'rust-belt' sectors...with worldwide surplus capacities...and [with a] totally inadequate [infrastructure]." [31]

The dramatic collapse may also have been due to severe miscalculations and technical errors in managing the transition. Though this is certainly true, it cannot be denied that the dramatic collapse was, most of all, a consequence of the overnight introduction of a free market in a previously non-market society, integrating the isolationist, import-substituting economy into a *laissez-faire* West German and world economy. "When the hitherto totally protected East German industry was exposed abruptly to West German and international competition," explained the above-cited author, "its production collapsed." [32]

Despite the recent catastrophic economic collapse and the tragic human cost, including the loss of entire generations in their forties and above, and dispite the resulting political turmoil, re-emergent racism and murderous atrocities, East Germany's suffering will certainly be resolved in the framework of one of the world's strongest economic powers, Germany. The uncompromising marketization of former East Germany, however, clearly shows the devastating impact of replacing a non-market system with a free-market economy overnight.

Although the East German case is somewhat extreme, the situation reflects major similarities in the Central and Eastern European countries. The former Solidarity adviser Tadeusz Kowalik presents a dramatic picture of the post-1989 Polish situation: "Over the first year alone (1990) the national income declined not by the forecasted 3% but by 13%, distributed income declined by as much as 18%, and industrial production declined not by forecasted 5%, but by 23%. Real wages were lower by about one third. Personal consumption declined by 15%...And what is more disastrous, by the spring '92 the Polish economy...is still systematically declining. Thus, a severe recession is turning into a long-lasting depression..." [33]

The Polish "slumpflation", as Kowalik described it, actually worsened in 1991. While the government predicted a 3.5% increase of the Gross Domestic Product, in reality the decline continued at an accelerated pace: the Vienna Institute for Comparative Economic Studies published the shocking revelation that productive investments declined twice as much in 1991 than in 1990, industrial output and the Gross Domestic Product continued to decrease by more than 10%, and the electro-mechanical and chemical industries, which decreased production by 12.7% and 13.3% in 1990, fell by 29.1% and 14.3% respectively in 1991.

In the spring of 1992, the decline reached its nadir, with GDP and industrial output down just under 30% and 40% respectively. Unemployment, which stood at 6% at the end of 1990, surpassed the 12% mark a year later. This kind of "destruction" is not linked yet to any kind of "creative" impact. As one of the Polish experts summerized: "Productivity is going down and production cost per unit is going up, further undermining the competitiveness of Polish products. The percentage for costs in the total revenues of enterprises increased from 78.9 to 87.1% in the first half of

[31] *Ibid.* p. 68.
[32] *Ibid.*
[33] T. Kowalik, *Creating Economic Foundation for Democracy* (manuscript), 1992, pp. 5–6.

1991...It is clearly evident that continuation of the 'shock treatment' policies enhances further the cost driven inflation by increasing the cost of capital and further reducing demand."[34]

In Czechoslovakia, where a similar shock therapy was introduced in January 1991, the consequences were similar: instead of the projected decline of between 5% and 10%, the Gross National Product fell over the year by 16% and industrial output dropped by 23%. At the end of 1992, these figures had reached 20% and 36% respectively.

It pays to note and warn, however, that not only the economy but the statistical service of the region is in flux and one have to count with major miscalculations and mistakes.

In the analysis of Kowalik, Kozminski, and several other Polish economists, the reason for the continuous decline is the ill-advised, ideological shock therapy. "To a certain degree," stated Kowalik, "this is a consequence of the collapse of trade with the USSR, but undoubtedly the main reason was an orthodox, and very rigid, austerity policy."[35]

This argument, however, is contradicted by the fact that a somewhat similar decline occurred in more "gradualist" Hungary, where industrial output dropped by 9.6%, 18.8% and 10% in 1990, 1991 and 1992 respectively, while the GDP decreased by about 30%. After a slow start, unemployment, which was 0% had gone above 12%, with almost one in four workers unemployed in regions such as the North-Eastern base of 'heavy industry'. According to what look like robust government-issued calculations, a further dramatic increase of unemployment is still ahead.

Moreover, there has also a striking decline in agriculture. Since this was one of the former success branches of the Hungarian economy and a leading export sector, its decline demands special and more detailed attention. On an international level, Hungary used to be ranked as one of the top five countries in terms of per capita grain and meat production. In the fall of 1991, the area which was reserved for wheat decreased by 25%, and fallow land increased five-fold. Animal stock decreased dramatically: the deputy minister of agriculture reported in May 1993 that the number of cattle and pigs fell by 41% and 48%, poultry by 50%. He added: "The burden of change of the regimes was suffered most by agriculture."[36]

Agricultural production declined by 10% both in 1990 and 1991, but in 1992 it fell by a dramatic 23%. The use of artificial fertilizers drastically dropped to one fifth of its previous levels. So-called "side" activities of the cooperative farms, such as food processing, and various kinds of industrial and service ventures, virtually disappeared.

In addition, there has been a strong outflow of capital from agriculture. (In 1992, interest payments on savings accounts produced returns four times higher than investment in, for example, pig fattening.) In 1991, half of the amortization was not covered, and agricultural assets began to decrease. The state began subsidizing the slaughter of

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[34] A.K. Kozminski, *Op.cit.* pp. 324–325.

[35] T. Kowalik, *Op.cit.* p. 6.

[36] L. Medgyasszay, "Dramai helyzet az allattenyesztesben (Dramatic situation in animal husbandry), *Nepszabadsag*, May 28, 1993.

animals. As a consequence, 137,000 people left agriculture in 1991. By 1992, only 440,000 people remained, half of those who worked in the sector a decade before.

In an analysis debated by the presidium of the Hungarian Academy of Sciences in early 1993, the authors maintained that "nearly one-third of the farms might be financially bankrupt in the near future...[and] there is a danger of a total disintegration of Hungarian agriculture." [37]

The first years of transition have thus caused more destruction in Hungarian agriculture than did the notorious forced collectivisation process.

Several factors have contributed to this destruction. In the first place, one should mention the legacy of a hidden agricultural crisis in the 1980s. Relatively high production cost did not cause perceptible consequences at the time, since export markets were available, and agriculture was heavily subsidized. But Hungarian agriculture, though very successful in its traditional activities, was unable to adjust to the world market's requirements. The hidden crisis became manifest from one year to the next after 1989.

Major mistakes were also a factor. The government, for example, accepted a re-privatization program of peasant farmland. This had been demanded by the Smallholder's Party, though (genuinely) rejected by all the other parties, including those of the governing coalition. The reconstruction of the old ownership structure, however, was being carried out in an entirely different historical context. Prior to the forced collectivisation, according to the census of January 1, 1949, some 56% of gainfully-occupied people worked in agriculture in Hungary. Today, only between 12% and 13% do so. In these circumstances, re-privatization could not provide an incentive for a renewal of agriculture, but rather, by creating a high degree of uncertainty, it would be likely to provoke a de-stabilization of agriculture. In addition, it coincided with an ideological crusade to eliminate cooperative farms, even though most of them have continued to operate.

The most devastating effect, however, was the elimination of subsidies. Not only budgetary tensions but also international requirements and an overblowen free-market ideology encouraged the government to do away with subsidies and open the domestic market. While Hungary earmarked a 10% state subsidy for its agricultural products in 1991, the European Community was providing 49%. Gyorgy Rasko, the deputy secretary for agriculture stated in an interview on December 24, 1992: "While the European Community has a 50% agricultural subsidy, Hungary, according to OECD calculations, has a negative subsidy...," by which he meant that Hungarian farmers paid out more in taxes than they received in subsidies.[38] Although the Community has an import tariff of 250% for beef, Hungary's is one of only 15%. Small wonder that food imports to Hungary from the European Community increased by 32% in 1991 and by 54% in 1992. On the other hand, Hungary could not exploit its increased agricultural export possibilities to the West (even though a 10% increase was granted for 1992). The first quarter of 1993 signalizes a continuing dramatic

[37] A. Sipos-P. Halmai, "Jelenkori agrarproblemak. Az atalakulo agrargazdasag feszultsegei es kibontakozasi lehetosegei (Contemporary problems of agriculture. tensions in the transforming agriculture and the possibility of ways out), *Magyar Tudomany*. 1993. No. 2. pp. 123, 127.

[38] *Magyar Hirlap*. December 24, 1992.

decline: Hungarian agricultural export decreased by 50%, while imports increased by 8% compared to same period in 1992.

A successful reorientation of Hungarian agricultural exports from the Comecon area to Western Europe was a major economic achievement, though there has been a high price to pay for it: "these exports are viable only at such a low price that it cannot entirely cover the cost of production."[39]

The same phenomenon battered Polish agriculture, where long-standing private farms had to face devastating competition from highly-productive Western agriculture. As Andrzej Olechowski, a close aid to Lech Walesa and member of several Polish cabinets expressed the religious belief: "even unilateral opening of the economy to the world is advantageous...Liberalization may be harmful...Nevertheless, the overall prosperity will increase."[40] As a consequence, reported Joel Haveman from Kaczewo in the summer of 1992: "The dairy cases of Poland's grocery stores are stocked high with butter from Germany and the Netherlands, so high that native son Brunon Wardecki cannot profitably sell butter even to his local market... When the Warsaw government engineered Poland's overnight transition to a free-market economy on January 1,1990, it virtually abolished tariffs on farm imports, making the country's agricultural market one of the most open in the world."[41]

Bulgarian agriculture, after re-privatizing land and re-establishing a maximum of 30-hectars peasant farms, dropped back to pre-industrial technology. In 1992, in addition, 1.9 million ships, 460,000 pigs and 253,000 cattle were slaughtered, since the small farms could not keep them.

The most dramatic decline, however, hit the traditional export sector of Bulgarian agriculture. The state monopoly of Bulgartabac used to be the world's Number One cigarette, and Number Two tobacco exporter. These two branches represented roughly one-half of the output of food processing. In 1992, tobacco production declined by 50% and the twelve processing, and nine cigarette producing firms worked at only 60% capacity. Bulgaria's share in the European market dropped to 10%. American export rose to twice the level of the previous Bulgarian record. Moreover, after halving tariff barriers, tobacco import reached 6.5 million kilograms, the amount produce of 10,000 Bulgarian tobacco farmers in one year.

Severe economic decline has been the most common characteristic of Central and Eastern Europe in the early 1990s. It was not only shock treated Poland or gradualist but consistently reforming Hungary that suffered the most massive losses. "The most dramatic output losses – measured output has fallen by more than half – have been in Albania...and the successor states of the former Yugoslavia," summarized two World Bank experts. "These extreme cases are attributable to special circumstances – in Albania, the disruptive disintegration of an unusually closed regime...and in Yugoslavia the civil war."[42]

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[39] A. Sipos-P. Halmai, *Op.cit.* p. 122.

[40] "Integracji dzien powszedni." *Zycie Gospodarcze*, No. 44, November 5, 1993. Cited by: T. Kowalik, in this volume.

[41] J. Haveman, "Silver Curtain: Economic Decaying." *Los Angeles Times*, August 11, 1992.

[42] M.I. Blejer and A. Gelb, "Persistent Economic Decline in Central and Eastern Europe. What are the lessons?" *Transition. The Newsletter About Reforming Economies*, The World Bank. Vol. 3, No. 7. July–August 1992. p. 2.

As a matter of fact the Yugoslav economy was on the verge of total collapse by the summer of 1991. Industrial production had fallen by 30% and the GNP by 20%, tourism to the country plummeted from eight million visitors in 1990 to just a few thousand in 1991, which alone led to a loss of $4 billion, and the unemployment rate soared to a catastrophic 20%. In 1992, small-Yugoslavia's output suffered a further 30% decline and inflation rate reached 223% in the first quarter of 1993.

The downturn was substantial throughout the region. During the first one-and-a-half years of transition in Bulgaria, before the radicalization of the government's reforms, economic decline reached dramatic proportions: according to the Organization for Economic Cooperation and Development, decrease in output was close to 14% in 1990, one of the most abrupt in Central and Eastern Europe. In the first half of 1991, industrial production declined by 29% and production in general by 22.6%. The extent of the crisis was evident in the fact that exports dropped by 50% in the first half of 1991 (while trade in rubles fell by 75%). In addition, domestic consumption and production were crippled by a sharp drop in imports (from $4.11 to $1.59 billion). In 1992, Bulgaria's GDP decreased by a further 13%. In Romania, where moderate reforms were cautiously implemented, industrial production declined by one-third between the summers of 1991 and 1992, and unemployment reached 6.7%.The decline of the GDP in 1992 reached 15.4%, a rate surpassed only by the successor states of the former Soviet Union which suffered, on average, a 19% decline in their GDP.

Besides the particularly tragic case of Albania and Yugoslavia, and considering all the possible mistakes of statistics, the GDP of the other countries of the region certainly declined by an average of 20% to 30% and industrial output fell by between 30% and 40%. It seems clear that the year 1989, the *annus mirabilis* was followed by the *anni miserabiles,* in other words, several miserable years.

What was the reason of the extremely sharp and unexpected economic decline in the early 1990s?

In the case of Poland, explanations mentioned earlier attributed the crisis to shock therapy, which undoubtedly spurred the country's sharp downturn. But this interpretation cannot explain the general phenomenon of economic decline throughout the region.

In December 1992, Janos Kornai, one of the leading experts of the state socialist economy, provided another explanation for the decline of gradualist Hungary: "There were some factors, connected with international fluctuations, which contributed to the decline, but their role had a secondary importance. The primary explanation is the following: the severe decrease of production is a painful side effect of the healthy process of changing the system. Whereas several elements of the mechanism of economic decline seems on the surface to be similar to other cyclical phenomena and structural transformations ..., this is something rather different...its cause is the transition from socialism to capitalism." [43]

Kornai's point that the transition has several unavoidable, negative side-effects is of course correct, but nobody predicted a 30% to 50% decline. Furthermore, the proposed solution implicitly alludes to a concrete blueprint to be followed. If things go wrong, just proceed faster: "To end the decline," recommends Kornai, and his sugge-

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[43] *Magyar Hirlap*. December 24, 1992.

stion postulates a single paradigm, the existence of only one road to follow, "one should not go backward, but forward, preserving the results of the transformation already achieved and accomplishing even faster the tasks still remaining."[44]

The "transformational recession," as Kornai called the economic decline in Central and Eastern Europe, has a multi-causal explanation. He speaks about six main factors behind it: "Shift from a sellers' to a buyers' market; Contraction of investment; Shift in the composition of output; Shift in the composition of foreign trade; Disruption of coordination; Enforcement of financial discipline."[45] In this interpretation even the "disruption of coordination" and "enforcement of financial discipline" are strong reasons for decline and economic chaos in Bulgaria and Albania, where the elimination of the old regime was not immediatelly followed by consistent reforms.

However, more and more experts are questioning the applicability of what David Stark formulated as "design capitalism." (He goes even further by challenging the term "transition" because the word implies a known end-result, and he prefers to use the "transformation.")

In addition, a third type of explanation has emerged. The drastic deterioration of general economic conditions, Domenico Nuti has observed, "is not [a] necessary concomitant of transition, nor a consequence of shock therapy..., but the unnecessary consequence of policy failures."[46] Nuti lists several policy failures, such as the dearth of liquidation and bankruptcy procedures, which had long encouraged firms to accumulate debt. He also criticized the lack of a "clear and coherent privatization program." But the primary focus of his criticism regards, "the failure in government management of the state sector."

Indeed, in most of the countries, the state sector was handled as if it were an instantaneously disappearing group of companies. State-owned big industry was written off, and served only as a source of state income. In most of the countries, state companies were, and are, overtaxed, unable to invest in themselves. They had used up their last reserves and had begun to concentrate on exporting to the West but, renounced by their respective governments, and unable to adjust to the rapidly-changing situation, they were, for the most part, doomed to oblivion. This "betrayed" ailing state sector, however, still represents the bulk of the responsible for between 50% to 70% of all domestic output, but there is little interest in revitalizing a part of it.

All the explanations, of course, contain elements of the truth. A certain degree of decline was unavoidable, the overly rapid transition caused even more damage, and policy mistakes contributed greatly.

The decline and extremely harsh disturbances, however, have deeper roots and causes. They are closely connected with an unquestioned, religious neo-liberal economic philosophy predominating in the region. The new believers are convinced that there is only one "design," an imagined, ideal *laissez-faire* capitalism without state ownership and intervention. All other options are to be rejected.

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[44] *Ibid.*

[45] Interview with Janos Kornai, "Anti-Depression Cure for Ailing Postcommunist Economies." *Transition. The Newsletter About Reforming Economies,* The World Bank. Vol. 4, No. 1, February 1993. p. 2.

[46] D.M. Nuti, "How to Contain Economic Inertia in the Transitional Economies." *Transition. The Newsletter About Reforming Economies,* The World Bank. Vol. 3, No. 11, December 1992–January 1993. p. 2.

Unlike the period 1988–89, when a "Scandinavian model" and Austrian *Sozialpartnerschaft* were relatively popular in East-Central Europe, the new governments now enthusiastically copy "Thatcherism" and "Reaganomics." The highly-redistributive Scandinavian model is considered too *etatiste* and socialist. In the place of *Sozialpartnerschaft*, the regimes seek to crush the trade unions, which they view as being either "Red" or anachronistic to the changing times, and they frown upon union organizing as potentially threat to democratic order. The half-century triumph of West European mixed economies in France, Italy, and Austria, where the state had owned between 20% to 50% of the economy, was counterbalanced by a pronounced trend towards privatization in the 1980s. The most successful road of the East Asian countries, which in several cases combined market-oriented modernization with dictatorship, and in all cases utilized strong state interventionism, has not even been considered in Central and Eastern Europe.

This ideological approach has also been the source of other serious mistakes. Since the neo-liberal paradigm is based on the assumption of an ideal equilibrium and a perfect market and market mechanism, the followers imagined that the rapid introduction of this type of market would automatically resolve everything.

Alec Nove, in a study of the gaps and illusions of transition, critically cited Marek Dambrowski and Vaclav Klaus as resisting "interventionist pressures" and "the demand for a kind of government investment policy." As Nove points out, any kind of resource allocation for restructuring, any "state influence on the branch structure of the economy," or any "priority in government (economic) policy" over the market mechanism is rigidly opposed. "No industrial policy, no energy policy, no investment strategy. All will come about by itself if and when macro-economic stabilization is achieved." [47]

During the years of transition, the hierarchy of economic goals was, in a way, turned upside-down. In the beginning, marketization and privatization were initiated in order to provide adequate market incentives to assure successful adjustment. During these early years, however, a religious "de-statization" became a primary goal in itself, and not economic restructuring and the attempt to generate an adequate response to the challenge of the world economy, which were 'temporarily' pushed aside.

Schumpeter's term of "creative destruction" had certainly never been used more often that during those two or three years in Central and Eastern Europe. By the end of 1992, however, there had been an unexpectedly striking amount of destruction, but the creative aspects of the transition were still to be seen.

"The fall in output," stated two World Bank experts, "does not seem to have been accompanied by the radical economic restructuring that many expected as part of the reform process." [48]

The first three years of the transition, which led to a spectacular breakthrough in the transformation from a planned, state-owned system to one that is privatized and market-oriented, and which achieved impressive results in coping with the former shortage-ridden economies, could not yet generate significant results in restructuring

[47] A. Nove, *Op.cit.* pp. 5,10.
[48] M.I. Blejer and A.Gelb, *Op.cit.* pp. 2–3.

the economy. The core issue of the structural crisis, the need for a structural-technological adjustment, is yet to be addressed. State socialism was unable to respond because of the rigidity of the planned economy, and the lack of adequate interest in a state-owned economy. The first results of the economic transformation, however, were not sufficient to initiate a major restructuring. There are structural changes regarding the share of industrial and services branches, the size structure of enterprises, and on a micro-economic, i.e. product level. The lack of governmental economic policy to initiate and assist the macro-economic restructuring has certainly been a contributing factor to the lack of adequate transformation. But state interventionism is still rejected by the new political elite of Central and Eastern Europe. The first minor small steps toward the needed structural changes – at least in macro-economic, i.e. branch level – are linked, almost without exception, to a few isolated large-scale investment projects of several Western conglomerates such as Volkswagen, General Motors, General Electric, Unilever and Suzuki. But very few have shown genuine interest in the area, and those who have mostly did so at the beginning of the transition period. Some other Western giants prefer to build profitable Pizza Hut and Kentucky Fried Chicken chains. Philip Morris has invested in Czech tobacco industry. Needless to say, however, neither the German and Austrian retail chains Bauerkleider and Meinl, nor PepsiCo can possibly generate major structural changes.

Foreign investments, in general, are rather limited. Western investors have found most of the countries in the region not to be investment-worthy. This is clearly illustrated by the fact that roughly $10 billion have been directly invested into the Central and Eastern European countries (excluding the former Soviet Union) in a three-year period, which is only one-sixth of the $60 billion invested in Latin America during the last eighteen months, or one-half of the amount of American capital that flowed into Mexico in the single year of 1992. What is even more telling is that, in 1992, Kazahstan itself received as much foreign investment (because of its oil and raw material sources) as all twelve of the Central and Eastern European countries in transition.

Moderate domestic sources and small foreign enterprises had no real impact on the development of competitive export branches, partly because of a lack of financial strength, partly because of their preference in investing in trade and services. Hence, the real causes of the dramatic economic decline recall the experiences and lessons of the past: lack of adjustment has typified and continued to typify peripheral regions. The structural crisis of the 1980s generated somewhat similar processes in Central and Eastern Europe and Latin America. Their reaction was not very different from that during the structural crises of the 1870s and 1930s.

The poor peripheral countries of Central and Eastern Europe were unable to adjust at that time to world technological and structural changes, and sought a way out by increasing their traditional exports without restructuring their foreign trade. They succeeded only in finding a safe shelter in a regional agreement system, which was isolationist and was set to maintain regional self-sufficiency outside the scope of the world market. The self-sufficient imperial unit of the Austro-Hungarian Monarchy helped conserve the obsolete structure of the Hungarian economy and its grain-producing agriculture by counterbalancing the devastating effects of the world market – which had a dramatic 30% decline in terms of trade for the European grain producing and exporting countries. Effective agricultural protectionism ensured that the Dual Monarchy was the market for Hungarian agriculture and granted higher prices and an increase of over 30% in the terms of trade for Hungary.

Although the Habsburg Monarchy was able, by means of protectionism, to avoid the devastating effects of the structural crisis of the 1870–80s, it was, at the same time, untouched by the challenges and inspirations offered by the world market, and this contributed to its retention of obsolete structures and hampered adjustment to the new.

This pattern of "non-adjustment" was repeated during the structural crisis of the 1930s. This time Nazi Germany created an isolationist trading block with *Südosteuropa,* signing a set of agreements with Hungary, Romania, Yugoslavia, and Bulgaria in 1934 and 1935. On a bilateral basis, the countries of the region kept their trade from the world by using a clearing system employing barter arrangements which thus avoided hard currency payment. This type of trade was directed entirely by the state, which also set and subsidized the artificially-fixed prices, the money for which was raised by special bilateral tariff reductions. The safe, protected market undoubtedly helped the crisis-ridden Central and Eastern European countries to cope with the devastating impact of the Great Depression but, once again, the price paid for this short-term advantage was rather high, in part because it meant an increasing economic and political dependence on Nazi Germany, as well as the preservation of the old, unchanging structure of output and exports.

The 'non-reactive' (or regressively reacting) attitude of the peripheral countries led to the collapse of the self-regulating market economy during the interwar years. It should be added that this system was in a deep and continuously deepening crisis throughout the world in those decades. "Market economy, free trade, and the gold standard...broke down in the twenties everywhere," noted Karl Polanyi, "in Germany, Italy, or Austria the event was merely more political and more dramatic." [49]

In Polanyi's interpretation, the self-regulating market – an institution of the 19th century and an invention of Great Britain – had "only haltingly functioned since the turn of the century," was wrecked by the War and the treaties that followed. Still, "the tendency of the times was simply to establish (or re-establish) the system commonly associated with the ideals of the English, the American, and the French revolutions... [However] in the early thirties, change set in with abruptness. Its landmarks were the abandonment of the gold standard by Great Britain; the Five-Year Plans in Russia; the launching of the New Deal; the National Socialist Revolution in Germany; the collapse of the League in favor of autarchist empires...[B]y 1940 every vestige of the international system had disappeared..." [50]

Albeit in an immensely deformed way, "fascism and socialism... were live forces in the institutional transformation," [51] and it is small wonder that most of the European peripheries in the East and South turned towards some version of fascism or socialism during the stormy 20th century. They did so because they preferred something other than the self-regulating free-market system, which they felt would be of no use to them in their drive to catch up with the West.

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[49] K. Polanyi, *Op.cit.* p. 30.
[50] *Ibid.* p. 23.
[51] *Ibid.*

Polanyi, however, was entirely mistaken when he buried the free-market system, declaring its demise to have taken place in the 1940s. The free-market system, with the direct contribution of the United States, triumphantly reconquered the advanced European "core" and worked very well after World War II. Moreover, it became an internationally-recognized and ideologically-formulated ideal at the end of the century.

Conclusion

Central and Eastern Europe, which is presently going through history's most dramatic and spectacular transition process of marketization and privatization, is also suffering the most destructive consequences of that transition. The lessons to be learned from this case are historically important.

In addition to various factors of decline, the major reason for this tragic deterioration was a premature opening of the countries' market without even a partial technological and structural adjustment to the world economy having been made. This "opening of the greenhouse door" – which involved exposing the contents of what had, until that time, been a carefully-protected hot-house – in the middle of the harshest winter, in effect destroyed a large percentage of the 'greenery.' The more sudden and radical the opening of the door, the more serious was the destruction.

In addition, a premature and over-emphatic 'de-statization' was used in the attempt to set in motion market-automatism which had not even existed nor, where it did, functioned properly in the non complete-market economies. As a result of a lack of effective state guidance – to directed investment in a cautious way, to devise a labor and structural policy – not only did the adjustments and the structural changes not take place, but some very negative consequences occured.

All of the mistakes and difficulties are connected to the erroneous choice of the model of transition. To avoid any misunderstanding, allow me to reiterate that replacing a non-market with a market, economy was an unavoidable prerequisite for adjusting to the technological and structural transformation of the world. Privatization of an almost-entirely state-owned economy was inseparable from marketization. But a transformation to a regulated mixed-market economy would have been more 'organic' and much smoother than one to an imagined free and self-regulating *laissez-faire* market system. History rarely tolerates U-turns. Revolutions, which introduce new calendar in a theatrical fashon, have always carried the heavy legacy of the very past they rejected and this, against the will and dreams of revolutionary radicals, has often pushed them to take courses of action that they, in their heart of hearts, had rejected.

Moreover, as we have seen above, the peripheries have never had a successful free-market system. This could not work in a backward economic environment and in non-market societies, and in fact has never worked outside the advanced "core" countries.

Over and above all this, the last one-third of the century has shown that *laissez-faire* economies themselves have had relatively serious problems in coping with the adjustment that have been called upon to make. The two major recessions – one at the end of the 1970s and the start of the 1980s, and the other at the early 1990s – clearly reflect the difficulties inherent in this adjustment.

By contrast, the most successful adjustment and growth have been produced by regulated mixed-market economies, that is where a protected domestic market is teamed with an aggressive export drive. These countries have strong, interventionist states which deliberately assist and, if necessary, replaced the market mechanism (as history proves, even *laissez-faire* countries tend to turn toward regulation and state interference during major structural crises or periods of economic turmoil).

The irony of history is that the attempted model of a free- market economy in its Chicago School text-book form does not exist in the more pragmatic reality of the "core" countries, which often protect their economically-sensitive branches and subsidize their politically-important sectors.

The Central and Eastern European political elite obediently and enthusiastically sought to introduce the *laissez-faire* system, whereas the 1992 American elections had already expressed the need for correcting such an approach. The Democratic candidate won the election because of his promised job-creation program and his plan to revitalize the ailing economy. The middle class recognized the need for certain sacrifices and, when it comes to health care and educational policy, for reform along the lines of a Welfare State. Hence, the reforming Central and Eastern European countries were striving for a system that was already being questioned in its country of origin.

Instead of a religious-ideological free-market approach, a more pragmatic, organic transformation via a regulated mixed-market economy would have more easily delivered up a relatively smooth and successful period of change and structural adjustment – one with a relatively large publicly-owned sector, strong state direction, and intervention in labor, investment and structural (industrial) policy, as well as a combination of liberalization and, in certain fields, protection of the domestic market.

Has the future of the region already been determined by the transition policy that has been adopted? According to certain views, the damage caused by the mistaken choice of policy is already irreversible. The decline is devastating and it may take decades for these countries to recover. Privatization, in the form chosen, has imposed unbearable burdens on state budgets, since the "crown jewels" of these economies – valuable and promising firms with great potential – were sold for small sums during the first wave of privatization. Meanwhile, the hopelessly-bankrupt ones which used to be subsidized from the profits of the more successful firms, which have been sold off, have remained in the hands of the state, which stands no chance of selling them. The dilemma – whether to subsidize or shut down – creates an insoluble problem for the respective governments. The alternative is high inflation and a budgetary crisis, or a drastic increase in unemployment, possibly somewhere between 30% and 40%.

The premature, suicidal opening of the domestic market has even destroyed branches that used to be successful. Moreover, the $3.1 billion surplus of the European Community's trade with five Central and Eastern European countries in 1992 clearly shows that, despite the rethoric on assistance, the "core" is profiting much more from free trade with the region than are the transforming counties.

Although the devastation is wide-spread, it would be premature to forecast an irreversible decline of the region. Policy changes and a model correction may reverse unfavorable economic trends. A more skilful combination of regulations *and* market may soon revitalize the ailing economies in transition.

One might also not exclude the possibility of an eventual acceptance of some of the region's countries into the European Community. In this case, the high price of adjustment to Europe's institutional-economic system would indeed be a worthwhile entrance fee to dear Europe. In reality, and based on historical experience, however, only a few countries of the Western rim of Central and Eastern Europe have any chance of achieving that aim: those which, using the metaphor of Endre Ady, the early 20th century Hungarian poet, have been "ferry-boat countries" in their thousand-year-long history, sailing towards the West part of the time and then sailing back to the East. They may now have a new historical opportunity for setting sail.

Not only Central and Eastern Europe but the entire world economy is in flux, though. The countries that are, and will be, successful are those that find a pragmatic way, based on their own circumstances, to adjust to a rapidly-changing international environment.

The Chicago School market ideology may not prevail. Frank Hahn's prediction, made during his lecture at the British Academy in February 1992, may be proven correct by the turn of the century: "I hope I may have convinced you that the problems raised by incomplete markets are real...Keynes...has been declared out of date and wrong by the very simple device of ignoring and assuming away all of the difficulties which he thought to be important. But they will not go away. When, as now appears to be the case, they are again recognized, economists will again become more circumspect in their judgement of market economies...The General Theory...will again seen as pointing to the right questions."[52]

History teaches us that the roads lending up to, and down from, the "core" are equally passable during the trying and demanding times of major structural crises. There will be new "victor" and new "victim" countries, rising or declining depending on their response to the challenges of the world economy.

On the other hand, history also proves that the starting position of the "core" and peripheral countries are far from equal. Though a few former "core" countries may decline and a few former peripheral countries may rise and join the "core," the bulk of the periphery will remain where it is, unable to compete and adjust. The poorest 20% of the world's population receives only 1.3% of the global income, and has a 0.9% rate of participation in world trade. This part of the world will continue to decline. This is certainly true for much of Eastern Europe as well.

An emerging new world economic system may rearrange the inter-relationships, structures and strength of countries and regions but it also reproduces a great deal from the old system. It appeares that, following the marketization trend at the end of the 20th century, the differences and conflicts between North and South, and East and West – though changed and in somewhat modified form – will nonetheless remain.

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[52] F.V. Hahn, *Proceeding of the British Academy*, 80. 1991. Lectures and Memoires. Oxford University Press. 1993. p. 217.

Felix Butschek
Franz Baltzarek

Austria's Transformation to Market Economy

– A Lesson of "Sozialpartnerschaft" –

1. Transformation and Dissolution

After the "Velvet Revolution" in the East, many economists held the opinion that a change from a centrally planned economy to a market economy is historically unique. This is certainly partly true, because such changes have occurred several times, though the scope and economic and institutional surrounding of the transformations were highly different.

In Austria such a change occurred twice, first, after World War I and a second time after World War II. This re-marketization was certainly not a specific Austrian development, because most of the European economies had to face similar problems, but in Austria in the former case, it had to be performed under specific circumstances – the dissolution of the Austro-Hungarian Monarchy – and a very specific policy was used for transformation.

In World War I authorities tried to introduce a sort of planned war economy making use of the private cartel organization within industrial branches and the banking system. With the help of the leaders of cartelized branches, the government founded semi-autonomous *Zentralen* in order to regulate the market, especially to reduce shortages in raw materials, foodstuffs, energy and foreign currencies.

Enterprises had to report the stock of their commodities and peasants had to deliver at fixed prices. Control systems for import and export were also introduced. The government interfered with price formation; prices and wages were fixed – although the price-control never worked well – and even apartment rents came under control. State subsidies were given to state owned and private armament industries.

In 1917 the *Generalkommissariat für Kriegs- und Übergangswirtschaft* was founded. Its leading personalities – especially Richard Riedl from the Ministry of Trade – believed that Austria's return to peace time economy should be accompanied by state intervention, price regulation, subsidies for industry and agriculture, and also for a new form of societal security. In their ideas the so called "Etatismus" was the future form of economic and social organization.

After the breakdown of the Habsburg Monarchy and at the beginning of the First Republic, social democrats became dynamic leaders in the great coalition with the Christian-Socialist Party. At the end of 1918 and early 1919 they continued to adopted institutions and organizational measures of the war economy. Central Europe sought to tackle the shortage of foodstuffs, raw materials, energy and foreign currencies and the danger of high inflation by state interventions. Additionally, a "statist" ideology prevailed: the social democrats, influenced by the revolution in Russia and the establishment of a Council Republic in Hungary and Bavaria, maintained that a new period of socialism with economic planning, *Sozialisierung* of private enterprises – all with the help of government and state – was imminent. At the end of 1919 Ludwig von Mises, later one of the most important fighters against etatism, economic planning, and state intervention wrote: "Die Republik hat das wirtschaftliche System des Kaiserreiches nur noch verschärft, sie hat die staatssozialistischen und merkantilistischen Tendenzen des Militarismus ausgebaut und erneuert."[1]

But in reality – although some nationalization was accomplished and the *Rätesystem* was discussed – Austria had to integrate its new state and economy into a world economic system of market economies. Within the large imperial economy of the Habsburg Empire before World War I, tendencies toward a self-sufficiency prevailed. During the war years when the Central Powers were cut off from the world market, there was no other alternatives. But after the dissolution of the empire into several small countries, it seemed necessary to return to the market system and to liberalize foreign trade. From the Austrian point of view, it was vital to resume all economic activities and connections with the successor states, especially to acquire energy and raw materials for the production of industry and foodstuffs for the population. Exports to the successor states should have been facilitated and the position of Vienna as the financial center of this region should have been preserved. Therefore liberalization took place very quickly in the banking system and then, of course, in export industries. Administrative regulation of international financial transactions ended in November 1920, state permitted more liberalized import and export trade at the beginning of 1921.

But the way back into market economy was paved with problems of administered prices, a large deficit in the state budget and the decline of the Austrian currency at home and abroad. The wage and price controls were generally canceled in 1919 and 1920, but rents, food prices and service fees in the public sector (railways, postal service, commodities of state monopolies like salt and tobacco) remained regulated. State subsidies allowed these prices to remain at a low level. But the subsidies amounted to 25% of the total budget in 1920 and nearly 60% in 1921. Additionally, since a great number of civil servants whom the young Republic inherited from the monarchy had to be paid, enormous deficits arose, which had to be financed by central bank loans – with the notorious inflationary consequences.

As long as food prices and service fees remained low, wage-claims wer moderate and trade unions were more interested in the enactment of social security laws. The roots of the "Social Partnership" between representatives of employers and workers which one can find in the social insurance system even before the war and also in the so called *Beschwerdekommissionen* of the big industries of the war period, played no role in 1919 and 1920. At this time all problems were managed by Government and Parliament.

But the social democrats left the Government in autumn, 1920. The improvement of social security was stopped, but maintained on a very high level. Wage claims increased and, as trade unions were successful in the indexation of wages, inflation,

[1] L. von Mieses, *Die politischen Beziehungen Wiens zu den Ländern im Lichte der Volkswirtschaft. Vortrag, gehalten in der 258. Plenarsitzung der Gesellschaft der Volkswirte am 2. Dezember 1919*, Wien, 1919, p. 14.

inherited from the war years, accelerated. When subsidies for food were canceled according to the *Abbaugesetz* in 1922 by the Conservative Government, inflation reached its climax. Postwar disturbances subsided only with the stabilization of the Austrian currency in context with the so called "Geneva Protocols" of 1923.

The real consequences of this "transformation" for economic growth are not entirely clear, because they must be seen in the context with the dissolution of the Habsburg Monarchy and its short-term negative impact on the Austrian economy. Production, consequently, suffered heavy losses, and GDP reached the prewar level only in 1928, years later than most of other European countries.[2]

2. Gradual Transformation by Social Partnership

After World War II the scene had changed considerably. First, Austria inherited the elaborate planned war-economy of the Nazi-German *Reich.* Nazi-Germany abandoned market system as an instrument of economic coordination quite early as a part of war preparation *(Neuer Plan).* Prices, wages, foreign trade and international financial transactions were strictly regulated. This system was further intensified during the war, when nearly the whole production and distribution came under administrative control.

Austria inherited not only the economic system, but also the economic situation. Total output had decreased more than 50% compared to 1937, the last year of Austria's independence, while the volume of money in circulation had increased sixfold. Nobody envisaged, at this moment, a reintroduction of the market economy. A socially acceptable distribution of the scarce means of living could certainly not be expected in this way. So the Austrian Government (or the Governments of the Austrian Provinces) retained the system of regulating production and distribution of commodities as well as that of fixing prices and of rationing investment and consumer goods – although not as intensively as during the last years of the war. But it should be stressed, that none of the two leading political parties of Austria – the *Österreichische Volkspartei* and the *Sozialistische Partei Österreich* – envisaged fundamentally a non-market economic system. They regarded the given system as transitory, and one that would finally lead to some sort of market economy.[3]

The Austrian situation resembled than that of nearly all other European countries. All of them had introduced rationing of consumer goods as well an allotment of raw materials, energy and semifinished goods during World War II. There existed widespread wage and price regulation. Likewise foreign trade and international financial transactions were strictly controlled. In most countries the money in circulation had grown considerably.[4]

None of the European countries removed all regulations at once; all of them preferred a gradual approach. They canceled the rationing of consumer goods together

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[2] F. Butschek, *Die Österreichische Wirtschaft im 20. Jahrhundert,* Wien-Stuttgart, 1985. p. 46.
[3] *Ibid.* p. 75.
[4] F. Grotius, "Die europäischen Geldreformen nach dem 2. Weltkrieg." *Weltwirtschaftliches Archiv,* Band 62. 1949. p. 106.

with the state allotment of raw-materials, energy and semifinished goods. Price and wage-regulations disappeared relatively early, or became inefficient. This was a consequence of the rise of an inflationary pressure, which forced governments and central banks to react. All of them undertook an internal monetary devaluation which rarely led to an immediate stabilization of their currencies. Devaluation was often not consistently accomplished, or governments were not in the position to balance their budgets, and inflation continued.

One example of the latter development was France. The regulation of the French economy was rooted in the thirties. In 1937, the *Commission de surveillance des Prix* were established. The extended war-time regulations remained in force after 1945, moreover, they became a part of the *Planification Indicative*. Price policy was directed by the *Direction Generale des Prix.*[5]

The French strategy, nevertheless, resembled neither Soviet-type central planning, nor strict regulations of the war-economy in the West. In connection with planning, however, considerable parts of the economy were nationalized in May 1946. (Energy sector, part of banking, insurance, Air France and Renault.)[6] The planning ambition of the French government made the monetary stabilization more difficult.

Already in the fall of 1944 a "liberation loan" was issued to sterilize the monetary overhang and in summer 1946 the notes were exchanged. Inflation, nevertheless, continued all the time because of permanent and considerable budget deficits. These were attributed to the investment-programs of the "Monnet-Plan" which had to be financed primarily out of the state budget while budget deficit, again, was financed by credits of the Banque de France. A retardation of inflation was reached only in the fifties.[7]

Germany was the last country to reduce its monetary base. This was due to political circumstances. After the war Germany stood under the control of the four occupation forces in their respective zones. Although in the first years after 1945 there remained certain common economic instruments, as, for instance, the currency (Reichsmark), each occupation force pursued its own economic policy. All of them accrued, in one form or another, reparations. To the extent that the reparations were realized by the dismantling of German factories, it limited the possibility to increase output.[8]

Only in June 1948, when the Western powers resolved to separate their occupation zones from the Soviet zone, (after they had economically united them to the BI-zone in 1947) the internal devaluation was perfected by the introduction of the D-Mark. This devaluation was accompanied by the removal of central economic planning.

This meant the replacement of central planning by the market as the system of economic coordination, but it meant in no way, that all prices became free. Some important foodstuffs, basic industries, like coal, steel and electricity as well as housing and

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[5] A. Hagelheimer, *Wirtschaftslenkung und Preisintervention.* Berlin, 1969. p. 218.

[6] C. Fohlen, "Frankreich 1920–1970" In: E. Aerts, A.S. Milward (eds.), *Economic Planning in the Post-1945 Period,* Leuven, 1990. p. 116.

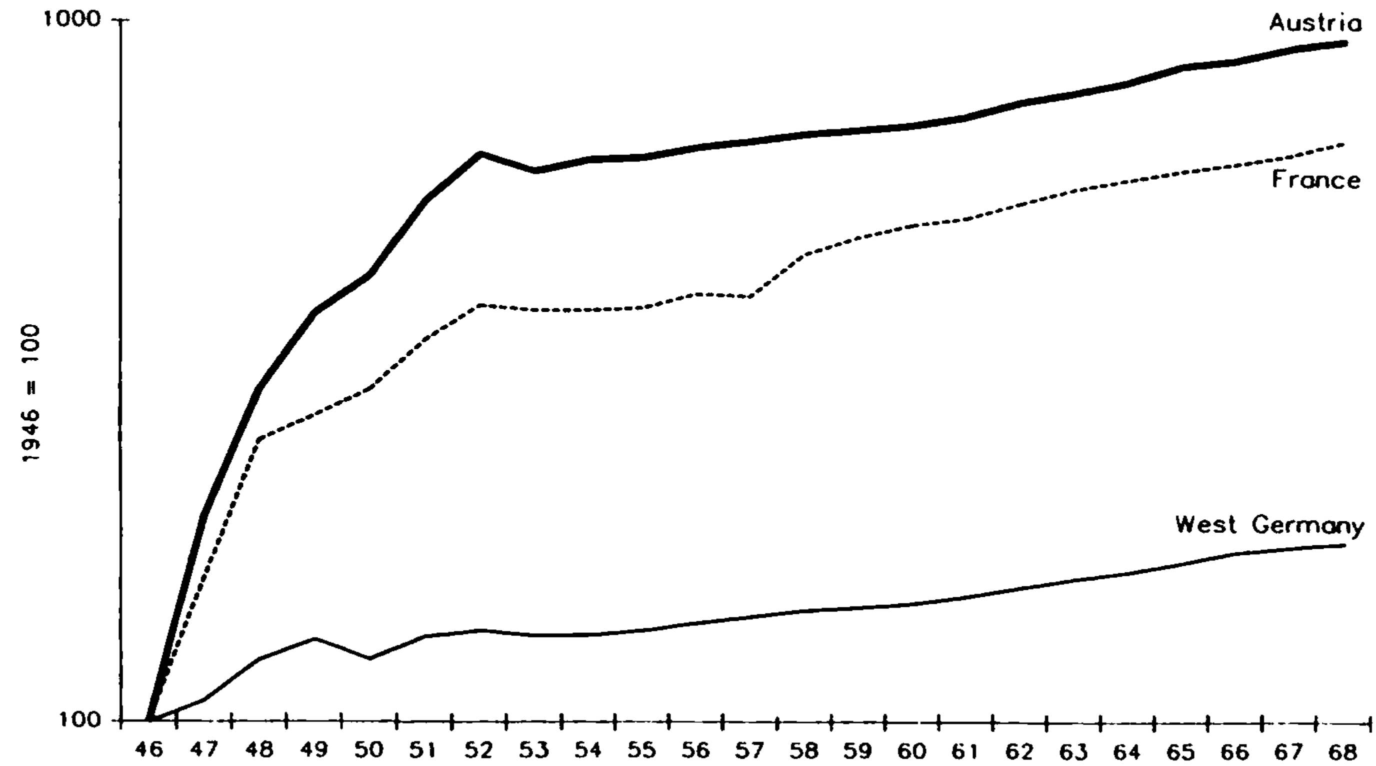
[7] *Ibid.* p. 122.

[8] K. Hardach, "Deutschland 1914–1970." In: C.M. Cipolla, K. Borchardt (eds.), *Die europäischen Volkswirtschaften im 20. Jahrhundert,* Stuttgart: G. Fischer, 1980. p. 65.

the capital market remained under control, especially because a continued inflationary pressure until the end of 1948, which alarmed the population.[9]

In spite of the frequently used arguments, the German "Währungsreform" was neither unique, nor early, nor complete. Compared with the performance in other European countries, no fundamental difference could be seen, except that it accomplished a bit more. This certainly does not pertain to Austria, whose transformation policy took a very specific approach.

Graph 1: *Consumer Prices in Austria, France and West Germany*



In Austria, some early steps were taken towards monetary equilibrium in 1945 when bank accounts were closed and the Shilling introduced as legal tender instead of Reichsmark, combined with an internal devaluation. Nevertheless this activity did not bring the economy any nearer to internal equilibrium, because during this entire period government financed a considerable budget deficit, which it ascribed to allied occupation costs, by central bank loans.

Although hardly any additional steps towards a market-economy were taken at this time – the growth of a black market cannot be regarded as such – one event should be stressed. In July 1946 nearly all basic industries and banking were nationalized. Energy production followed in 1947. No party understood these steps as a road towards a planned economy. Their main goal was to prevent the Soviet Union from taking possession of the so called "German Property". But it was also conceived as an additional policy instrument, and above all, it became a central factor of postwar Austrian economy. Roughly 20% of manufacturing industry's turnover fell upon nationalized enterprises.

[9] Ch. Buchheim, "Attempts at Controlling the Capitalist Economy in Western Germany (1945–1961)." In: E. Aerts, A.S. Milward (eds.), *Op.cit.* p. 26.

When in 1947, in spite of price regulation, inflation accelerated, it was not government but the social partners who started an initiative to stop this development. A commission *(Wirtschaftskommission)* was established, whose members were drawn from employers' and workers' organizations as well as from agriculture, and, lastly, government. All changes of wages and prices would be unanimously settled within this commission. Although price regulation remained in force, it was expected that wages and prices should be stable first of all because members of the labor market organizations were disciplined. This assumption proved to be correct virtually throughout the postwar period.

The economic policy pursued by the commission was to keep nominal wages and prices constant at the inmediate postwar level and let production grow up to this level. Workers should not participate in the increase of productivity until the internal equilibrium was reached. Politicians, of course, were aware of the necessity to adjust price structures as well as to modify taxes or social insurance contributions. Only these corrections should be recognized as a reason for wage increases. The entire system was introduced as a "general collective agreement."

The first pact proved to be a full success. After the negotiated increase of prices and wages, inflation came to a halt, especially since the policy was reinforced by another internal devaluation of the Schilling *(Währungsschutzgesetz)* at the end of 1947. Nevertheless, the social partners and Government initiated a second agreement in September 1948, which again contained some price and tax corrections and the corresponding wage increases. The second agreement was also successful insofar as after the negotiated increases, prices remained stable. In 1949 internal monetary equilibrium had finally been achieved and GDP regained the prewar level. The black market disappeared and the director of the Austrian Institute of Economic Research, Professor Nemschak, admonished the politicians to return to the market system. The parties continued their activity within this system, because it seemed to be very convenient for all of them to settle social and political problems centrally. They continued to bargain for additional agreements: a third in 1949, and a fourth in 1950, which caused some political turmoil. Nevertheless they concluded a fifth one in 1951, which totally failed and inflation accelerated again.[10]

The permanent use of the instrument of *Sozialpartnerschaft* that had been established to fight inflation, had changed its genuine character. It became at last the cause for inflation itself. Inflationary expectations came up as a consequence of the regular sequence of wage and price accords, led to a "political inflation"[11] more so since monetary policy never counteracted because of the fear of dampening investment.

Final stabilization, however, came about also – at least partly – through the activity of social partners. When it became clear after the fifth price-wage agreement that inflation could no longer be stopped by this way, the social partners agreed upon a "Price-Reduction Program" *(Preissenkungsaktion)*, by which entrepreneurs obliged themselves to lower their prices. The trade-unions promised not to claim wage increases for one-and-half years. This agreement was backed by monetary and fiscal

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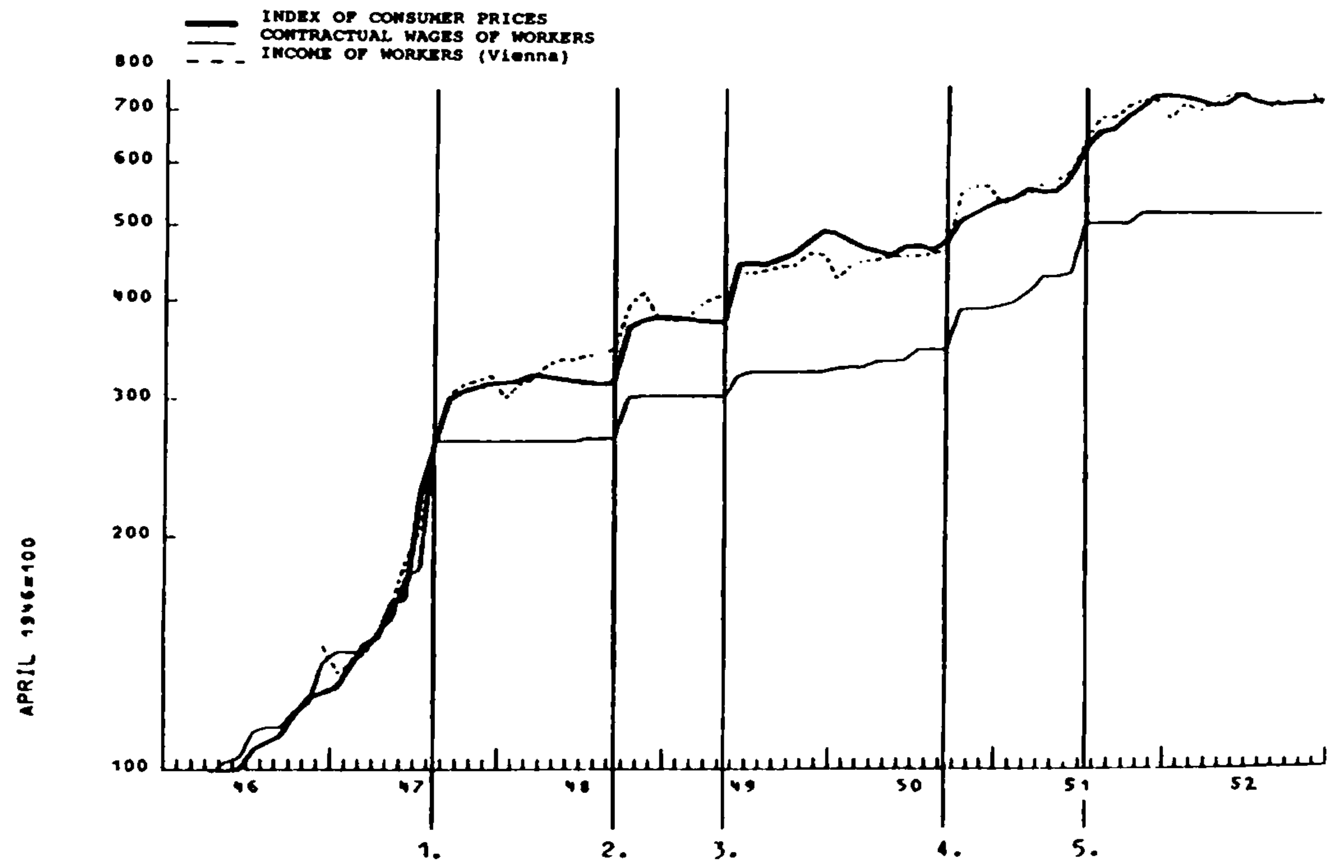
[10] F. Butschek, *Op.cit.* p. 99.

[11] M. Bronfenbrenner, F.D. Holzman, "A Survey of Inflation Theory." In: *Surveys of Economic Theory*, Vol. I. London: St.Martin's, 1966. p. 71.

policy – and inflation suddenly stopped, because the change of the "regime" seemed trustworthy.[12]

Graph 2: *Contractual Wages, Income and Index of Consumer Prices, (1946–1952)*



During this entire period the regulation of the economy was gradually loosened. Rationing of wine was abolished in 1947, fruits, vegetables and wood followed in 1948, eggs, potatoes, bread in 1949, and at the beginning of 1950 all foodstuffs regulations were abolished.[13] Similarly state regulations of production, distribution, prices and subsidies were also gradually removed.

With the "Price Reduction Programme" the system of the "Price-Wage-Agreement" and the period of postwar planning ended. Parallel to this action, Minister of Finance Kamitz initiated a classic stabilization policy with a reduction of budgetary deficit, and the National Bank increased interest-rates and limited the volume of money in circulation. This did not mean, that all economic regulations were abolished. Many remained in force: in the first place in agriculture (up to now), and in foreign trade and international financial transactions. But fundamentally market became the main coordinator of economic activities.

This policy led to a transitory stabilization crisis, which halted economic growth in 1952 and raised the unemployment rate to 8.7% in 1953. But this was only a short

[12] T.J. Sargent, *The Ends of Four Big Inflations*. NBER, Conference Paper, Nr. 90. Cambridge, Mass. 1981. p. 2.

[13] P. Meihsl, "Die Landwirtschaft im Wandel der politischen und ökonomischen Faktoren." In: W. Weber (ed.), *Österreichs Wirtschaftsstruktur gestern-heute-morgen*, Berlin, 1961. p. 570.

interruption of the growth-path. In the following years Austria entered the period of the "economic miracle", which lasted until 1962.[14]

How should the Austrian performance be assessed? Austria had more than doubled its GDP-level of 1945 during this period. But as has been pointed out, all Western countries found their way from war-time regulations to a market economy, and most did this earlier than Austria. In fact all countries which suffered grave destruction were able to reconstruct their economies in this period more or less to the same extent. Inflation remained basically under control.

One could argue, that considerable economic growth was reached in Austria in spite of quite unfavorable conditions. The country was occupied by the Allied Forces until 1955 and the situation in the Soviet zone was very difficult. Besides the conduct of the occupation forces, most of the industrial enterprises as "German property" were expropriated by the Soviet Union. This meant an aggregate annual loss of approximately 2% of the Austrian GDP in these years.

GDP-Growth 1945 to 1952 in constant prices[15]

Countries	per cent
Austria	134.4
Denmark	42.8
Finland	60.6
France	139.0
Germany *)	133.1
Italy	112.2
Netherlands	154.4
Norway	55.2
United Kingdom	7.6

*) 1946 to 1952

There was another aspect that should be considered. When "Wage-Price-Agreements" provided high economic stability, it also stabilized social relations. Trade unions cooperated in the wage-price-system not only because they sought a smooth transformation from postwar planning to the market, but also in order to gain a foothold in formation of economic policy. Austrian trade unions extended their traditional room of manoeuvre – wages and social policy –, to general economic policy. The Wage-Price Agreements provided the first institutional framework for that.[16]

This trade union policy led to the foundation of the Parity Commission and the Council of Economic and Social Questions as the final installation of Social Partnership in Austria. The Wage-Price System was the first decisive step on the road to social stability of the Austrian society.

[14] F. Butschek, *Op.cit.* p. 109.
[15] A. Maddison, *Phases of Capitalist Development*, 1982, p. 174.
[16] F. Butschek, *Op.cit.* p. 38.

This status, of course, hardly can be proven by quantification. One indicator, however, can be seen in the fact, that Austria has – together with Switzerland – the lowest strike rate of all democratic countries.[17]

3. A Model for the East?

Could the Austrian model have any relevance for the Eastern countries? One should recognize that some elements of the Austrian policy can also be found in the transformation process of the nineties. Tripartite agreements were concluded among unions, government and enterprises on wage increases in Czechoslovakia in 1991, showing that market-rhetoric were more radical than politics.[18] When a sudden inflow of used German cars endangered domestic market, the Czech Government did not hesitate to introduce special taxation to halt this. In Hungary a Council for the Reconciliation of Interests (CRI) has been founded and the Hungarian policy comes even nearer to a gradual approach. But the first years of transformation were basically characterized by shock treatment in several Central and Eastern European countries. It can be described by sudden liberalization of prices and foreign trade, external and no internal devaluation, but forceful monetary and fiscal stabilization. It led to a severe decline of GDP for at least three years – even if statistics may overstate it. Empirical judgements on alternative ways of transformation are hardly possible since a genuine gradual approach does not exist in the region.

GDP-Development in Central and Eastern Europe[19]
between 1990 and 1992
(as per cent of previous year)

Countries	1990	1991	1992 *)
Czech Republic	- 2.0	- 14.0	- 7.1
Slovakia	–	- 15.8	- 6.0
Hungary	- 3.3	- 11.9	- 5.0
Poland	- 11.6	- 7.6	- 1.0
Romania	- 7.4	- 13.7	- 15.4

*) preliminary

The Chinese model might has to be taken into consideration. China is a less developed country with a large agricultural sector and a rather totalitarian political structure. In spite of its political rigidity and temporary backlashes, economic trans-

[17] *Ibid.* p. 259.
[18] D. Begg, "Economic Reform in Czechoslovakia: Should we Believe in Santa Klaus?" *Economic Policy*, October 1991, p. 270.
[19] H. Gabrisch, *Under the Impact of Western Recession*, Forschungsberichte des Wiener Institutes für Internationale Wirtschaftsvergleiche, No. 197, June 1993, p. 15.

formation, however, is going on in a gradual-regional way since many years. Of course China is still far away from a proper market economy but it has made considerable progress in this direction. The game is not finished yet, but there was not the slightest reduction in growth rate, on the contrary, growth remained all the time rather impressive.

Comparing the models of transformation, one has also to consider the different international and national conditions after World War II, and after the "Velvet Revolution."

The former case was characterized by an entirely different foreign environment. Drawing the consequences from World War I as well as from the interwar period, the United States developed and instituted postwar assistance and a comprehensive economic design with the Bretton Woods System. And when the realization of this system met difficulties, additional relief was provided by the Marshall-Plan. So the enormous physical destruction and manifold shortages were overcome very quickly.

The events in Central and Eastern Europe surprised the world. No one had expected what would happen. No research had been done on the problems of transformation or on international assistance. Foreign aid remained within narrow limits. The international economy has remained stagnant which generated trends towards protectionism. Additionally, the Eastern countries have to meet the already well established competition of the Newly Industrialized Countries.

There were many endogenous and exogenous elements, which contributed to the economic backlash of Central and Eastern Europe. The planning system ran more and more into difficulties and the dissolution of the Comecon as well as the collapse of trade with the former Soviet Union caused detrimental effects for their economies. These have been discussed lately in comparison to the dissolution of the Austro-Hungarian Monarchy.[20]

Nevertheless there seems to exist some flaws in the "shock-approach". Some studies suppose that the monetaristic stabilization policy went too far; that it did not only eliminate excess demand, but reduced aggregate demand as well – by budgetary and monetary policy and wage restrictions.[21]

This policy was, at least partly, due to the unrealistic assessment of the post-communist economies. The recommendations of the Western advisors were always based on the mechanics of a Western market economy. They did not realize that a sudden price liberalization in an extremely monopolized market must lead to excessive price increases – which induce additional restrictive measures. The sudden introduction of current account convertibility and the liberalization of foreign trade not only contributed to inflation through the necessary devaluation of the national currency, but it exposed domestic industry to an extremely high pressure.[22] Although postwar Anglo-American economic design envisaged pure market economy too, nobody had the idea of realizing this at once. Even when the market coordinations were instituted again

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[20] R. Dornbusch, "Monetary Problems of Post-Communism: Lessons from the End of the Austro-Hungarian Empire." *Weltwirtschaftliches Archiv*, Vol. 128. No. 3. 1992. p. 416.

[21] See: *Transition from the Command to the Market System: What went wrong and what to do now?* Vienna: Wiener Institut für Internationale Wirtschaftsvergleiche 1993. p. 21.

[22] *Ibid.* p. 23.

nationally, governments were cautious not to open their economies to the international flow of goods, services and payments too quickly. This was underlined by the creation of institutions like GATT and EPU, which were founded with the goal of liberalizing international trade flows.

Historical experience shows that in certain periods protectionism had positive consequences for economic growth.[23] If this was correct for the industries of established market economies, it should apply far more to an economic system in the making.

Another aspect neglected by the adherents of the "shock treatment" is the time period and the institutions involved.[24] The war economies lasted some years, in Germany one decade, in the planned economies of the Eastern countries for forty years, and in the Soviet Union roughly seventy years. The economic agents in the former case were well aware of market attitudes, but not in the latter cases. This is especially true for entrepreneurs, who, in spite of the regulation of production and prices, remained owners of their enterprises during the war and continued to make economic calculations.

Furthermore, the entire institutional setting remained more or less unchanged from the commercial banking system to commercial law. In the Eastern countries, all these institutions were lacking. All of them needed to be re-introduced, not only in the sense of formal enactment but also in the change of attitudes. "While Europe's emerging market economics have made considerable progress in passing the relevant laws and in establishing or adapting organizational structures on paper which may often be done by the stroke of pen, the adjustment of behavioral patterns, including the accumulation of new institution-specific human capital is necessarily a time-consuming process." [25] This author, nevertheless, attributes the backlash in the East mainly to the necessary "institutional revolution."

In the specific case of reprivatization it should be learned from post-World War II experiences in Europe. Private entrepreneurs are the core of a market economy. Privatization will be easily accessible with small firms especially in the service sector, but it seems unclear, how the bulk of big industrial plants should in a short time reach this goal. But one may ask, whether is it really necessary to act quickly? An important state sector is not only the experience of Austria, but many other European countries such as France, Great Britain and Italy, which nationalized important industries after World War II. To gain additional instruments to foster economic growth, some newly and successfully industrialized countries like Korea and Taiwan show, that extremely high growth is not hampered by a considerable share of state-owned industry.[26] No doubt, state-owned industries in a market economy are a potential source of difficul-

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[23] P. Bairoch, *Economics and World History. Myths and Paradoxes*, Chicago: University of Chicago Press, 1993. p. 45.

[24] J. Kornai, "The Post-socialist Transition and the State: Reflections in Light of Hungarian Fiscal Problems." *AER*, No.5. 1992. p. 2.

[25] H. Schmieding, "From Plan to Market: On the Nature of the Transformation Crisis." *Weltwirtschaftliches Archiv*, Vol. 129. No. 2. 1993. p. 237

[26] W. Urban, *Economic Lessons for the East European Countries from Two Newly Industrializing Countries in the Far East?* Wiener Institute fuer Internationale Wirtschaftsvergleiche, Forschungsberichte. No. 182. April 1992. p. 26.

ties too, but this depends on economic policy. These enterprises, at least in the fifties, were the core of economic growth in some European countries.

Finally, an additional problem should be taken into consideration which extends beyond the borders of economics. From an economic point of view inflation is regarded, at least in the long run, as detrimental to economic growth. Therefore financing of the public budget by the central bank is strictly forbidden by all respective laws. In history, these regulations were frequently suspended in case of emergency especially during wars and after – this policy was pursued until the recent past, as has been said before. Many governments were politically too weak to afford a monetary and fiscal consolidation.

One must not say, that all payments by inflationary money creation are fictitious, because except in the case of extreme hyper-inflation, such payments can provide effective demand by redistribution of income. Again, an Austrian example may be provided. Immediately after World War I the Government granted unemployment benefits to all people of working age. The returning prisoners of war received at least a minimum assistance. Likewise it subsidized food prices to ensure a minimum consumption for all social groups.

The Government was in the position to do this only because of central bank financing. It was simply impossible for social and political reasons – not to speak of technical problems – to raise taxes sufficiently at that time. This policy accelerated inflation. But Austria, unlike Hungary and Bavaria, avoided desperate revolutions.

Hyper-inflation emerged but it did not prevent economic growth and could be stopped before the Geneva Protocols were ratified and long before the international loan was effectuated merely by the credible change of the "regime." Society as well as the economy were now, so to speak, "mature" for monetary consolidation.

And this seems to be precisely the problem of some Eastern countries facing transformation. It is not only a question whether "shock therapy" is economically sensible, but its political implications should be born in mind, if monetary stabilization is discussed.

Returning to the transformation policies after World War II in Austria, but also in most other European countries, one may say, that they avoided precisely what has occurred in the present transformation: the excessive restriction of aggregate demand and the extreme pressure on the national economy, especially industry, to adapt to new circumstances. During the whole period of the price-wage agreements, fiscal as well as monetary policy remained fundamentally expansive. In 1952-53 a classic stabilization policy was adopted which led to stagnation (0.0%) of GDP in one year and a comparatively high unemployment rate in the following one (8.7%). But this short interruption opened the way to an "economic miracle" with an average growth rates of 6.3% in real terms.[27] The gradual liberalization of foreign trade and financial transactions gave these economies – and especially their industries – time to adapt to international competition without losses. Although the circumstances of the transformation after World War II, and after the "Velvet Revolution" differ, it seems, nevertheless, that economic policy should have learn something from economic history.

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[27] F. Butschek, *Op.cit.* p. 109.

Roland Schönfeld

How to Cope with Transition

– The Special Case of East Germany –

Introduction

The German economy is sliding into its fourth recession since post-war "*Wirtschaftswunder.*" Internal consumption and exports are shrinking, industrial orders are in a slump, and registered unemployment has risen to more than four million or almost 10% of the total labor force. Without numerous and costly programs to relieve the labor market, like retraining, temporary public works and the subsidizing of virtually bankrupt companies, the number of unemployed workers would rise to 5,5 million.[1] A growing budget deficit, mainly caused by increased transfers to East Germany, has to be tackled. West German and international investments in East German industry are far below expectations. East German production, cut in half since 1990, is stagnating. Since the breakdown of the communist regime in East Germany in 1989, about 75% of the jobs in industry have been destroyed, and almost every other East German worker has either been laid off or forced into early retirement, or is waiting to become redundant in a temporary government job.

After the euphoria of 1990, there is a growing dissatisfaction and a sense of frustration among the West and East German populations. East Germans are disappointed. They feel underrated, treated as second-class citizens, regarded as worthless workers, their lifelong endeavors have failed and their economy, once eleventh among the world's industrial nations, is in shambles. West Germans tend to regard the new *Lander* (federal states) as a "bottomless pit," and as the cause of rising taxes and reduced welfare. There is less understanding and sympathy between East and West Germans than ever before.

Post-Unification Crisis

What went wrong after the unification of the two Germanies? What are the reasons for these widely unexpected results of the grand scheme of the Currency, Economic and Social Union?

With the Union Treaty between the Federal Republic and the GDR; put into operation on July 1, 1990, the West German DM became the official currency of the GDR, the Ostmark was given up.[2] A common German market was created by the removal

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[1] *Frankfurter Allgemeine Zeitung*, 10 October 1993, *iwd Informationsdienst*, Cologne: Institut der deutschen Wirtschaft, 19:48, 2 December 1993, pp. 4–5.

[2] W. Schrettl, "Economic and Monetary Integration of the two Germanies." In: *Economic Systems*, 15:1, April 1991, pp. 1–17. Roland Schönfeld, "Methoden und Probleme der wirtschaftlichen Integration der neuen Bundesländer in Deutschland." In: K.-D. Grothusen (ed.), *Staatliche Einheit und Teilung – Deutschland und Jugoslawien*. München: Südosteuropa-Gesellschaft, 1992, pp. 125–143.

of all trade barriers between the two states to free the flow of goods, services and capital. Full labor mobility was brought about immediately by cancelling travel restrictions. Central planning of production and distribution ended. Prices of goods and services, except for rent, transportation, and energy, were set free.

With the political unification on October 3, 1990, West German legislation, including economic, tax and social laws, was extended to East Germany immediately. Thus, a *"Blitz-transition"* from a planned to a market economy was executed on the territory of the former GDR.

The effects of this transition were devastating. When the hitherto totally protected East German industry was exposed abruptly to West German and international competition, its production collapsed. Damages and deficiencies caused by socialist planning in production, services, housing, infrastructure, agriculture and environment became evident.

The East German economy was in a desolate state. In contrast to Hungary and Poland, there had not been the slightest attempts by the Honecker regime leaders to reform the highly centralized planning system and to allow private economic activities. Due to its weak trade position with the West, the GDR had accumulated foreign debts of $17.9 billion through 1989,[3] notwithstanding West German financial aid amounting to billions of DM every year.

The technological gap between East German industry and that of the industrialized West could be counted in decades.[4] Antiquated machinery produced poor quality goods at high costs, and with a considerable rate of waste. Labor productivity came up to only one third of the West German level. Most factories were overstaffed. Principal industries were concentrated in "rust-belt" sectors – steel, chemical, heavy engineering, ship-building, textiles – with worldwide surplus capacities.

Infrastructure was obsolete and totally inadequate. Roads, railroads and telecommunications had stagnated at a pre-war level and were badly in need of repair. Public services lacked modern equipment. Pollution, caused by lignite-burning power plants, factories and households, and by a startling neglect of environmental protection, was enormous.

When the Communist regime of the GDR collapsed, hundreds of thousands of East Germans migrated to West Germany, most of them young, skilled blue- and white-collar workers and professionals, with their families. After the Berlin wall collapsed, this migration increased. The drain of labor was undesirable for political and social reasons, and the economy of the GDR became unviable. In West Germany, older workers were pushed out of jobs, and housing shortages in industrial centers were exacerbated. The reduction of the migration from East to West was one of the main

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[3] *Neue Zurcher Zeitung*, 23 May 1990. This is considerably more than the $11.5 billion East German debt that Western analysts assumed as late as 1989. *PlanEcon Report* 6, nos. 18–19, 11 May 1990, p. 41. By 1993, the liabilities of the former GDR foreign trade companies had been reduced to DM 3.7 billion ($ 2.2 billion). Outstanding GDR credits, mostly irretrievable, of DM 5 billion ($ 2.9 billion) were left over in 1993. *Frankfurter Allgemeine Zeitung*, 18 October 1993.

[4] Significantly, historians and official curators of monuments were worried that fast modernization of the East German economy would destroy one of the last regions in Europe featuring "monuments" – machinery and equipment as well as complete factories – from the early industrial age. G. Staguhn, "Wo der frühe Kapitalismus überlebte", *Frankfurter Allgemeine Magazin*, 12 April 1991, pp. 52–62.

reasons for offering quite favorable conditions to the East German population when the Currency Reform was implemented. In fact, with the Currency, Economic and Social Union put into operation on July 1, 1990, the migration decreased, though it never ceased completely.[5]

The collapse of the Comecon clearing system, the depressed state of the post-communist economies of Eastern Europe and the dissolution of the Soviet Union, deepened the crisis of the East German industry. Trade between eastern Germany and the Comecon countries had been of considerable importance. Between 66% and 69% of the GDR's foreign trade involved Comecon, and between 36% and 39% involved the Soviet Union alone.[6]

A continued sale of East German industrial products in the Comecon market would have been important to the survival of numerous East German firms. Not only political but also economic considerations had led the GDR to be the most loyal of the Comecon members. Only Bulgaria and Mongolia had higher shares of foreign trade with the "socialist world market."

The GDR's considerable investments in the Soviet Union included the joint development of oil, natural gas, and mining projects. In that way, the GDR was able to secure long-term deliveries of energy and raw materials at relatively stable prices. All these vital imports could be paid for by supplying East German machinery and equipment, and other industrial products which were not competitive in Western markets, to the Soviet Union and other Comecon countries in bilateral barter agreements.

The Soviet Union and the GDR had been each other's principal trading partners. The relevance of the Soviet market to individual East German firms was considerable. Many of the GDR's industrial combines delivered between 20% and 40% of their output to Soviet clients. Estimates by the Institute for Applied Economic Research in East Berlin indicate that 480,000 East German workers, some 15% of the GDR labor force, owed their jobs directly or indirectly to trade with the Soviet Union.[7]

When the eastern markets broke off in 1990–91, the East German export industry lost its main clientele. Requiring payment in DM or other convertible currency these enterprises found their former partners in Eastern Europe either illiquid or preferring better and cheaper goods from Western suppliers. Due to high production costs, they were unable to compete with West German, West European, American or Asian firms, in spite of heavy government subsidies.

The extremely expensive production methods of industrial enterprises in East Germany were made manifest by the Currency Union. After the wall in Berlin was opened, the exchange rate of the East German currency had dropped to 20 Ostmark

[5] 388,396 East Germans migrated to the West in 1989, 395,343 in 1990, 249,743 in 1991 and 152,920 between January and September 1992, a total of 1,186,402 or roughly 7% of the East German population in 1989. Since October 1992, migration amounts to about 17,000 per month – these being mostly young job-seekers. From 1989 to September 1992, 203,960 West Germans moved to eastern Germany, and their number is rising. K.-P. Schweitzer, "Alte Menschen in den neuen Bundesländern," *Aus Politik und Zeitgeschichte*, Beilage zu das Parlament, B 44/93, 29 October 1993, Table 1, p. 40.

[6] R. Schoenfeld, "Unification and the Future of German Trade." In G.L. Geipel (ed.), *The Future of Germany*, Indianapolis, Indiana: Hudson Institute, 1990, pp. 78–92.

[7] H. Machowski, "Aussenwirtschaftliche Verflechtung zwischen der DDR und der UdSSR." *DIW Wochenbericht* Berlin: Deutsches Institut fur Wirtschaftsforschung, 25 May 1990, pp. 289–292.

for 1 DM. With goods from the West being readily available, and the stability of the domestic currency being increasingly distrusted, the value of the Ostmark kept tumbling. Despite warnings of the Deutsche Bundesbank that inflationary tendencies could be unleashed by unrealistic conversion rates, the West German government offered quite generous conditions for political and social reasons.

Effects of the Currency Union

Due to the Currency Union, on July 1, 1990, East German savings, running up to approximately 175 billion Ostmark, were converted at a rate of 2 Ostmark for 1 DM, and limited amounts per head were even changed at a rate of 1 for 1. Thus about 120 billion DM were created from one day to the next, increasing the total amount of DM circulating by roughly 10%. With West German firms using surplus production capacities and additional imports to cover the sudden East German demand, however, the suspected inflationary pressure failed to appear.[8]

Wages, salaries and old-age pensions were converted at par to keep income differences between East and West Germany from growing even more. By a conversion rate of 2 Ostmark for 1 DM, the huge 260 billion Ostmark debts of East German enterprises[9] were cut by half. The consequences of the Currency Union and the creation of a common German market for commodities, labor and capital turned out to be disastrous for the East German economy.

East German consumers refused to buy expensive low-quality goods from domestic production.[10] Sales to East European countries dwindled when invoiced in DM. It became evident that the production costs of East Germany's industry were far too high for its enterprises to survive in the fierce international competition after prices had been converted at a rate of one-to-one.

The industrial enterprises of the GDR, producing for foreign markets, had spent between 4 and 10 Ostmark of production costs to earn 1 DM in export. The gap was closed by state subsidies and special exchange rates for currency proceeds. Even enterprises with relatively modern equipment proved not to be competitive when prices were converted one for one. East German camera-maker Pentacon, tipped as a likely post-unification success, ended up as a failure. Its production costs per unit turned out to be seven times higher than its earnings from sales.[11]

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8 The rising inflation rate worrying the Deutsche Bundesbank (German Federal Bank) since the beginning of the 1990s was caused mainly by increasing budget deficits due to huge transfers of public funds to eastern Germany. The inflationarypressure convinced the Federal Bank to keep interest rates high and money scarce.

9 Since the economic reforms of the 1960s East German industrial or other companies were obliged to finance investments by borrowing money from the state banking system. Thus the government of the GDR diminished its own (rising) internal indebtedness. With hardly any administrative restrictions and no market controls, this financial system was widely abused by managers of state companies.

10 In 1993, eastern German products still amount to only about 30% of the turnover of eastern German domestic trade (foodstuffs 40%). In western German domestic trade, their share is extremely small, due to the lack of convincing market concepts and a negative image of eastern German products. *Frankfurter Allgemeine Zeitung*, 13 October 1993.

11 *The Economist*, 11 May 1991, p. 67.

Converted at a one-to-one rate, East German wages averaged about half of the wage level in West Germany. Labor productivity, however, reached only one third of the Western standard. Inspite of that incongruity, wages of East German workers started rising rapidly after the unification. By 1993, labor costs in East Germany had climbed, on average, to 66%, and labor productivity to only 40% of the West German level. Labor costs per unit are still about 50% higher in East than in West Germany and the latter is on top of the international table![12]

Within two years after the unification, the East German GDP contracted 33%; based on 1989, even about 50%. Between 1990 and 1992, the output of processing industries declined by 64%, of energy and mining by 35%, of agriculture and forestry by 50%. Not until 1992 did the East German GDP start growing again from the low level it had reached.[13] Many factories had to close down. Others tried desperately to avoid liquidation by laying off workers. Mass unemployment has been spreading rapidly in the new Lander. In Saxony, for instance, one of the world's most industrialized regions in 1936, jobs in machine building and electrical engineering industries decreased by 80% till mid-1993; in the once famous textile industry even more.[14] Restructuring schemes for inefficient state enterprises are based mainly on a greatly reduced labor force.

Since labor market conditions improved in West Germany in 1990-91, partly due to the production boost caused by the demand for western goods of 16 million East German consumers and by huge government orders to the construction industry, hundreds of thousands of East Germans have found a job in the West. Recently, however, unemployment had been growing again in West Germany, thus aggravating labor market conditions in the East.

Since 1990, millions of jobs have been destroyed in eastern Germany. Available jobs shrank from 9.4 million to 6 million in 1994. At this time, 37% of the East Germans employed in 1989 have been laid off. Women are even worse off than men. The former high rate of female participation in the labor-force – more than 90% of eastern German women had a job in 1989 – has sunk considerably.[15] In September 1993, 1.2 million eastern Germans, or 15.2%, were registered as unemployed. But this is not the whole picture. About 150,000 were in short-term – in most cases virtually "zero" – work. Presently, 295,000 are engaged in state-financed training and retraining; 203,000 in temporary jobs offered by the government. About 700,000 workers have left East Germany for good. A further half a million are commuting – often over long distances – to jobs in West German cities. So far, 826,000 East German workers have accepted favorable offers of early retirement. Without the government keeping the unemployment rate in eastern Germany artificially low by preserving redundant jobs, it would be at least 1.4 million higher.[16]

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[12] Kurt Vogler-Ludwig: "Beschäftigungsperspektiven für das vereinigte Deutschland", *ifo Schnelldienst*, Munich: ifo Institut für Wirtschafgsforschung, 16:17, 1994, pp.8, 10.

[13] M. Schrenk, "Structural changes in eastern Germany." *Transition*, Washington, D.C.: The World Bank, 4:1, February 1993, p. 10.

[14] *Frankfurter Allgemeine Zeitung*,, 21 October 1993.

[15] In mid-1993, the unemployment rate of women in eastern Germany was 19.6%, of men 10.5%. *Frankfurter Allgemeine Zeitung*, 22 June 1993.

[16] *ifo Wirtschaftkonjunktur*, Munich: ifo Institut fur Wirtschaftsforschung, 2, 1993, p. A2. *Frankfurter Allgemeine Zeitung*, 8 October 1993.

There is no doubt that the rapidly rising wages have accelerated unemployment in eastern Germany and hampered the creation of new jobs there. With wages rising faster than productivity, more and more workers were forced out of their jobs. In certain sectors wages have reached about two thirds of the West German level. The trade unions have been pushing very hard to close the gap between incomes in the eastern and western parts of Germany. Their efforts were supported by West German industries worried about "unfair" competition from East German enterprises using cheaper labor.[17] High labor costs are regarded as a main cause of continuous deindustrialization in eastern Germany. Investors are being forced to economise on labor and to introduce capital-intensive production methods, an odd thing to do in a region with major unemployment. The mortage of high labor costs will slow the decline in unemployment even after the economy recovers.

High, and still rising, unemployment among the eastern German population, and the gap between living conditions[18] and prospects between East and West are among the most serious problems of present German interior politics. Social inequalities are widened by diverging rates of unemployment and early retirement. Due to the slow progress of job creation in eastern Germany, the government is not only forced to take emergency measures which distort the labor market, but also to choose a detrimental and costly industrial policy, with politicians and state officials, not private entrepreneurs, deciding upon investments, production sites and programs, output and personnel.

Capital intensity is further increased by state subsidies designed to improve the returns on investments in the eastern German economy. Investment allowances make up about 30% of newly invested capital. In addition, considerable tax exemptions are offered for investments in eastern German plants. Clearly, those subsidies weaken the market forces and incite investment which may prove inefficient in the long run. In fact, investment allowances are financing rising wages by closing the productivity gap. Wage-interest relations are distorted, discriminating against labor-intensive production.

This policy, necessary as it may be for social reasons, will damage and weaken the efficiency of the German economy for the years to come. It slows down the restructuring of eastern German industry. Subsidizing inefficient or even unviable factories delays inevitable processes of adaptation to world market conditions and programs crises and breakdowns in the future, as we can observe currently in the case of the West German steel industry.[19] It will be indispensable, yet very difficult, to adopt a

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[17] Trade unions and employers' associations in important German industries had decided in 1991 to raise the eastern German wage levels from about 60% of the wage levels in western Germany to 80% in April 1993 and to 100% by April 1994. Only the recession has slowed down the early adjustment. *iwd Informationsdienst*, Cologne: Institut der deutschen Wirtschaft, 19:51, 22 April 1993, p. 4. A change of wage policy, by introducing a separate collective bargaining in eastern Germany, instead of binding this labor market to western German wage agreements, is being discussed in 1993.

[18] The average income of private households per month was DM 6,417 in western Germany in 1992, and DM 1,311 in eastern Germany. Workers' households had DM 3,472 in the West and DM 1,238 in the East, old age pensioners Dm 5,379 and DM 1,239, unemployed persons DM 1,408 and DM 470. K.-P. Schweitzer, op. cit., table 4, p. 43.

[19] State subsidies for the eastern German economy have risen from DM 25 bn in 1991 to DM 39 bn in 1993, while those spent in western Germany were cut from DM 67 bn to DM 61 bn. 95% of the latter served to keep unviable industries going. *iwd Informationsdienst*, Cologne: Institut der deutschen Wirtschaft, 19:41, 14 October 1993, pp. 6–7.

middle course between permanent subsidizing and the destruction of industries which offered jobs to a whole region.

To alleviate the deteriorating economic situation in eastern Germany, the German government has taken several emergency measures. In order to improve the chances of dismissed workers in finding new jobs, government agencies have been offering training facilities free of charge. Those lacking knowledge and experience in using most modern machinery and equipment, needing additional training to prepare them for high-tech jobs, or desiring to change their skill, can apply to these agencies. Yet the demand does not meet the full capacity of available training facilities. Generous unemployment benefits, short-term work contracts, and a widespread fatalism seem to keep many unemployed from taking advantage of this opportunity. In spite of high unemployment, private enterprises in East Germany are complaining about a severe lack of skilled workers.[20]

In regions with a particularly high rate of actual and expected long-term unemployment, laid-off workers are being absorbed into "employment promotion companies" *(Arbeitsförderungsgesellschaften).* They are supposed to slow down the growth of unemployment in the new Lander and, for the individual worker, bridge the months or years until he or she has found another job. These companies, which are run by the government, guarantee the workers approximately the same wages as the ones they received before they were laid off. They are responsible for pulling down disused factories, cleaning up polluted sites, and providing other services. However, they are being criticized for competing unfairly with other new, private firms offering the same services.[21] Since they take the pressure off the unemployed, they are said to keep them from looking for secure jobs in regions and branches with better prospects.

Other government measures to curb mass unemployment in eastern Germany are also widely discussed. Investors purchasing former state enterprises in the new Lander must guarantee a minimum number of jobs and a certain volume of investments for at least two years. The risks involved have allegedly kept many potential investors away. It is questioned whether this obligation has created a simple job which would not have been created anyway. Not even the threat of penalities will make investors hire more costly workers than are absolutely needed.[22]

A particularly delicate issue is the continued provision of virtually bankrupt enterprises with state-guaranteed credits to postpone their collapse and liquidation and the destruction of their jobs. Economists are worried about the growing interference of Lander governments scrambling to rescue factories threatened with closure in order to safeguard jobs and industries in areas of high unemployment.[23] In order to prevent

[20] In 1992, only 23.5% of eastern German workers participated in training programs offered by industry, compared to 40% in western Germany. In privatized eastern German companies more workers (28%) were encouraged to improve their skills than in *Treuhandstalt* firms (18%). *iwd Informationsdienst,* Cologne: Institut der deutschen Wirtschaft, 19:28, 15 July 1993, pp. 6–7.

[21] There is a growing resistance of private service enterprises in eastern Germany against state subsidized competitors. *Frankfurter Allgemeine Zeitung*, 16 November 1993.

[22] H. Willgerodt, "Der flüchtige Diktator. Knappes Kapital übt ökonomische Zwange aus," *Frankfurter Allgemeine Zeitung*, 14 August 1993, p. 11.

[23] An outstanding example is the takeover by the state of Thuringen of Jenoptik and Zeiss in Jena. With guaranteed restructuring subsidies of DM 3.6bn ($ 2.1bn) this industry could become a "bottomless pit" as a result of shortsighted regional policy.

the threatening deindustrialization of large parts of eastern Germany, the federal government has pledged to preserve "industrial cores", even irrespective of economic considerations. Thus outmoded and rundown industrial dinosaurs like large chemical plants in Saxony or steel plants in Brandenburg will be kept alive, since they are the biggest employers around.

Seeking to slow down the collapse of industrial production, the federal government has been offering cheap export credits and guarantees to eastern German companies, particularly for deliveries to CIS and Eastern Europe. Whereas western German producers increased their deliveries to Eastern Europe by 23% between 1989 and 1992, and their imports from this region by 58%, eastern German exports sank from DM 28.9 bn to DM 7.2 bn, their imports from DM 26.1 bn to DM 4.6 bn. Eastern German industries are still largely unable to meet the demand of their customers for sophisticated investment goods. The structural crisis in the new Lander has also reduced the import demand as well as export capabilities.[24]

Privatization Policy

In an effort to revive the eastern German economy, the federal government has promoted private enterprise and the privatization of the state sector ever since unification. Private ownership of the productive assets is regarded as a constitutive element of the western German economic order. Private enterprise has been the basis of West Germany's economic success in the past four decades. Politicians and economists are convinced that private entrepreneurship is the only thing that can raise economic efficiency and labor productivity in the new Lander to western German levels.

Above all, medium-sized and small private firms are expected to play an important role in the production structure, and to increase the demand for labor. In the old Federal Republic almost 80% of all jobs had been provided by firms with less than 500 employees. Only private enterprise will be able to raise the investment capital – estimates run from 500 to 800 billion DM ($ 300 to 480bn) – needed to modernise obsolete production plants and to produce new, competitive goods. Only private entrepreneurs have the experience and ability to restructure old firms and run profitable new ones.

Eastern Germany's poor infrastructure is regarded as a major obstacle to the reconstruction and privatization of the economy. Therefore, considerable amounts of public money are being invested in the improvement of telecommunications, roads, railways, schools and hospitals, in the retraining of public servants and the setting up of a modern civil service, in the restoration of monuments and in the elimination of ecological damage.

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[24] *iwd Informationsdienst* Cologne: Institut der deutschen Wirtschaft, 19:33, 19 August 1993, pp. 6–7, and (19:26, 1 July 1993), p. 1. Much of the reduced output of eastern German goods is still being exported to eastern Europe, taking advantage of Hermes' generous state export financing. DIW Wochenbericht Berlin: Deutsches Institut für Wirtschaftsforschung, 39:92.

Most of the expenditures for the new Lander are being charged to the central government budget. The growing budgetary deficits are covered mostly by credits,[25] and, since 1991, also by additional direct and indirect taxes. Since 1991, about 170 billion DM ($ 100bn) of public funds have been transferred to the East German economy each year as financial aid. Only about 40% of these public funds were earmarked for investments necessary to improve the conditions for private enterprise in eastern Germany. Approximately 60% of these amounts were earmarked for social purposes, such as subsidies for state enterprises, public insurance companies, funds for unemployment benefits, retraining facilities and employment promotion companies.[26] Given that these transfers of budgetary means will be necessary for several years to come, the share of investment will increase with economic recovery in eastern Germany.

Generous investment allowances and tax exemptions, cheap credits and export guarantees – particularly for deliveries to CIS and Eastern Europe – are being granted to newly established firms and privatized state companies. Since 1990, hundreds of thousands of (mostly young) entrepreneurs have seized the opportunity to set up their own firms in eastern Germany, above all in the service sector. Many of them are one-man or family firms and therefore have only a minor effect on the eastern labor market. The bankruptcy rate among these newcomers is high. On the other hand, these small firms are rather important for training managers "by trial and error". The share of these new firms in eastern German industry is, however, tiny.

That is why the privatization of the state sector, and particularly state industry, has been given priority as the most important condition of the economic reconstruction and recovery in eastern Germany. The *Treuhandanstalt*, a state agency run under the auspices of the Ministry of Finance, was given the task of restoring private ownership in the almost completely nationalized East German economy. Founded in East Berlin in the spring of 1990, by the then Modrow government, the Treuhandanstalt

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[25] In 1994 (as in 1993) a net increase of about DM 70 bn ($ 41bn) of the federal debt and a total of DM 167 bn ($ 98 bn) of all German state debts (federal and Lander governments as well as municipalities etc.) will be inevitable. *Neue Zurcher Zeitung*, 25 November 1993. The total German state debt will rise to approx. DM 2,000 bn ($ 1,200 bn) by the end of 1994. Approximately one third of these debts, DM 630 bn, are caused by unification. Interest payments for these Dm 630 bn will amount to approx. DM 30 bn ($ 18 bn) per year from 1994 on. *Neue Zurcher Zeitung*, 22 June 1993. In 1994, DM 250 bn of *Treuhandanstalt* debts, DM 140 bn of various debts of the former GDR, and DM 30 bn of state housing construction companies' debts, a total of DM 420 bn ($ 250 bn), will be comprised in a *"Erblastentilgungsfonds"* (hereditary liabilities amortization fund) to be paid off in 30 years. *iwd Informationsdienst*, Cologne: Institut der deutschen Wirtschaft, 19:13, 1 April 1993, pp. 6–7. For a summary of the development of German public sector finances see J. Sperling, "No Carrots, no Sticks: The External Consequences of German Unification" in N.J. Meyerhofer (ed.), *Germany and the United States Facing the Post-Communist World*, Flagstaff, Arizona: Northern Arizona University, 1993, pp. 16–21.

[26] Eberhard Wille, "Die Belastung der öffentlichen Haushalte durch die deutsche Wiedervereinigung," *Volkswirtschaftliche Korrespondenz*, Munich: Adolf Weber-Stiftung, 31:9, 1992. *iwd Informationsdienst*, Cologne: Institut der deutschen Wirtschaft, 20:2, 13 January 1994, pp. 2–3. "Rather than make eastern Germany an attractive place to work and invest, however, the government chose to make it an attractive place to receive and spend transfer payments". Alan Reynolds, "Reconsidering Economic Masochism in Germany." In: G.L. Geipel (ed.), *Germany in a New Era*. Indianapolis, Indiana: Hudson Institute, 1993, p. 248.

had to start virtually from scratch, but it has developed into a successful privatization agency.

Record of the Treuhandanstalt

With a staff of 4,000, supervised by experienced managers from western Germany, the *Treuhandanstalt* has in three years sold 5,722 of its 12,900 companies to private investors, reprivatized – i.e. returned to the expropriated former owners – 1,274, transferred to local governments 307 and liquidated 2,579. About 950 enterprises were still managed by the *Treuhandanstalt* at end-1993. Of the 4.1 million employees of the *Treuhandanstalt* in 1990, there remained only 233,000. The owners of privatized companies have pledged to invest about DM 177bn ($ 104bn) and to secure 1.44 million jobs.[27]

West German banks, insurance companies, and chain stores have taken charge of the respective branches in eastern Germany. Almost all formerly state-run service firms such as retailers, carriers, hotels and restaurants have been privatized. West German power companies are meeting the eastern German demand for electricity. They are reorganizing the inefficient eastern German lignite-burning plants, modernizing their obsolete facilities, improving their safety standards and reducing excessive pollution. The eastern German construction industry has been sold, mostly to western German contractors benefitting from huge public orders to build roads, railways and bridges, to renovate buildings, to repair water supply and sewage systems, to develop telecommunication networks, to restore monuments and to eliminate the worst types of ecological damage.[28]

The *Treuhandanstalt* has been encountering major difficulties in the privatization of other industrial branches. To facilitate the sale of state industries and to break up the monopolistic production structure, it began by splitting 316 huge state trusts, the so-called "Kombinate", into 8,500 independent companies which were given the legal status of corporations, or limited liability companies. In the course of privatization, by splitting or selling parts of enterprises, their number grew to about 13,000. With almost all eastern German enterprises placed under its control, the *Treuhandanstalt* became, in effect, "the world's largest industrial holding".

Originally, the *Treuhandanstalt* was not meant to act as a holding company and had been designed to make itself redundant as soon as possible. At present, it plans to finish its task and existence in 1994. To achieve its goal of privatizing the eastern German economy, it sold former state companies, initially in direct negotiations with individual purchasers and later by inviting tenders in international journals and by

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[27] *Treuhand Informationen*. Berlin: Treuhandanstalt, no. 17, December 1992, p. 6. *iwd Informationsdienst*. Cologne: Institut der deutschen Wirtschaft, 19:27, 8 July 1993, pp. 4–5. *iwd Informationsdienst*, Cologne: Institut der deutschen Wirtschaft, 20:4, 27 January 1994, p.4. *Frankfurter Allgemeine Zeitung*, 27 May 1994.

[28] Construction is one of the few booming branches in the East, with a growth of 11% in 1993, and employment rising by 7%. Its productivity has reached 70-80% of the western German level. *Frankfurter Allgemeine Zeitung*, 25 October 1993.

public auctions. This conservative method had been used for selling state property in the Federal Republic since its foundation in 1949. The question of offering most of the state enterprises to the East German population free of charge or against a token fee – as has been practised in former Czechoslovakia in the meantime – was discussed in the parliament of the GDR in 1990 but never seriously taken into consideration after unification.[29]

Of the industrial enterprises sold so far, 2,364 (or 33%), mostly small or medium-sized units, were handed over to former managers or other employees in management or employee buy-out schemes.[30] Most of the purchasers were western German firms. Only about 5% of the enterprises were bought by foreign investors, above all French, Canadian, Swiss, British, Austrian and American firms. Their growing number has stimulated hitherto hesitating western German companies into trying to secure the remaining profitable investment opportunities.

Despite these obviously successful operations of the *Treuhandanstalt*, its financial balance-sheet is disappointing. By 1994, the *Treuhandanstalt* will have accumulated a total loss of DM 275bn ($ 160bn). The main reasons for this deficit were modest privatization proceeds of DM 68bn amounting to DM 343bn and the enormous demand for subsidies for restructuring, regulating old debts or just keeping unviable companies alive. The unsold companies, among them huge chemical and steel trusts, are a growing source of tremendous losses.[31]

The obstacles to privatization were manifold. It has proved to be extremely difficult to evaluate the assets and to estimate the future profitability of eastern German enterprises. For example, western valuation methods to calculate the capitalized value of future profits were in most cases unsuitable. Future financial burdens caused by the need to eliminate ecological damage, for instance, are almost impossible to calculate. In some cases, necessary information was withheld by the old managers fearing for their jobs. Opening balance sheets, prepared by all former state companies after the currency union, were often based on poor and unreliable data, or they simply painted too favorable a picture. Sometimes the management tried to scare away potential purchasers by even exaggerating the poor financial status of the enterprise. All of the enterprises to be sold lacked the prerequisites for admission to the stock market.

The *Treuhandanstalt* is widely critized for exaggerating when attempting to hedge the risk of selling eastern German assets below their value. The price of eastern German enterprises was frequently reduced by heavy obligations of the purchasers to invest and to create jobs, to be enforced by penalties. Only hesitatingly, the *Treuhand-*

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[29] The privatization strategy of the *Treuhandanstalt* was criticized by Gerlinde Sinn und Hans-Werner Sinn, Kaltstart. *Volkswirtschaftliche Aspekte der deutschen Vereinigung*, (Tubingen: 1991), who recommended minority shares in privatized industry for the eastern German population as a recompense for temporarily renouncing wage raises.

[30] *Treuhand Informationen*, Berlin: Treuhandanstalt, no. 19, July–August 1993, p. 9. The management buy-outs arranged by the Treuhandanstalt are criticized by economists for being unviable in many cases without continued financial aid. *Frankfurter Allgemeine Zeitung*, 22 November 1993, p.18 (Interview with Karl Kauermann).

[31] *iwd Informationsdienst*, Cologne: Institut der deutschen Wirtschaft, 20:4, 27 January 1994, p.4.

anstalt has been ready to take over the heavy debts o former state enterprises inherited from socialist financing policies and to guarantee the removal of invisible ecological damages in order to facilitate the negotiations with investors. Some hasty sales at low prices demonstrate both the insecurity and the inadequate knowledge of Treuhandanstalt employees. Sometimes they failed in tough negotiations with clever Western businessmen. Cases of outright corruption show the high amount of temptation involved.[32] The shortage of capable personnel and the fear of making mistakes have ever now and then delayed negotiations until the potential purchaser lost interest. Opinion polls among small and medium-sized German enterprises active in East Germany or interested in investments there have shown that the performance of the *Treuhandanstalt* is ranking as the most serious obstacle to privatization, followed by the deterioration of market conditions in Eastern Europe, the present economic situation in Germany and pending property claims by former proprietors of assets in eastern Germany.

Pending property claims have been a major impediment to the privatization of former state assets. Most of the land, buildings and plants in eastern Germany were privately owned until the end of the Second World War. Between the end of the war and the foundation of the East German state in 1949, large landed properties and industrial assets owned by so-called "Nazi activists" and "war profiteers" – virtually all of the gentry and of big business – were expropriated under the auspices of the Soviet Military Administration in its occupation zone. Allegedly, the Soviet government made its agreement to German unity conditional on those "achievements" being kept up. Thus it was stipulated in a treaty between the Federal Republic and the GDR on 15 June 1990 that these assets will not be restituted to former owners.[33] In those cases the persons and companies concerned can claim indemnities only from the federal government. Thousands of law suits are to be expected over the actual value of these properties.

About 1.15 million western and eastern German citizens have applied for the restitution of property expropriated and nationalized by the East German government after its foundation in October 1949. Due to fragmentary records and the lack of capable personnel in eastern German administrations, only about 32% of these assets have so far been returned to their former owners.[34] Since the GDR had refused to pay compensation for assets formerly owned by Jewish citizens and expropriated during the Nazi period, property rights have to be traced back to 1933.

To cope with the ownership problem and to facilitate privatization, the German government in March 1991 passed a controversial Investment Law which was im-

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[32] A fact-finding committee of the Federal Parliament is investigating cases of corruption related to privatization. In June 1993, there were 447 judicial inquiries into fraud, deceit and corruption with *Treuhandanstalt* employees involved. Investigators described as "breath-taking" the cooperation between representatives of the *Treuhandanstalt* and investors. The *Treuhandanstalt* itself estimated losses caused by criminal agreements at more than DM 3 bn ($ 1.8 bn). *Frankfurter Allgemeine Zeitung*, 21 June 1993, 19 October 1993, 4 November 1993. *Treuhand Informationen*, Berlin: Treuhandanstalt, no. 19, July–August 1993, p. 7.

[33] *Gemeinsame Erklärung*, 15 June 1990, Bulletin no. 104 (Bonn: Presse- und Informationsamt der Bundesregierung, 1990), pp. 1119–1120.

[34] *iwd Informationsdienst*, Cologne: Institut der deutschen Wirtschaft, 20:17, 28 April 1994, p. 4.

proved and tightened up in 1992.[35] Although giving priority to restitution in principle, it permits the sale of former state enterprises to investors ready to reorganize the firm and to safeguard jobs. The sales by the *Treuhandanstalt* cannot be contested, regardless of pending restitution claims of former proprietors. Even if the legitimate owners or their heirs should wish to carry on production, the *Treuhandanstalt* can refuse restitution if another investor seems to have the better prospects. But prospective legal proceedings against the Treuhandanstalt's decision have been scaring away potential buyers. A bill settling indemnities for expropriated and not restituted assets in eastern Germany, presented by the federal government in 1993, has raised violent discussions in the parliament and the media. Considering the desolate condition of the state finances, a compromise will earmark state bonds amounting to DM 12.6bn ($ 7.4bn) and bearing no interest, to be redeemed in 2004, as a compensation for former proprietors.[36]

East Germans complain that only a few of their enterprises remain independent. Most of the privatized firms have become subsidiaries of West German companies. East German industry, they fear, will end up as an "extended work-bench" of the West German economy. Many purchases of East German firms are allegedly made by westerners to eliminate competitors.[37]

The number of East Germans capable of buying and running an enterprise is rather small, however, occasionally the *Treuhandanstalt* got into trouble when it kept old managers and made them run their enterprises in competitive markets. Used to highly centralized command structures, most of the East German managers are unable to adjust to new conditions which require initiative, independence and risk-taking. The *Treuhandanstalt* has fired hundreds of East German managers for political reasons, but thousands for sheer imcompetence. Up to 20,000 managers are needed urgently in eastern German enterprises to take charge of production, marketing, controlling, accounting and the like. West German corporations encounter difficulties recruiting managers for their eastern German subsidiaries among their own employees. Living conditions in the new Lander are not attractive to them, and the problems of reorganization are enormous. Another incentive offered by the *Treuhandanstalt* to attract managers from the West to take over East German enterprises is the "management companies" sharing their profits with the managers while all the eventual risks are covered by the *Treuhandanstalt.*

The shortage of capable managers also hampers the *Treuhandanstalt's* second task: to reorganize viable state enterprises in order to facilitate their privatization. The rapidly deteriorating economic situation in Eastern Germany has raised doubts about "privatization at any cost". Growing political pressure is being exerted on the Treuhandanstalt to refrain from driving firms into bankruptcy if they cannot be sold.

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[35] The investment law is criticized for keeping expropriated former owners or theirheirs from taking care of their property in the eastern German economy, instead of offering them their assets with the obligation to invest or to sell, lease etc. The law is widely regarded as a "second expropriation". Companies restituted to former proprietors are discriminated against. Whereas the *Treuhandanstalt* tends to offer favorable conditions to new investors, restituted firms are often overburdened with old and costly new debts. *iwd Informationsdienst*, Cologne: Institut der deutschen Wirtschaft, 19:20, 20 May 1993, p. 7.

[36] *Frankfurter Allgemeine Zeitung*, 24 November 1993.

[37] V. Vincentz. "Privatization in Eastern Germany. Principles and Practice." *Working Papers*, no. 146, Munich: Osteuropa-Institut, 1991, pp. 14–15.

According to politicians in East and West alike, it should attempt to restructure the remaining enterprises, increase their efficiency and save as many jobs as possible. Thus, many companies that ought to be liquidated because they are too deeply in debt, non-competitive and losing money every day, are kept going by "liquidity credits" guaranteed by the *Treuhandanstalt*. The prospects of such enterprises are gloomy. The *Treuhandanstalt* is a state agency. If private investors refuse to become involved in an obsolete and run-down state company, how could the *Treuhandanstalt* hope to be successful? Its employees lack the experience and information necessary to reorganize enterprises. Scarce capital is being wasted. Workers are kept in the wrong jobs and deceived about their chances to remain there. Private enterprises are pushed out of the market by heavily subsidized competitors underselling them. The eastern German production structure is prevented from adjusting to world market conditions.

If the *Treuhandanstalt* is forced to focus on subsidizing firms that cannot be privatized instead of liquidating them, it or some other agency will end up as a state holding company administering thousands of unviable enterprises at taxpayers' expense. Public money will be poured into dead-end industries and dud companies. Economically, it would have been a grave mistake to put up with a "mixed economy" over a long period of time,[38] including a large, inefficient state run industry. For social and humanitarian reasons however, mass unemployment and the depressed morale of the East German population must be taken into account.[39] Unemployment is a heavy blow for workers who had been convinced that they have a lifetime job. Young people have to be offered hope and prospects in order to keep them from following the wrong leaders. Therefore, state intervention in the economy will be necessary; however, it must be temporary and handled with care. At last, only the market can determine an efficient production structure for the whole of Germany.

Alternative to Unification?

Was there an alternative to the methods of economic unification that were eventually chosen?[40] Before the Currency, Economic and Social Union came into effect on 1 July

[38] A "mixed economy" strategy was recommended as early as 1991 for the sake of "safeguarding the eastern German industrial capacity against further destruction" by the former eastern German economist Harry Maier, Integrieren statt zerstoeren. Fur eine gemeinwirtschaftliche Strategie in den neuen Bundeslandern, Aus *Politik und Zeitgeschichte*, Beilage zu Das Parlament, B 29/91, 12 July 1991, pp. 3–12. According to the German Minister of Economies, Rexrodt, there is no state guaranted preservation of the remaining Treuhandanstalt companies in state hands, just a respite to alleviate their adaptation to the market. *Neue Zuricher Zeitung*, 14 July 1993.

[39] Unemployment in eastern Germany is also creating dangers of political instability and radicalization. The increase in *Ausländerfeindlichkeit* (animosity toward foreigners), which is not limited to the eastern part of Germany, is a symptom of this disorientation. See Stephen F. Szabo,"The New Germany and Central European Security." In: J.R. Lampe, D.N. Nelson, R. Schoenfeld (eds.), *East European Security Reconsidered*. Washington, D.C.: The Woodrow Wilson Center Press and Südosteuropa-Gesellschaft, 1993, pp.43–45.

[40] For critical analyses see: W. Schrettl, "Transition With Insurance: German Reunification Reconsidered." *Oxford Review of Economic Policy*, Vol. 8, No. 1, 1992; and Raimund Dietz, "The Impact of the Unification on the East German Economy." *WIW Forschungsberichte*, No. 172 Vienna: Wiener Institut fur Internationale Wirtschaftsvergleiche, 1991.

1990, many eastern (and even some western) economists had suggested that East Germany should be preserved as an independent national entity, with its own currency, trade and wage policy, for a transitional period of several years. According to those advocates of a "soft landing", the wages should have been kept low and the Ostmark devalued heavily to allow East German enterprises to compete in domestic and foreign markets, in spite of their low productivity. In addition, imports from West Germany and other countries were to be curbed by tariffs and quotas. These methods were meant to buy time for the restructuring of East German industry and prepare it for its integration into the world market. Experts recommending the continued political independence of East Germany hoped for saving the existing capital stock from becoming obsolete when the economy was exposed to international competition, which would cause the collapse of a large part of the industry along with subsequent mass unemployment.

Though their fears were undoubtedly justified, in retrospect, any beneficial effects of this scheme seem even more doubtful. Toward the end of the eighties, the economy of the GDR was on the brink of a breakdown. In 1988, the communist leadership was advised by its experts that the country was approaching illiquidity, due to its excessive exterior indebtedness and the unfavorable development of its balance of payments. In October 1989, an analysis of the state of the economy presented to the Politburo pointed out that halting the growth of indebtedness in 1990 would require a decrease of the living standard by 25–30 percent. There was no help from the Soviet Union which had made clear that it could not fulfill its commitments deriving from the trade agreement with the GDR for 1990. In November 1989 the state planning commission predicted the country's bankruptcy in 1991, if not for massive foreign aid.[41]

With Comecon trade proceeding to world market prices and hard currency, a large part of East German exports were to collapse. Moreover, a heavy devaluation of the East German currency would have raised import prices. In an economy heavily dependent on imports, this would inevitably have affected commodity prices in general. As has happened in other post-communist countries, the devaluation of the currency, together with the liberalization of prices in monopolistic production structures, would have started an inflationary spiral. Inflation might have wiped out the cost advantage of East German enterprises or forced the currency to depreciate, creating considerable unrest and speculation against the Ostmark. The decay of the currency and growing trade and budget deficits would have provoked import restrictions, thus impairing the economic recovery.

Fighting against inflation and balance of payments constraints, the government of an independent GDR would have found itself in a much less favorable position than the leaders of other countries in transition. Since the DM had been a symbol of wealth and purchasing power for the population of the GDR and had been in great demand as a second currency even before, a booming black market in DM and the final replacement of the weaker currency by the stronger one could hardly have been avoided.

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[41] Wolfram Fischer, Harm Schroeter, "Die Entstehung der Treuhandanstalt." In: W. Fischer, H. Hax, H. K. Schneider (eds.), *Treuhandanstalt. Das Unmoegliche Wagen*, Berlin: Akademie Verlag, 1993, pp. 17–26.

Protected by low labor costs and devaluation as well as tariff and quota barriers, the inefficient East German industrial sector might have had a chance to survive and safeguard a large part of its jobs. However, the opening of the Berlin wall and the restoration of a common German labor market with no restrictions whatsoever for job-seeking citizens of both states would have threatened the East German economy with an early collapse as a consequence of mass emigrations of its skilled workers and professionals. The common German citizenship, defended over four decades against growing pressures from within and abroad, could not have been easily given up. Thus, nobody could have hindered East Germans from choosing the higher living standard and the better prospects. With its labor force leaving the country, the economy of the GDR was doomed. A separate East German citizenship and strict border controls between the two Germanys – an absurd idea in itself –, were the prerequisites of a viable East German state.

Political, not economic considerations swung the decision in favor of an immediate unification with West Germany. Under the circumstances described, the economy of an independent East German state had not even a minor chance of survival. The GDR did not have the opportunity of other post-communist countries to safeguard the competitiveness of its producers on the domestic and foreign markets by means of economic and monetary policy. Thus, the Currency, Economic and Social Union was not the cause of the collapse of the East German economy, but the only way to avoid a desaster. It was a rather successful attempt to offer better prospects to the eastern German population. It was to lay the ground for restructuring the East German economy. It meant an immanent guarantee that the living standard would not fall but would gradually be raised to the western German level.

The conditions of the Union Treaty, criticized widely among western economists as too favorable, were meant to safeguard the savings and the property of the East German population. There were early warnings that real wages high enough to keep the eastern Germans from moving westwards would create immense problems for the eastern German low productivity-industry and lead to mass unemployment, another incentive to migration. Unforeseen events like the sudden redirection of eastern German consumers' demand to goods of western origin and the collapse of trade with East Europe greatly contributed to the difficulties of the producers in the new Lander. In order to raise the productivity of East German plants quickly and restore their competitiveness, the government chose as the only promising means a fast privatization of industrial and other assets, that is, their sale, for the most part, to mostly West Germans capable of restructuring inefficient enterprises.

Since these enterprises were unlikely to become efficient and yield the expected profits as long as they remained in the hands of the government, the decision in favor of privatization was correct. The German gorvernment, burdened with huge financial liabilities deriving from the economic union, was not in a position to keep the whole of East German industry viable for long. The speed at which factories and land have been privatized, however, can be questioned. A slower pace of privatization might have saved some of the social hardships imposed upon the eastern German population. For the sake of a smoother transition and a more successful integration of the two German peoples it might have been wise to retain temporarily a larger and gradually decreasing state industry and to extend the privatization process over a period of, say, 10 to 15 years.[42]

West German economists and politicians underestimated the extent of depreciation of eastern German industrial assets caused by the economic unification. The psychological effect of this loss was devastating. East Germans found themselves deprived of the fruits of life-long toil. They had spent their lives as the underprivileged part of the German people. They were the true loosers of World War II, being politically oppressed and economically exploited, and held at a low living standard with their material chances and personal mobility limited. Definitely worse off than their co-nationals in West Germany, they had however, the assurance of a lifetime job. Now having entered the unified Germany virtually empty-handed, many of them were laid off and received only unemployment benefits, early retirement pensions, or welfare.

Unemployment, a phenomenon unknown up to this point , is regarded as a personal blow, a social degradation and frequently a financial desaster. Being laid off means the loss of a community with many more social functions than just offering jobs. The cumulative effect of closing down several big plants simultaneously in the same region has resulted in desolation, the diminution of social contacts and reduced professional chances. Traditional qualifications, held in high respect in the former GDR, have swiftly lost importance. A massive transfer of skilled manpower being absolutely necessary, eastern Germany is now overrun by West German managers, bankers, engineers, skilled workers, public officials and all sorts of advisors. By the East Germans, this kind of tutelage is sensed as humiliating. In the West, understanding for the sensibility of the eastern German population is often lacking. Both peoples, living under different political and social systems for decades, have grown apart. They differ, often considerably, in their thinking, menality, morals and values. Many eastern Germans accommodate only reluctantly to the demands of a market economy – initiative, flexibility, self-reliance, but also selfishness, ruthlessness and greed.

The costs of restructuring the economy of the new Lander were underestimated. This is even more true the costs of raising the real incomes of the eastern German population and bridging the gap between the lower productivity in the East and the higher living standard in the West. Only now has the federal government started to tell the German people harsh truths about the tremendous financial burden of the unification. So far, the government apparantly has not dared to demand substantial sacrifices from the western German population. A large part of the expenses caused by the transfers to East Germany has been financed by raising public indebtedness, postponing liabilities to future generations. West Germans who were spared considerable

[42] The Nestor of the German economists, Wilhelm Krelle, wrote me after reading an earlier version of this paper in September 1992: "The extreme wage raises in conjunction with the antiquated capital stock and the collapse of eastern markets could lead to a massive breakdown with social and political consequences we all do not want. Thus the lesser evil might be to retard the transition process somewhat and to keep firms with the prospect to become efficient in the medium or long run, above water till then. Of course these means will be missing for the modernization of the infrastructure and other investments important for growth. However, economically one must stay within the limits marking the stability of the political and social system". (Translation by the author).

reparations after World War II and benefitted from all the opportunities offered to them by their economic system and integration in the western world, are accepting additional taxes and reduced incomes only grudgingly.

Thus, the German model of transition, compared to the efforts and performance of other countries in Central and Eastern Europe, is a "worst case scenario" in terms of the material and psychological costs of the process. The concern that eastern Germany could turn into Germany's "mezzogiorno" has not yet been completely dispelled. However, German unity could have all the prerequisites of a success story. East Germany has become a part of a well-functioning market economy. The costs of transition, though higher than expected, are borne by one of the wealthiest countries in the world. Modernization of the eastern German economy has been initiated by a technically most advanced partner. Privatization can rely largely on western German capital and know-how. The new Lander have been integrated in a politically stable state with a fully developed welfare system. As part of Germany, they have obtained full membership in the European Union.

Public expenditures for renovating the eastern German infrastructure, for the professional training of labor, and for improving the living conditions to reduce social tensions are worthwhile investments. They will increase the efficiency and crisis-resistance of the whole German economy. As in the Federal Republic after the Second World War, a most modern industry is being constructed upon the ruins of the old system that will urge western German and foreign producers to become more competitive. The principal asset of eastern Germany in this reconstruction process is its modest and hard-working population.

Paul Marer

Economic Relations between Eastern, Central and Western Europe

– An Historical Perspective –

Introduction[1]

The thrust of this essay is that developments during the past 500 years have created three distinct regions in Europe, defined partly by geography and partly by history, that must be taken into account when considering prospects for economic cooperation between the transition economies of Central and Eastern Europe and the already economically integrated countries of Western Europe. Europe's three main regions are:

(1) Developed and democratic Western Europe, whose long-term political future is not being seriously threatened. Western Europe encompasses the lands west of the eastern borders of today's Scandinavian countries, Germany, Switzerland, Austria and Italy; it also includes Greece.

(2) Precariously democratic and economically lagging Central Europe, made up of countries whose prospects of remaining democratic and becoming viable mar et economies are quite good, and where Western policies can make a difference for the success of those endeavors. Central Europe is situated between the Scandinavian-German-Italian speaking lands and the Russian-Ukrainian world's eastern and southern borders; it excludes the Balkans. Central Europe has been aptly called The Lands Between: it encompasses the Baltic states, Poland, the former Czechoslovakia, Austria, Hungary, Slovenia and Croatia.

(3) Eastern Europe is made up of the rest of the countries, whose prospects of remaining or becoming democratic and well-functioning market economies are less clear and where Western policies are likely to make a more modest difference. Eastern Europe is comprised of all the lands to the East and South of Central Europe, and includes the Balkans.

This division of Europe is somewhat arbitrary and simplified. The progression from more developed West to the less developed East is not a straight line. For example, Greece is included here as part of the West even though during for much of the last 500 years its development was closer to East Europe's than to West Europe's. The same can be said also of Spain, Portugal, and Sicily. In fact, the Mediterranean region has certain features that set it apart from each of the three regions of Europe.

Notwithstanding these and other caveats, Europe's three regions are sufficiently distinctive, and the differences between them have sufficient current policy relevance, to warrant emphasizing them in this essay.

[1] *The author would like to thank Professors Robert Byrnes, Charles Jelavich, John Kulczycki and Toivo Raun, as well as daughter Eva Marer, for valuable comments on an earlier version. This acknowledgement does not imply that the individuals thanked concur with the author's statements and interpretations.*

Part I sketches, in the briefest possible way, the 500-year history of Europe, mentioning some of the forces that have caused the three regions to develop differently. Part II examines the nature of economic integration in postwar Western Europe. Part III discusses the prospects of economic cooperation between the economies of Central and Eastern Europe and those of Western Europe. Part IV notes the policy implications of the analysis.

1. Economic Development of Europe: an Historical Perspective

The central feature of world history between 1500 and 1815 (Napoleon's defeat and the Congress of Vienna) was the expansion of Europe and the spread of European civilization-with its positive as well as negative aspects-throughout the globe. Until around 1500 the world had, on the whole, pressed in on Europe; after 1500 Europeans pressed across the planet.

Uneven economic development was behind the shift in power. In 1500, more than three-quarters of the world's surface was inhabited by food gatherers, hand-cultivators and herdsmen. The rest – mostly in England and the Western and Northern parts of Continental Europe – were plough cultivators, who were more productive. This enabled them to multiply and to accumulate the resources to finance economic development, once the other conditions for it were met.

In Europe itself, the division between Western and Central Europe on the one hand and Eastern Europe on the other coincides roughly with the dividing line between Western and Eastern Christianity and the different value systems and world views that they represented. The fundamental values of religion were transmitted to the people because of the strong involvement of the church in education and because religion accompanied and gave meaning to every significant event in the lives of individuals and communities.

The areas where Roman Catholicism and later Protestantism flourished became more fertile grounds for the development of capitalism than the areas where the Eastern Orthodox Church remained predominant. The former is associated with rational ascetism and a strong work ethic. For example, the motto of the Catholic Benedictine order was *ora et labora!*, meaning "pray and work!" And the association between Protestantism and capitalist development ("help yourself and God will help you too") has been emphasized ever since the writings of Max Weber.

The Orthodox Church kept itself more aloof from worldly developments, remained subordinated to the state and tended to support the preservation of the state and the status quo generally, including feudalism, inherited privileges, and serfdom.

Around 1500, Roman Catholicism dominated in the west and Greek Orthodoxy (with Muslim overlays) in the east. The dividing line ran through Poland and Lithuania in the north, down to Dubrovnik, to the Adriatic Sea.[2]

What, then, defines "Central" Europe? Briefly – and thus much oversimplified – Central Europe is that region to which Western political and economic developments

[2] *The Times Atlas of World History*, Hammond, Maplewood, New Jersey, 1978, p. 182.

came later and were disseminated more slowly than in Western Europe, but nevertheless arrived earlier and spread faster than in Eastern Europe. Hence the apt characterization of Central Europe as "The Lands Between." [3]

The agrarian revolution that began in the 16th century in north-west Europe – Britain, Belgium and Holland – had produced an efficient, commercialized farming system by 1800. That in turn made possible the industrial revolution. In less than a century, Great Britain became the workshop of the world. And England and Holland became not only the greatest textile producers, but also the largest manufacturers and owners of merchant fleets.

England was the first, early in the 18th century, to create a unified common market at home. On the Continent, economic development was hampered well into the 19th century by stiff tariff and non-tariff barriers between the states and the principalities within them. The economic development of western and central Europe was promoted wherever tariffs and other barriers to trade and the free movement of people were reduced or abolished. France abolished internal tariffs in 1790. In Germany, a customs union (Zollverein) was established in 1834, gradually extending the link to independent states, preceding the political unification of Germany in 1871 under Bismarck. In Switzerland, tariff barriers between the *cantons* were removed between 1848 and 1874, while Italy achieved economic and political unity in the 1860s. Moldavia and Wallachia (most of their territories in present-day Romania) entered into a customs union in 1847. In the Habsburg dominions the customs frontier between Austria and Hungary was abolished in 1850; in Russia, the customs frontier with Congress Poland was abolished in the following year. [4]

However, the tariff-free area of the Habsburg Empire included only Austria, Hungary and Bohemia. Much of the rest of Central and Eastern Europe was too backward to have much trade in manufactures and thus to participate in the division of labor.

A strong central state had an important role in creating a customs union and other conditions of capitalist development in Western Europe and in pockets in Central and Eastern Europe. But the extent to which the state was needed to financially support the entrepreneurs, or to try itself to be the entrepreneur, differed greatly. In England and in the Low Countries, capitalist entrepreneurs arose more or less spontaneously because society itself created the conditions under which new ideas, inventions, and capitalist accumulation could take place. In Germany. capitalism was created jointly by indigenous resources, by state support for banks (that in turn helped finance new ventures), and by foreign investors. In Central and Eastern Europe, capitalist development was brought about, with a delay and in much more dampened form, mainly by the *state*, with the assistance of foreign capital.[5] In Eastern Europe, the state played an even more important role, although the role was not, as a rule, efficiently performed.

The modern nation state – defined by John Stuart Mill as a group of individuals inhabiting a given territory and sharing certain historical, cultural or other traits, who

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[3] *A. Palmer, The Lands Between*, New York, 1970.

[4] *The Times Atlas*, op. cit., pp. 210–211.

[5] *I. Berend and Gy. Ranki, The European Periphery and Industrialization*, Akademia, Budapest, 1977.

are willingly governed together – arose in the 18th and 19th centuries. A key factor was the desire of the emerging classes of capitalists, entrepreneurs and the bourgeoisie for more freedom and rights, but also greater legal and economic support (such as enlarged markets, the enforcement of contracts, and law and order) than the conservative "ancien regimes" could provide.

Over the centuries, powerful central governments emerged, enabling their rulers to create a modern nation state by achieving a high degree of economic and political integration within their borders, defending those borders against foreign foes. Modern nations are thus rooted in *"civic-territorial" nationalism,* as exemplified by Britain, France and the United States.[6]

There is also another type, *"ethnic-cultural" nationalism,* which became a permanently strong force in societies where alien rule or severe (perceived) injustice was imposed by foreign powers. At various times in the last century – and in some cases down to the present – these include(d): in Ireland, against England; in Belgium, against Holland; in Norway, against Sweden; in Greece, against Turkey; in Italy, against Austria; the Czechs and the Magyars against the Habsburgs; the people under Magyar domination against Hungary; in Poland, against Russia; and so on.

The peoples of Central and Eastern Europe, being on the periphery of development and lacking the independent national states that most peoples in Western Europe were eventually able to create, assigned a special role to national cultural identity: preserving the "purity" of the native language, folklore and each group's own version of its history. These images became a substitute integrating force, a basis for national identity. Groups emphasized the uniqueness of their own language, history and culture, as a counterbalancing factor to the dependence of their nation and people.[7] This "culture as the nation" concept involved a nationalism that, in certain cases, was so defensive as to be offensive, with hostility directed not only against the dominating foreign powers but also against each other. The turbulent histories and mixed populations in many parts of Central and Eastern Europe gave each group of people the sense that it had to fight against other groups to strengthen its national position – and territorial claims – in the area in which it lived.[8] To be sure, civic-territorial nationalism has also shown itself capable of being aggressive, but perhaps less frequently than ethnic-cultural nationalism.

In the reshaping of Europe that followed the defeat of Napoleon in 1815, the Habsburg Empire can be considered the embodiment of Central Europe: it controlled all or parts of six of (what later became) the nine states in this group, the Baltic states being the exceptions. Was the Habsburg Empire a constitutional state *(Rechtsstaat),* which means a state based on the rule of law, or did it remain "the prison of the people" in a pseudo-constitutional form? While at the time of the Congress of Vienna and until the middle of the 19th century it probably was close to an absolute monarchy, the Empire did evolve in the direction of a constitutional monarchy (especially after the Compromise of 1867 with the Hungarians), but with remnants of absolutism, although with a

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[6] *A. D. Smith, National Identity* University of Nevada Press, Reno, 1991.

[7] *Berend, I., "The Role of Cultural Identity in Eastern Europe." In Eastern Europe: A Question of Identity.* Occasional Paper of the East Europe Program of The Wilson Center, Washington D.C., 1986, p. 13.

[8] *Ibid.*

comparatively wide range of liberal civic rights. Thus, the Habsburg Monarchy eventually became the eastern border of European liberalism, "the lands between." [9]

World War I led to the destruction of the Habsburg, German and Russian empires and ushered in communism in Russia. At Versailles, the victorious allies – the United States, Britain and France – created or sanctified new states and boundaries. Although the truncation of some and the creation of other independent states was, in some cases, an improvement over the prewar situation, the borders were not drawn well, as a rule. Large ethnic minorities were left with or attached to states dominated by other ethnic groups. For example, Czechoslovakia and Poland contained large German minorities, the redemption of which became one of the objectives of Germany's inter-war policy. The financial exigencies facing the economically weak successor states in Central and Southern Europe led them to impose stiff tariff and non-tariff barriers on goods originating in the neighboring countries that impeded intra-regional trade. And whatever trade flourished despite the protectionist environment was decimated by the effects of the Great Depression, which hit the countries of Central and Eastern Europe even more severely than it hurt the nations of Western Europe.

Given the withdrawal of the United States into isolation and the shortsighted policies of Britain and France also, Germany could become the dominant – and dominating – economic and military power in Central and Southern Europe. In terms of population and industrial strength, Germany's economic and military potential – which it soon realized – was now without any counterbalance in Central Europe. Germany was eager and soon successful in placing the countries of Central and Eastern Europe under its economic and later political and military umbrella.

World War II left Europe not only politically disorganized but also in a state of economic prostration. The main countries of Western Europe and their protector state, the United States, had able postwar leaders who made several intelligent policy moves. Learning from the mistakes the Allies made after World War I, the United States treated fairly the defeated countries and gave significant economic assistance, the Marshall Plan, to Western Europe. By contrast, the Soviet Union under Stalin extracted from Central and Eastern Europe unrequited resources of approximately the same order of magnitude as America poured into Western Europe via the Marshall Plan, with East Germany carrying the brunt of the burden.[10]

The economies of Central and Eastern Europe also grew rapidly after the War, until the early 1980s. But the imposition on them of communism and central planning caused their economies to become seriously "misdeveloped." That, in turn, helped preserve these regions' economic periphery status vis-a-vis Western Europe.

One manifestation of Central and East Europe's misdevelopment was the distorted geographic and commodity composition of their trade, on which the small size of their economies makes them, inevitably, to depend. Vis-a-vis the Soviet Union, the Central and East European countries became net exporters of energy- and raw material-inten-

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[9] *Hanak, P., "Between East and West: Is There a Central European Identity?" Occasional Paper of the East Europe Program of The Wilson Center, Washington D.C., 1986.*

[10] *P. Marer, "Soviet Economic Policy in Eastern Europe." In Joint Economic Committee, U.S. Congress, Reorientation and Commercial Relations of the Economies of Eastern Europe.* U.S. Government Printing Office, Washington D.C., 1974.

sive manufactures, initially geared to meet Soviet needs, and net importers of energy, raw materials and intermediate products. Thus, the patterns of industrialization and intra-bloc trade continued to proceed along what might be called a "pre-World War I track", not along a more modern "post-World War II track, wih would have meant ever higher values being added to a relatively stagnating or shrinking material input base, with infrastructure and services being continuously upgraded. The excessively material-incentive structure of production and trade and the neglect of infrastructure and services are two of Central and East Europe's many unwelcome legacies from the communist era. The policies behind these developments helped maintain the relatively backward status of their economies vis-a-vis more developed Western Europe.

2. *Postwar Economic Integration in Western Europe*

Economic integration can take various forms and proceed through several stages. The simplest form is creating a *free* trade area, in which tariffs are abolished among the members but each member maintains its own external economic barriers against non-members. The next stage is the formation of a *customs union,* in which a common external tariff system is erected. A *common market* abolishes restrictions on the mobility of goods and services as well as on capital and people (factors of production) – the "four freedoms," as it is called. This requires the removal of three types of barriers – physical, technical, and fiscal. The elimination of *physical barriers* gets rid of obstacles such as passport controls and checks at the internal frontiers. The removal of *technical barriers* eliminates differences in standards, such as for electrical appliances and fittings. The removal of *fiscal barriers* harmonizes the types of taxes being collected and the rates on those taxes. *Full economic integration* presupposes the unification of monetary, fiscal, and social policies and requires the setting up of a supranational authority whose decisions are binding for the member states.

The extent and the distribution of the benefits and costs of integration depend on the type of economies that are being integrated. In just about any conceivable case, benefits tend to exceed costs by substantial margins, especially in the long run. Most of the gains come as a result of eliminating (large) barriers to trade among the members, which make it possible for producers to exploit economies of scale and scope. More importantly, increased competition forces producers to become more efficient, which accelerates economic progress. Further substantial gains arise when countries establish a common market, when barriers to the free movement of factors of production are eliminated. The gains that can be obtained by moving beyond the common market stage, toward full economic union, are largely political.

Integration is thus not an all or nothing proposition. In addition to the stages just mentioned, integration has several further dimensions: economic, monetary, and political. One – perhaps utopian – vision of European integration advocates full economic, full monetary and substantial political integration among the member states. Economic integration is desired for the large economic gains that the free movement of goods, services, factors of production and people entails. Monetary integration, which at the end stage means a single currency, is desired because it supports the deepening of economic integration by reducing the cost of economic transactions and mitigates the currency risks of investing across borders. (However, relative to the size of the gains that countries can obtain through economic integration through the common market stage, the estimated gains of monetary integration are modest.) Political integration-which means having centralized, or at least a highly coordinated set of domestic and foreign policies, is desired for two sets of reasons. Unified or coordinated domestic policies are supposed to give individuals and organizations a "level playing field" in the member countries. And coordinated foreign policies are advocated to give the group greater voice and weight in regional and international affairs.

Economic integration up to the common market stage can be achieved without monetary or political integration. But full economic union demands a common currency, which in turn requires similar monetary, fiscal and social policies of the member states. One way or another this means that states must relinquish the autonomy of economic policy, which is a profoundly important step toward political integration. Hence the conclusion that political integration is a precondition of full economic and monetary integration, and not the crowning last stage, as it has often been thought.[11]

The member nations of an integration unit must decide whether integration should proceed at a single speed or whether it may proceed at multiple speeds, and the conditions under which other countries can become affiliated with the group.

The 1957 Treaty of Rome envisioned the eventual, step-by-step creation of a common market; the Treaty said practically nothing about monetary or political integration.[12] The six original members were France and Germany, Italy, The Netherlands, Belgium, and Luxembourg. In 1973, the United Kingdom, Denmark and Ireland became members. In 1981 Greece, and in 1986 Spain and Portugal joined.

As of January 1, 1993, the European Community removed most barriers to the free movement of goods, services and factors of production, thereby creating a *European Union* (EU) of 12 states.

In early 1994, the EU announced the terms on which four members of the European Free Trade Association, or EFTA (Austria, Finland, Norway and Sweden) can join the Union. Voters in all four countries will be asked to approve the terms of the referendum. If they do, the Europe of 12 will become the Europe of 16 as early as January 1, 1995.

Triggered by the reunification of Germany, the heads of the member states of the EC (as the Union was then still called) reached an agreement in 1992 to push integration further, toward full economic and monetary union. The agreement is enshrined in the *Treaty of Maastricht*, subsequently narrowly ratified by the states. The Treaty sets down the common conditions, such as the maximum rate of inflation and the maximum public debt, that, when reached, makes a member country "ready" for full economic and monetary integration with those other members that had also met the specified conditions. The Treaty thus recognizes the possibility that members will reach the next stage of integration at different times, that further integration might proceed at multiple speeds.

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[11] *M. Fratianni, "What Went Wrong with the EMS and European Monetary Union?" Paper presented at the Conference on European Identities, Indiana University, Bloomington, February 1994.*

[12] *Ibid.*

The driving force for the Treaty was the desire by the smaller members-fearing an economically powerful and politically dominant Germany – to rely on full economic integration to reduce Germany's freedom to pursue independent policies. Whether the Treaty can be implemented remains a big question. The basic issue is that the steps required to implement it presuppose the ability and the willingness of the member states to move toward converging monetary, fiscal and social policies, and a willingness to yield policy making decisions in those areas to supranational bodies. It is not at all clear that all or most of the member states are, or will soon be, ready for such a step, given the histories, policies and preferences of the members, as well as the large disagreements on the future of European integration among political groups within the individual states.

There are two fundamentally different concepts of what the last stage of European integration should be like. One concept envisions Europe as a loose federation; the other, as the member countries having granted substantial rule-making and policy-making authority to the Union's central organs. The former "liberal" position, exemplified by the Conservatives in Britain, holds that economic integration should mean primarily the removal of impediments to voluntary transactions between individuals and firms that happen to reside on different sides of a border. In this view, the liberalization of markets should not be accompanied by detailed and intrusive harmonization of national laws and regulations, a fusion of bureaucracies and the creation of interventionist supranational institutions. Competition should be promoted and the role of the state reduced. This conception of integration is more "friendly" to admitting new countries because new members would have fewer "harmonization" requirements to conform to than under the alternative concept.

The alternative concept envisions the Union to be more centralized, with many more laws, regulations and policies standardized. This vision of European integration – exemplified by the French and the current President of the European Union, Frenchman Jacques Delors – is based on the premise that all "distorting" differences in the legal, institutional and social frameworks among the member countries should be eliminated and economic and social policies harmonized, all under the watchful eyes of a strong supranational body. The Maastricht Treaty leans strongly in the direction of this concept, perhaps the main reason why it has been receiving only lukewarm political support and why it may not be (fully) implemented.

3. Prospects of Economic Cooperation between Central and Eastern Europe and Western Europe

The fundamental lessons of West European integration for the countries of Central and Eastern Europe are that it is possible for different countries to join an integration group at different times, that a country's integration with the EU can proceed in stages, and that a newcomer need not, automatically, aim to go the full distance.

A country can obtain most of the EU's *economic* benefits by achieving a common-market-type of integration with the EU. Full membership, with a commitment to participate in the implementation of the difficult Maastricht Treaty process, may of course be pursued, but mainly for *political* reasons. The desire by several countries of

Central and Eastern Europe for membership in the EU appears to be driven not so much by the expectation of immediate large economic gains (since increased competition would also impose large costs in the short- to medium-run), but by an almost desperate need for political and military security, given the ethnic fighting in the former Yugoslavia, in several republics of the former Soviet Union, and worrisome developments and prospects in Russia and Ukraine.

One concern throughout the region is the sudden political rise in Russia of extremist nationalist Vladimir Zhirinovsky, who is making well-publicized claims on territory within the borders of Poland and threatens to absorb some of the newly independent successor states of the USSR. Other concerns include the tensions between Ukraine and Russia. For the smaller countries, membership in the European Union would implicitly provide some security protection. Equally important, membership in the EU is viewed as supporting entry into NATO, although it is conceivable that NATO membership would precede association with the EU.

There are 22 "transition economies" in Central and Eastern Europe, several that became newly independent after the fall of communism, whose territories are located fully or partly in Europe. All of them would like to have improved economic relations with the EU, in many cases preferring some type of a formal association with it, in some cases aspiring for full membership in the organization.

What fundamental, long-term considerations should determine which countries are "ready" for what type of cooperation with the EU? Four basic factors may be suggested: geographic location, economic system, level of development, and political system. The greater the degree of compatibility between a prospective new partner and the EU with regard to these factors, the more ready would such a country be to enter into some type of advanced cooperation with – possibly even full membership in – the European Union, and the more ready should the EU be to welcome cooperation with such a country.

Location is important because economic cooperation among countries with contiguous borders, or at least borders that can be reached easily, make much more economic sense than integration between countries that are separated by non-members.

Economic system is important on account of systemic compatibility. Since West European integration is fundamentally market-driven, only countries that are market economies, or are well under way to transforming their economies into one, and are clearly committed to such a system, should be considered ready.

Economic development level is relevant in judging the economic and political compatibility of a prospective new partner with the EU. The larger the gap in development levels between an integration unit's current members and a prospective new partner, the more difficult it would be to meaningfully integrate the new country, in part because the political opposition is likely to be substantial on both sides. The more developed West European countries would be less willing to open their borders to products and workers from a country with much lower wages, or shoulder the burdens of financing assistance programs to the less developed new member. And the less developed members of the Union would be concerned about losing some of the financial and trade advantages of their status. And the less developed is a new partner, the greater would be its concern about opening its markets to foreign competitors that are so much more productive. These considerations explain, for example, why the integration between Mexico and the United States and Canada under NAFTA involves only free trade, not envisioning a more advanced type of economic arrangement.

The political system and its stability are important. Economic integration requires some (in the liberal concept) or substantial (in the more centralized concept) harmonization of institutions and policies of the member countries. The most important political dimension of the deep economic integration that has already been accomplished in Western Europe is that only democracies can be considered for membership, or remain members in good standing. Although no country can give absolute guarantees, the prospects should be reasonable that a new member would remain a democracy and that its future governments would respect human and political rights. (Association short of full membership can, however, be envisioned with less stringent conditions regarding the partner's domestic political system.) Political stability also means, among other things, no prospects of armed conflict with neighbors that could embarrass the EU or force it to take sides.

Over the years, many non-member countries, including some of the transition economies, had been granted various types of preferential trading arrangements with the EC. For example, in 1991 Association Agreements were signed, and later ratified, with Czechoslovakia (today, the Czech Republic and Slovakia), Hungary and Poland. These agreements liberalized (though not unconditionally) these countries' access to the EU while giving them more time to grant reciprocal market access to the EU members. The Agreements stated that the eventual EU membership of these countries is envisioned.

In March 1994, the EU signed an accord for trade and political cooperation with Ukraine, the EU's first such pact with a former Soviet Republic. Under the agreement, the EU will grant Ukraine preferential trade status and remove quotas on certain Ukrainian imports, while Ukraine will remove obstacles to EU imports and investments. The pact allows EU companies operating in Ukraine to use a convertible currency. While the agreement does not offer Ukraine the prospect of membership, it provides for an eventual free-trade zone with the EU.

In April 1994 Hungary formally applied for membership in the EU, the first transition economy to do so. Although the EU has indicated that it will not deal with new applications (other than those already pending for the EFTA countries) before the scheduled 1996 meeting of the heads of governments of the member states, Hungary did submit its application in order to obtain the right to participate in all subsequent negotiations about EU institutions and policies.

How ready and attractive are the 22 transition economies as EU prospective partners for the EU?

The 22 transition economies of Central and Eastern Europe are divided into four groups, based on the enumerated "readiness" factors. The emphasis is on important and relevant similarities within the groups, not on the many significant differences that of course exist among the countries within each group.

Group One: The Eight Most Attractive and Eager Partners. This first tier includes eight transition economies: the Czech Republic, Hungary, Poland, Slovenia, Slovakia, and the three Baltic states of Lithuania, Latvia and Estonia. I am somewhat uncertain that Slovakia belongs with this group, or that a country like Bulgaria should not be placed with this group. Be that as it may, the logic – as well as the doubts – about which country belongs with which group are indicated.

Each of these eight countries is either bordering current or already accepted members of the Union (Poland, the Czech Republic, Slovakia, Hungary, and Slovenia) or are within easy transport distance from such countries (the Baltic States to Scandinavia). It is worth noting, for example, that Finland is now Estonia's main trading partner.

All eight countries (with the possible exception of Slovakia) have made from satisfactory to excellent progress in transforming themselves into market economies. Two important considerations warrant placing the Baltic states with this group. One is their excellent record since 1990 of successful macroeconomic stabilization (bringing inflation under control), accompanied by the introduction of their own strong and de facto convertible currencies. The other factor is reasonable assurance that even a Russia with resuscitated imperial ambitions would not try to occupy or control these states again, notwithstanding the large Russian minorities living within the borders of Latvia and Estonia.

Concerning the level of economic development, although it is difficult to accurately measure it, most assessments place these countries near or above the poorest current members of the Union, Portugal, Spain and Greece (with Slovakia perhaps the exception). Because during early transition from central planning to a market economy, exchange rates tend to depreciate very substantially in real terms and may deviate from purchasing power parity by as much as two- or three-hundred percent downward, exchange-rate-based comparisons of per capita dollar GDPs do not provide a sound basis for judging these countries' comparative levels of development. Alternative rankings, such as those based on physical indicators or purchasing power parity, probably yield more plausible results.[13]

Concerning the political system and its stability, the borders of each of the eight countries appear to be secure, either in the sense that the country has no significant territorial claims on other countries and vice versa, or in the sense that it is unlikely that any of their future governments would undertake military action to try to change existing borders (as in the case, for example, of the dispute between Hungary and its Romanian, Slovakian and Serbian neighbors concerning their treatments of their large Hungarian minorities, or the minor border problem between Estonia and Russia). This fact presumably imparts a certain degree of long-term political stability to these nation states.

Because the EU wants prospective new members to be, and to remain, democratic, political culture is important in judging democracy's prospects. In the inter-war years, Czechoslovakia maintained democracy and most of the countries, including the Baltic states, enjoyed independence. (Slovenia was of course a part of Yugoslavia, but other "positive" considerations override this factor.)

Some would argue that, with the exception of Czechoslovakia, none of the other countries in this group has a strong democratic tradition. Several countries (outside the Baltic states and Slovenia) also have histories of aggressive "ethnic-cultural nationalism" – a past that does not provide strong assurance of a stable and democratic future. But as political scientist Charles Gati so aptly put it, the key to political

[13] *P. Marer, et. al., Historically Planned Economies: A Guide to the Data.* The World Bank, Washington D.C., 1992, Chapter 5.

traditions is not so much the presence or absence in the past of a strong multiparty, democratic political order, but that of a democratic political culture, i.e., political tolerance, to uphold the rights of those with whom one disagrees, to treat or even to think kindly of national and religious minorities, to tolerate their "unusual" habits and lifestyles, to accept, affirm or – heaven forbid! – welcome, diversity. Arguably, these are not the traits one readily associates with all of the countries in this group. And communism, with its extreme categories and sharp distinctions, has tended to reinforce the negative aspects of this political culture.[14]

But the coin also has another side. While one may concede that the democratic tradition in most of these countries is weak, it is not altogether absent. And in considering whether these countries are "politically ready" to join Western Europe under some formal arrangement, it is important to realize that membership in the European Union – or its firm prospects - would help stabilize these democracies and improve their political culture. Just as Greece, Spain and Portugal were admitted to the EC in part to make their turn to democracy irreversible, the same reasoning holds for these countries, too. As Janos Martonyi, Hungary's Deputy Secretary of State put it: the European Union sets down codes of conduct which, if obeyed, would help solve the region's deep-seated security problems and help keep politicians of the extreme right or left from coming to power.[15]

Group Two: Eight Less Ready Countries. Eight transition economies are placed in the second tier: Ukraine, Belarus, Moldova, Romania, Bulgaria, Croatia, Serbia, and Albania, whose prospects for successful transformation into well-functioning market economies, with sustained economic growth, appear to be less promising than those of the eight transition economies in the first tier. Belarus' economic and political fate seems to be tied closely to that of Russia. Bulgaria, Romania and perhaps even Albania may have somewhat better prospects than the others and could join the countries in the first group. Ukraine has the size and the industrial base to join that group also, but the best guess is that its seemingly unresolvable conflicts with Russia will preempt much of its energies in the future. Neither Romania nor Moldova is well located in Europe. And it is unlikely that even after the cessation of the hostilities, Croatia and Serbia will be able to enjoy the kind of peace and political stability that are preconditions for sustained development, or that they would be welcomed soon into the economic alliance system of Western Europe.

Group Three: Five Insulated and Troubled States. In this third tier are Bosnia, which is sure to remain an international basket case for many years to come; Macedonia, whose landlocked location, sandwiched between neighbors that have territorial claims on it, does not bode well for its economic future; and the three remaining European successor states of the former Soviet Union: Georgia, Armenia and Azerbaijan. In addition to the ethnic fighting that is taking place in these countries, their isolated location, far from Western Europe, prompts their being grouped with countries that are the least likely to want to join, or would be welcomed, into close association with Europe.

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[14] C. Gati, "Eastern Europe: Problems of Political Identity." Occasional Paper of the East European Program of The Woodrow Wilson Center, Washington D.C., 1986.

[15] *As quoted in The Economist,* March 13, 1993, p. 21.

In a Group by Itself: Russia. Russia's size, military might, dominating political importance and vital interests outside Europe make it inappropriate to classify it in a group with any other country, or for Russia to wish to join, or to be considered for membership in, the European Union. In addition, Russia's prospects for sustained economic recovery and transformation into a market economy are somewhat questionable also. The reasons include Russia's inevitable long-term preoccupation with ethnic-political problems within and near its borders, the likely continuation of the centuries-old tug of war between "Westernizers" and "Slavophiles," the centralizing traditions of its government, the enormity of its inherited economic problems, and the continued strength of the elites who came to power under the communist rule (a factor that is also present in several other countries). These factors could lead to a slowdown, or possible paralysis, of the will to implement the fundamental economic and political reforms needed.

What are West Europe's perspectives on institutionalized economic cooperation with the transition economies of Central and Eastern Europe?

West Europe would obtain several important benefits – but would also have to shoulder certain costs – if it made a firm commitment to extend some institutionalized form of association with, possibly full membership in the EU by those transition economies that are the most "ready," i.e., by approximately those in Group One. West Europe would derive the following important benefits from such arrangements:[16]

(1) *Improved Economic Stability in Central and Eastern Europe.* Most importantly, Western Europe needs to do what it can to shore up the countries on its Western borders against economic and political instability and the likelihood that paranoid and extreme nationalist politicians will gain power. Association agreements, but especially a commitment to full membership, would decrease the chances of that happening in Central Europe because opening the markets of Western Europe – which in turn would encourage investment flows to Central Europe – would be the single most important "economic aid" that West Europe could grant to its eastern neighbors. It is clear that successful domestic transformation to a market economy would have to be accompanied by an export-led growth; the logical markets for Central Europe would be each others' markets plus those of Western Europe. The tapping of both sets of markets would be much easier if the group of countries would have close institutional affiliation with Western Europe.

(2) *Reduced Appeal of Extremists in Central Europe.* Membership in the European Union, though itself is not a security pact, would provide a form of security guarantee and thus automatically reduce the strengths of extremists. Membership would also impose on the countries a certain required code of political conduct; there would now be a carrot as well as a stick to prompt compliance.

(3) *Potentially Large Economic Benefits.* If Central Europe recovers and achieves sustained growth through integration with Western Europe, that would provide substantial economic gains to Western Europe. Access to Central and Eastern Europe's competitively-priced labor, especially its highly skilled professionals, would help make Western Europe more competitive in the global marketplace.

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[15] *As quoted in The Economist*, March 13, 1993, p. 21.

(4) *Improved Ability to Cope with Mighty Germany.* In a few years, the costly and difficult task of absorbing the eastern part of Germany and bringing its infrastructure and the people's standard of living on par with western Germany's will have been completed. Germany will then be the overwhelming economic and political power in Europe. Membership of Central Europe in the Community would improve Europe's ability to cope with mighty Germany, since there would be institutional and political guarantees against "imperialist" actions, should any future government of Germany, once again, be inclined in that direction.

Turning to the possible costs for Western Europe of institutionalizing economic cooperation with the transition economies, five reasons have been put forward for not – or not yet – entering into such arrangements. In decreasing order of importance and plausibility, they are:

(1) *Financial Costs.* Budget transfers from the Community's regional fund (about a quarter of the Community's budget), plus the cost of supporting their farmers under the Common Agricultural Policy (about half of the budget) would amount to between $ 6 and $ 10 billion a year for four of the Central European countries (Czech Republic, Slovakia, Hungary and Poland), adding about 5% to the Community's total current budget of about $ 200 billion. The poorer current members (Spain, Portugal, Greece and Ireland), who are net beneficiaries of intra-community transfers, are the strongest opponents of admitting countries from Central and Eastern Europe because they are afraid that the new expenditures would be financed by reducing transfers to current members.

(2) *Decision Making Would Become Even More Difficult.* The Community's institutions are "bureaucratic edifices, with every interest represented and every ruffled feather smoothed."[17] Designed for six members, the decision making is already cumbersome with 12 members, perhaps soon to be 16. Admitting from four to eight new members from Central Europe would increase the difficulty of decision making under current institutional arrangements. While this is true, the original idea of the fathers of the Community, Frenchmen Jean Monnet and Robert Schuman, to extend the union to all of Europe, should not be stymied by bureaucratic considerations, even if the decision making rules would have to be revised.

(3) *The Prospective Partners are Not Ready for Membership.* The Maastricht Treaty envisions that members would have comply by 1997 with five criteria of economic and monetary stability: low rates of inflation and long-term interest rates, a budget deficit under 3% of GDP, a public debt ratio of less than 60% of GDP and two years of currency stability within the Exchange Rate Mechanism.[18] Although none of the eight Central European countries currently meet all of these criteria, two counterpoints should be made. One is that these criteria are not automatic qualification procedures but guidelines. How much time a prospective new member would be given to meet them either before or after joining the Community is a matter for negotiations. More importantly, several of the current members of the EU, such as Germany, are not in full compliance. Should the transition economies of Central Europe be given a tougher test for admission than some of the countries of Western Europe that are already members?

[17] *Ibid.*
[18] *Commission of the European Communities, The Single Market in Action.* Brussels, 1992.

(4) *Increased Competition Would Hurt Sensitive Industries.* Producers in coal, steel, textiles, footwear and agriculture are worried about increased competition from the East. The two obvious counter arguments are that even in these sensitive sectors, only about 6% of the Community's imports currently come from Central Europe, which could rise to around 10 to 12% if they were admitted. More importantly, if Central Europe has a comparative advantage in these sectors, allowing them to rely on their exports would make all parties net gainers, according to the theory of comparative advantage.

(5) *Increased Flow of Migrants to West Europe.* Some are concerned about a possible new flood of workers seeking jobs in Western Europe, on account of current wage and salary levels in Central Europe being only one-fifth to one-tenth of those in Western Europe. The flood of new workers, the argument goes, would worsen West Europe's already high rate of unemployment (in the 10 to 20% range, depending on country). This argument has little validity. While Hungary's borders are open to Austria and wage differences are at least five-fold, Hungary has had the lowest rate of migration to West Europe. Large-scale migration does not seem to happen because two neighbors have different living standards, but because there is dangerous political instability, persecution and fighting, or their likely prospects. The best way the Community can reduce the chances of mass migration is to help create the economic underpinnings of political stability.

4. Conclusions and Policy Implications

Over a period of 500 years, Europe split into three distinct regions: Western Europe, Central Europe and Eastern Europe.

Central Europe is a transitional region between West and East Europe, historically, politically, culturally, and in terms of economic development levels. The people of this region came from the East, have had permanent contact with the East, but turned increasingly toward the West and see themselves as part of the West.

There are fundamental historical, cultural, geographic, political and economic reasons why the eight Central European states are more "ready" for some kind of advanced economic cooperation with Western Europe than are the region's 14 other transition economies. A firm commitment by Western Europe to such type of economic cooperation with the countries of Central Europe would be in the interest of both parties.

Repeatedly during the past 150 years, the people of Central Europe have tried to move closer to the West, but without a great deal of success. Perhaps the first such occasion was in 1848, when virtually the entire region rose in revolt against alien rule, putting forward national demands, with France, England and the United States as the kind of model states. The uprisings were put down by joint military intervention by the Habsburg and Russian monarchies. In 1919, when most of the countries in this region gained their independence, the West did not treat them fairly, drawing the borders to suit their great power interests. In the inter-war period, the democratic great powers became isolationists, leaving much of Central and East Europe to struggle alone with their immense problems, eventually to be taken over by Nazi Germany.

And after World War II, the West did not do all it could have (certainly not in the eyes of people in the region) to prevent their falling under Soviet domination.[19]

There is a new request today "to join the table," and thus an opportunity for Western Europe to respond more positively. While it is up to the parties themselves to make the decision, United States policy should be to promote and facilitate Central Europe's closer cooperation with Western Europe. But ways should be found that such cooperation not be at the economic and political expense of those European transition economies that are not, or not yet, ready for such a step. One way to do this is to aim for a more advanced type of economic and political cooperation with those transition economies that are more ready for such cooperation, and to promote less advanced types of cooperation with the other transition economies.

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[19] *R. L. Hutchings, "U.S. Interests in Eastern Europe Beyond the Cold War", manuscript, 1993.*

TAMAS SZENTES

The Transformation of Central and Eastern Europe

– A Study on the International Context of the Process –

1. Nature and Components of Transformation

Since the late 1980s Central and Eastern Europe has been undergoing profound changes in all the spheres of social life, the effects of which are far-reaching both for the countries concerned and the international community, while the final results and consequences of such a transformation are still unpredictable.

The historically unique and heavily contradictory nature of this process follows not only from the peculiar international conditions under which it is unfolding but also and substantially from the simultaneousness and interactions of changes or tasks which in the past history and/or in other regions of the world normally used to come on the agenda in a more or less separable way, succeeding rather than accompanying each other. Such as:

(a) the change of a "system," of an entire economic and political power structure, involving large-scale and radical shifts also in property structures and ownership relations, namely a wave of privatization as well as qualitative changes in the rules of resource allocation, income distribution and political decision-making mechanism;

(b) "demilitarization" and "de-etatization" of the economy (and society), a switch-over of the national economy from a more or less militarized order, a command system, i.e. a kind of "war economy" to a normal "peace economy"[1]

(c) the replacement of the rules, institutions and mechanisms of the centrally administered (militarized), so-called "centrally planned" economy by those of a more or less spontaneously operating market economy, involving liberalization of the rules and decentralization of the decision making in the economy;

(d) a "quasi-primitive capital accumulation" coupled with rapid income differentiation and an artificially accelerated creation of a proprietor class;

(e) modernization of the economy both structurally and technologically, i.e. a sectoral and technological restructuring, as well as in terms of its institutions and rules;

(f) a (re-)opening of the society towards the outside world, a relinking with the world economy by organic relations (trade and factor mobility) of the economy after a temporary delinking;

[1] The problem of transition (a real and well identifiable one) from a "war economy" to "peace economy" appears as a more or less common problem of the countries under transformation, not only because the military confrontation and arms race with the West are over but also and mainly due to the "originally" militarized nature of the system to be transformed. I shall return to this point on the militarized nature of state socialist system. Differences in this respect are, of course, particularly considerable among the countries, as a consequence of their different role in the former military bloc and also owing, primarily, to the different measure of former reforms.

(g) a crisis or recession in the economy with internal and external disequilibria, growing unemployment, inflation and indebtedness, thrusting the crisis and debt management, stabilization and adjustment policies into prominence;

(h) a critical deterioration of environment with the danger of ecological catastrophes, requiring urgent and large-scale environment protection measures;

(i) a total or partial collapse of the former social security system which is to be replaced as soon as possible by a functioning social safety net;

(j) a profound reform of the entire redistribution system with substantial changes in the structure of the state budget, in taxation, in credit and banking policy, in the financing of social services, public health, education, cultural and other institutions as well as municipalities;

(k) a disintegration of the previous social value system and the (re-)formation of another one, including the replacement of the previously dominant economic and political philosophy as a means of legitimation;

(l) democratization, a change-over from an authoritarian state-party system to a pluralistic, multi-party system of parliamentary democracy coupled with an unfolding civil society;

(m) a decentralization of governance, a redistribution of the functions and spheres of authority and competence in favor of local communities and municipalities;

(n) the rise of nationalism (the endeavors of new nation-building) and nationality conflicts as influential factors in domestic politics and inter-state relations, requiring a new security system and conflict management in the region;

(o) the collapse of a former empire, a kind of decolonization," i.e. the (re-)gaining of national sovereignty, and a disintegration of the former (Comecon) structure of intra-regional economic relations and cooperation, to be replaced by new intra-regional relations.

Even if, in view of the inter-linkages or certain overlaps between some of the above-listed distinct components of the process of transformation, this long list can be reduced, it is quite obvious that at least *five or six different sets of problems must be faced at the same time by the countries of the region.* Above all they have to cope with the problems of the change of the system, involving, among many other changes and tasks,[2] also privatization and the need to reconstruct the social cohesion. They have to re-link their countries to the world economy and society, with the required structural adjustment and modernization, including the "decolonization," i.e. a drastic reorientation of foreign relations. In addition, they have to stop the almost catastrophic deterioration of the environment and initiate an improvement. All these tasks, needless to say, require a kind of crisis management.

But however concentrated the scope of issues may appear if grouped into such broad categories, it remains quite obvious that the ways and means of solution, the required "therapies" are necessarily quite different, often contradictory and counteracting. It follows that no easy and quick "transition" can be expected, and that the time dimension of the major components of the transformation process far exceeds a few years, even if, as a miracle, they are harmonized or cleverly reconciled. Though the case in

[2] See also the list of the components of transformation.

one or another country, of a possible "upward spiral motion" should not be excluded, it is unlikely and cannot represent a feasible scenario for all the countries of Central and Eastern Europe. Much depends, of course, on the international conditions.

A realistic analysis of the transformation process prescribes not only the revealing of those conflicts or interactions and inter-linkages appearing between and within the major parts of the process, its success criteria, policy requirements etc. It makes also necessary to identify, as much as possible, the real legacy of the past, to explain the very nature and characteristics of the so-called "existing" or "real socialism,[3] its failure and defeat, and to register the results and limits of its reforms ("reform-socialism"). In spite of basic similarities, however, one should also face the major differences between the individual countries.

This study cannot venture to extend the analysis to all the above issues. It restricts to a short analysis of the origin, nature and major consequences of the sate socialism and its earlier reforms in an international context, and to the outlining of the main normative criteria as well as some practical difficulties and dilemmas of a full transformation.

There are many over-simplifications, illusions or superficial conclusions in the related literature. One of them, perhaps the most dangerous, is the naive belief shared by many both in the West and in the East that the systemic transformation simply deletes a "wrong chapter" in the history of these societies, and brings them back to "normalcy" which has been temporarily interrupted by the existence of communist regimes. This misbelief and many other typical oversimplifications usually follow from the divorce of the external and internal factors in the explanation of the rise, defeat or transformation of state socialism, i.e. either from considering it merely as an export product and attributing its collapse to external pressure, or from considering the development of domestic processes of the given societies in se as purely or primarily endogenous, taking them out of the context of global changes and international context. Such a neglect of the organic role in the internal processes, of the impact of external, global processes of the world seems to correspond to the conventional approach of comparative system analyses and country studies, in which the natural unit of analysis is an assumed entity surrounded by state frontiers, and the external relations or effects are taken into consideration at best as secondary factors.

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[3] Numerous books, papers and articles have been written about the former socio-economic system called "socialist", "communist", "Marxist", "Bolshevist", "Stalinist", "state-socialist", "centrally planned", centrally administered", "one party" or "state-party", "Soviet-type" system, "real", "existing" or "underdeveloped socialism" etc. Although sometimes I also use alternatively such vague but conventional terms as synonyms, I definitely prefer the term "Stalinist," particularly when speaking about its most characteristic, par excellence stage before any liberalizing reforms, and "state socialist," in a more general sense. By referring to the "father" of the system (at least in the sense of who has established its first model in practice and conceptualized its permanently militarized character in theory) the unnecessary ideological biases and debates can be avoided.

It is often noted, quite correctly, that despite the great number of studies on the former system in the "East", a thorough, comprehensive and realistic analysis of it is still lacking (perhaps because in most of the studies the way of approach and assessment are ideologically biassed, namely by placing this system into the context of the "socialism versus capitalism" dichotomy, or reflecting an oversimplified "subtraction approach" in its comparison with a (non-existing) ideal-type system.

However practical this approach proves to be, a full understanding and realistic assessment of the nature of the former system and its transformation require its analysis in the context of world development. One can explain its inherent conflicts and contradictory effects only if placing it indeed into the context of historically changing international conditions and external challenges. It is only in the light of the latter that one can understand why previous reforms had created hopes and illusions about its reformability, followed by disillusionment. It may also explain why its full transformation has become both inevitable and difficult, and meet intra-society or international reservations, or revulsion and why the present process of transformation seems to eliminate not all the major negative characteristics of state socialism or not only its negative features but also some of its positive achievements.

The present process of transformation in these countries cannot simply be described as a return or "transition from socialism to capitalism."[4] It is not only the identification of socialism with the former state of these societies which can be doubted but also the identification of any social system as defined in theory, with a concrete society existing in reality. Neither capitalism nor socialism in their idealized, theoretically defined form can appear in any living society of the contemporary world. Each society necessarily bears the marks of its own past and its countervailing forces responding to the inherent logic and rules of a given "system", and each develops under the effects of other societies in an increasingly interdependent world.

Neither the rise nor the crisis and transformation of state socialism in Central and Eastern Europe can be properly understood unless both the internal factors – historical background, traditions, cultures, social structures and attitudes, and political forces – and the external effects, challenges and pressures of the outside world are taken into due account.

2. *Origin and Main Characteristics of State Socialism*

The very origin of the system in general, but particularly in its "homeland", Soviet Russia, clearly demonstrates its double, both internal and external determination. It was rooted in a historical coincidence of the culmination of an internal social crisis and an international conflict.

The internal social crisis was a consequence of a widely recognized and (more or less suddenly) unbearable social inequalities which in the absence of appropriate conflict management and income redistribution mechanisms, paved the way for violent revolution aiming at a forced social equalization by the "expropriation of the expropriators." On the other hand, the international conflicts and hostility were caused by underdevelopment and the (more or less suddenly) recognized imperative need of national emancipation, modernization and catching up with the advanced nations. Besides international reactions to the revolution, in the absence of an appropriate

[4] M. Gaudier, "Economic Reform, Social Change and Institutional Perspectives in Central and Eastern Europe. An Analysis of the Literature." *Serie Bibliographic*, Institute international d'etudes sociales, Geneva, 1992, No. 16, p. 27.

international conflict management and resource redistribution mechanisms, it led to confrontation with the outside world and to aggressive endeavors to gain external resources.

This explains why this system has manifested not only (and perhaps not even primarily) a "social project," a certain domestic order of society but also a (sort of national) "project of modernization," inducing an increasing incorporation of the socialist rhetoric with a (Soviet) "imperial-nationalist" demagogy. It also explains why the transformation of this system, after its failure both as a social(ist) project and as a project of (national) modernization, shows also a dual character. The transforming countries are facing a double task, namely to find solution both for the internal and the external problems. They are going to create a new internal order (changing the social system), and, in some cases, also to accomplish unfinished nation-building. Internationally they seek to adjust the world system by modernization, relinking, structural adjustment and catching-up.

However, apart from other diverging conditions, it is for this very duality why substantial differences appear among various individual countries in respect of the relationship between national aspirations and the rise, development and collapse of state socialism as well as the direction of its transformation. Though the participation of domestic forces in the establishment and operation of the system cannot be doubted in any country, the case of the countries which were heavily subject to Soviet influence and were more or less forced by the Soviet Union to adopt or maintain such a system, obviously differs from the case of those where the system came into existence without external intervention, or in fact as a very product of national resistance and liberation wars making thus use of nationalism as legitimization.

The rise of state socialism was originally linked both with an intra-society conflict in the given countries and with an international conflict emerging from their dependent periphery or semi-periphery position in the world economy. The regime reflected both a class endeavor of social emancipation and a national endeavor of national emancipation.[5] The canalization into a socially and ideologically different, but also militarized étatist system, of similar two-sided conflicts and dual efforts, explains also the rise of Fascism in those countries of the past with acute social crisis and an upsurge of nationalism. The substantial difference, between, on the one hand, an openly aggressive racist military system, such as Nazism-Fascism, having caused a world war and a Holocaust, and, on the other, the system which declared, and at least pretended to support, the equality of peoples, cannot be overlooked, even if some of the methods applied by them were very similar. It is this very difference and also the hopes about the later realization of the declared aims of socialism in a more peaceful time which explain why the "existing socialism" was able, even in its par excellence version, and much more in its reformed variants, to invoke, unlike Nazism-Fascism, at least temporarily, certain sympathy of so many intellectuals, humanists and democrats as well, until its real face ex post facto was openly revealed.

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[5] See: T. Szentes, "Real Emancipation and Peaceful Cooperation Aiming at a New Democratic World Order." In: M. Thee (ed.), *Preparation of Societies for Life in Peace*. Norwegian University Press, Oslo, 1987, pp. 279-291.

The actual formation of the "Stalinist" system was shaped by several historical factors and conditions. Above all by historical underdevelopment[6] and the preservation of a dual, pre-industrial and semi-industrialized economy, with the survival of pre-capitalist institutions, traditions and social habits which generated an imperative need for modernization and the idea of "catching-up" with the advanced countries.

The original or derivative hostility of the international environment played a similarly important role. It resulted de-stabilizing efforts, military threats and cold war attitudes, arms race and trade discrimination, all of which induced or reinforced and seemingly legitimized both internal militarization and international bloc policy by real or perceived dangers.

The false concept of "socialism in one country" (or in a few backward countries), breaking away from the world capitalist system and building up a new society and a new ("second") world system, independently of and in confrontation with capitalism had its impact as well.

It also pays to note the subjective qualities, traditional messianic (combined with a cynical) conceit, errors and crimes of the political leadership alienated by means of concentrated power and privileges from the masses of society and pursuing an adventurer policy.

In the countries of Central and Eastern Europe the introduction of the Soviet-type "socialism" after World War II – besides the participation of communists in the anti-Nazi resistance movement, and their active role in postwar reconstruction which temporarily increased their relative popularity – was undoubtedly linked with specific conditions.

First of all, the division of Europe into two spheres of influence, followed by the Cold War. Furthermore, a concomitant "over-radicalization"[7] and polarization in the political life, smashing the former partnership and coalitions, and pushing the democratic parties out of the government and parliament (either by a "salami tactic" or a coup-d'etat). It was "helped" by a more or less direct Soviet intervention, political and economic pressure or its indirect influence to force or strongly encourage the adoption and copying of the Soviet model.

The above specificities in historical conditions and particularly in respect of the relationship between nationalism and the state socialist system may help to understand certain features and differences in the present transformation process, too. The legacy of this system follows of course also from its established mechanism and effects of its operation, and not only from its birth conditions.

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[6] See: A. Gerschenkron, *Economic Backwardness in Historical Perspectives*, Cambridge, 1962; I.T. Berend-Gy. Ranki, *The European Periphery and Industrialization 1780–1914*, Cambridge University Press, 1982; T. Szentes, *The Political Economy of Underdevelopment*, Fifth edition, Akademia, Budapest, 1988.

[7] "Over-radicalization" with the tendency of political polarization was a rather common phenomenon in those countries where some domestic political forces could rely (or just assumed the opportunity of relying) on the support and protection of a foreign power, due to which they were highly inclined to neglect the real intra-society power relations and to substitute the alliance with external forces for the search of constructive compromises with the domestic ones.

The most general and substantial *sui generis* characteristic of the system in its *par excellence* or "classic" form[8] can be summarized as follows:

(a) delinking or isolation from and confrontation with the outside world, inducing a complex militarization of the society and economy as well as the political system, its institutions and also the ruling party itself;

(b) etatism, based economically upon the dominance of state ownership and institutionally on the excessive role, coupled with paternalism, of an increasingly alienated and concentrated (party-)state power which oppresses the existing weak elements of "civil society", the individual initiatives, entrepreneurship and creativity, and intervenes in all spheres of human life;

(c) a monolithic, hierarchically structured state-party system as a base of étatism, with an anti-democratic, monopolistic exercise by the ruling party of power, decision-making, control and selection, owing to the fusion at top level, of the state and the ruling party and the subordination of the state administration at all levels to the local leadership of the party, depriving the public service of its competence, while condemning all the other parties (if they survive at all as a mere formality) and all social organizations and trade unions to the role of "transmission belt" only;

(d) a quasi-military organization and centralized management system of the economy, similar to that of a war-economy. It reduced the role (if any) of the market, with overall and detailed planning, centralized decision making, co-ordination and control, vertical relations between the actors, shortages, resource waste, "soft budget constraints"[9] and an adventurer economic policy, neglecting the objective conditions and applying forced methods of "primitive accumulation", accelerated growth, industrialization and collectivization;

(e) an ideological and cultural monopoly with a centralized and hierarchic pattern of control over cultural life and social sciences, imposing upon the latter an ideological function of legitimizing the political power and its practice in accordance with the canonized official (pseudo-)Marxist dogmas regularly adjusted to the pragmatic interests of the leadership.

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[8] In view of undoubtedly considerable differences between the early period of revolutionary changes aiming at a rapid socialist transformation (at least in those countries where the system had its primary origin in an internally induced revolution) and the stage of existence of the system in its consolidated, institutionalized form as developed under Stalin's rule in the USSR (or under the rule of other dictators) a distinction has to be made, indeed. It is also obvious that the subsequent period with various, partially successful or abortive reforms of the system, which preceeded and prepared its transformation, should also be distinguished.

Whether the historically decisive, consolidated and institutionalized form of the system has organically followed from the anticapitalist revolution and the early stage of socialist transformation, or just the contrary, was a "counter-revolutionary" deviation, views are just as widely different as in respect of the assessment of the subsequent "reform-communism". Without dwelling on such debates I simply apply such distinctions and when outlining the major characteristics of the system I refer, of course, to its institutionalized Stalinist version, its "par excellence" (in Kornai's term: "classical") form.

Kornai, in his *The Socialist System: The Political Economy of Communism.* Princeton University Press, 1992, distinguishes the "revolutionary transition toward the classical system", the longer period of the "classical socialism" and the "reform system" (or "reform socialism"), while calling the emerging new system "post-socialist", a "transition from socialism to capitalism".(pp. 19–20.)

[9] See: J. Kornai, *Economics of Shortage*, North-Holland, Amsterdam, 1980, and *Op.cit.* 1992.

The inherent logic of the regime is the logic of militarization which follows from isolation and confrontation with the outside world, and directly manifests itself in a military interpretation of the assumed internal "class struggle" as well as the international struggle for a "world socialist transformation". This logic, which was a more or less natural and historically sensible concomitant of the early period of revolutionary changes and "war communism" in Soviet Russia, has not only remained and spread but also became a lasting and comprehensive determinant of the consolidated system of "par excellence" Stalinism everywhere, explaining its all other features. Militarization explains – the already mentioned excessive role of the state – so typical in war periods – and its massive direct intervention in the economy, leaving hardly any role to market spontaneity, except in "black market." It was closely connected to the system of centralized management and planning with detailed instructions, targets or norms in kind and a quantitative approach. Centralization of accumulation of the available surplus, resource allocation and redistribution, coupled with "investment hunger", "expansion drive" and "soft budget constraints" – like in the army or during a war – all well-known characteristics of a war-economy. A combination of regular supply shortages, excess demands and large scale squandering, wastage and uneconomic investments, weak price and cost sensitivity – like in the military sector of any economy – the neglect of the ecological conditions and the large-scale practice of environment pollution, like in wars or military exercises, are also typical for a militarized system. The co-existence of labor shortage and full employment on the macro-level with a latent unemployment "within the gates" on the micro-level is a rather known phenomenon in the army. Autarkic economic policy driving for self-sufficiency, accelerated growth and giving priority to heavy industries, are so characteristic in both state socialism and in war economies. Militarization also explains the general provision of the most basic necessities of life, such as food, water, clothes, shelter, medicine to all on a low level (like within the army), and the combination of a more or less egalitarian system of wage and income distribution among the masses, with excessive privileges and fringe benefits for the "nomenclatura", the elite of "officers." The oppression of individual initiatives, creativity, spontaneous activity and the restriction of publicity and information, the predominance of security forces and considerations, vigilance and suspicion are equally characteristic for a militarized regime and state socialism.

Such a militarization of society was a consequence of isolation from a hostile outside world. But, on the other hand, it was not possible to maintain it without hostility for long. This makes it understandable why any release of isolation, any contact (such as during World War II) with foreign societies, or a partial normalization of relations, a detente and gradual re-linking with the world economy have necessarily and increasingly undermined the basis of the system, and why its transformation is so closely inter-linked with the opening of these societies towards the outside world.

3. Consequences of State Socialism in the Light of World Development

However temporary and relatively short the period of the operation of the state socialism in its *par excellence* form had lasted in Central and Eastern Europe, its consequences have proved far-reaching and manifold. This is due, primarily, to the fact that during the first postwar decades when all the countries of the Soviet Bloc were more or less isolated from the rest of the world by the "iron curtain", decisive new processes were emerging and unfolding in the latter. Beside that, the very direction, radicalism and accelerated tempo of structural and institutional changes within these countries had a strong and long-lasting impact as well. Thus the present process of transformation necessarily involves also a belated response to, a drive for catching up with, far-advanced processes, as well as the costly correction of the previous development path.

The above-mentioned processes included the technological development, namely the first wave of a scientific and technological revolution creating new dynamic industries, shifting the development centers, reshaping the international division of labor and transforming the world economy.[10] It went, however, hand in hand with trans-nationalization, the rise and forging ahead of giant transnational corporations with new investment, capital export and technology-transfer policy, internationally redeploying industrial and service activities. As a part of this process the economic integration of Western Europe have drawn a new economic border between the countries within and the countries outside the organization of integration. The staying away or being excluded from such processes in a critical period, in their early stage, means the missing of an opportunity which never returns but under much worse conditions and at much higher costs (if at all).

It would be an ahistorical rather than irrational question to pose: how the economies of Central and Eastern Europe would look like today if, for example, they could have seized the opportunity to take part in the European integration from the very beginning, instead of begging now for admittance as late-latecomers.

What has added to the consequences of having missed as part of Europe a historical opportunity, was the direction of those radical changes in the structure of the Central and Eastern European economies and their institutions, implemented with an accelerated speed in a relatively short period, which proved to contradict the rules of the game and modified requirements of the world economy. Though such a direction of structural and institutional development did not necessarily follow from delinking itself, – economic history proves that a certain degree of a temporary delinking could be well used for modernization – the chance and facility to deviate from and the propensity of the leadership to neglect the adjustment requirements are, in general, far greater than without it.

The kind of modernization, particularly the type of industrial development which started in these countries or was imposed upon them in the form of a copied Soviet model or in accordance with the military needs of the latter, did represent, indeed, a 19th century pattern of modernization rather than a contemporary up-to-date one in "post-industrial" societies. Priority was given – obviously for military considerations – to the development of iron and steel industries and other sectors of the heavy industry. The latter were able to play the role of decisive dynamic centers and engines of

[10] See: T. Szentes, *The Transition of the World Economy. New Directions and New Interests*, UNU-ZED, London, 1988.

economic growth in the 19th century only, but hardly any more even in the first half of the 20th century when the production of electric motors, and internal combustion engines, the automobile and aircraft industries etc. took mostly over their role as pulling forces. Let alone the new era since World War II which has given birth to completely new centers of development and economic dynamism. The role of industries with R&D capacities, producing electronics and computer technology, semi-conductors, micro-chips, automatized machineries, synthetic materials, nuclear energy, the means of cybernetics, informatics and telecommunication, became decisive. They were followed by the new waves of technological revolution by the production of robot and laser techniques, computer-aided-design and programming, biotechnology and bioenergy.

The neglect in development policy and resource allocation not only of the above mentioned new engines of growth but also of the needs of development (or even the maintenance costs) of economic infrastructure, while concentrating so much on a few heavy industries, has added to the structural biases and misorientation. The high energy and raw material input and its heavily pollutant nature and its bias for quantitative rather than qualitative performance were also typical symptoms of the economy, marking an obsolete structure and modernization concept.

4. Reform of the System: Reasons, International Conditions and Limitations

The need and opportunity for reforms were, of course, linked with great many domestic and international conditions beyond the recognition of the blind alley of extensive development. A socially and politically more important domestic factor was the widely recognized contrast between the declared aims and harsh reality, between socialism in theory and "socialism" in practice. The admission by the leadership (as e.g. at the 20th Congress of the Soviet party by Khrushchev) of the mistakes and crimes made earlier or the failure in general to meet the original promises about socialist welfare, democracy etc. and the acquaintance by an increasing number of people with the reality of the Western societies and living standards – in obvious contradiction with official propaganda – did also play an important role in a rising discontent. These all have fueled large-scale disappointment and social unrest, led to sporadic strikes, demonstrations or even revolts and have thereby forced out a reform policy even if all the strikes, demonstrations and revolts were brutally defeated.

However, besides the internal factors and in the background of domestic socio-political motions we can always find certain changes in the internal conditions or the role of external effects, which induced (and also set limits to or made abortive) the reforms of the regime. The first reform attempts aiming at a shift in development priorities and some minor changes in economic management were obviously linked with Stalin's death in 1953. A new wave of reform policy as well as (this time more open) manifestations of social unrest followed the 20th Congress of the Soviet Communist Party in 1956 and was also connected with a certain relaxation of East-West confrontation. It has aimed a more radical, profound modification and democratization of the system, and has culminated in the Hungarian revolution. The defeat of the latter by Soviet military intervention, coupled with sharpening East-West conflict and the Suez crisis, has marked again and temporarily the failure of reformism. In the 1960s it was primarily the beginning of detente and its temporary success, which facilitated the reform forces as well as the internal opposition to initiate again or force out a new reform wave. The latter has reached its peak in the "Prague Spring" of 1968. The Warsaw Pact military intervention has smashed the latter, stopped, reversed or retarded both the process of detente and that of reforms in most countries of the Soviet Bloc for a while. Nevertheless certain results of these processes proved irreversible, thereby preventing a full return to the Stalinist variant of the system at least in some of these countries.

The survival of the 1968 Hungarian economic reform coupled with a certain liberalization and an extension of certain human rights was a clear indication of the beginning of a new era, that of "reform socialism" resulting in a post-Stalinist version of the regime. It has kept up not only the hopes of other countries about the possibility to follow this pioneering attempt but has undoubtedly generated also new hopes (or illusions rather) about the reformability of the system in general under the circumstances of the predominance of the Soviet power in the region.

However, as long as the Cold War conditions of a "bipolar world" with the myth of two world systems have survived, and the internal power structures and institutional mechanisms, legitimized by misleading ideological dogmas, have remained largely intact, the transformation has never had the chance to wholly unfold and become fully irreversible. At best, some partial reforms could take place. From time to time there has also been a cautious, gradual and discrete extension of some civil rights, a quasi-democratization through paternalistic concessions, rather than democratization through institutional changes. All radical attempts which have questioned or undermined the fundamental structure and ideology of state socialism, whether they were linked or not with manifest conflicts and revolts – such as in 1956 in Hungary, in 1968 in Czechoslovakia and in 1956, 1970, 1976 and 1981 in Poland – have been suppressed until 1989.

The results of the reform process, however limited, inconsistent or even ambiguous they were, should not be underestimated, particularly in the light of the narrow scope of manoeuvering opportunities within the Soviet military bloc and geopolitical limitations, pressure and the dangers of intervention. By replacing several characteristic features of state socialism by new ones they have not only increased its internal inconsistencies, disequilibria and disfunction, thereby also making a full transformation necessary, but have also paved the way for the latter in a positive way.

Thus the legacy of the state socialism includes not only negative but great many positive assets, too. As the new, post-communist regimes cannot start with a *tabula rasa*, the real question is not simply about their ability and willingness to eliminate all the negative features and consequences of the previous regime but also on how to use those positive assets left behind by its reforms in and after the final transformation.

"Reform-socialism" has failed in Central and Eastern Europe (and is likely to fail also in other countries, too), which seems to suggest an *ex post facto* conclusion that state socialism was *ab ovo* non-reformable "on its own base". Today it is quite fashionable in the related analyses to reduce the role of earlier reforms merely to their negative effects which, by building incompatible elements into the operation of the system, practically undermined its assumed "consistency", and to derive the increasingly recognized need of full transformation from those very inconsistencies and disturbances caused precisely by the half-way reforms. There is, undoubtedly, a certain truth in such an assessment, but it seems to reflect a kind of "purist" approach.

No doubt, the crisis of the regime has been prolonged rather than solved by the reforms, while additional factors have contributed to its further deepening, such as the (delayed) impact of the world economic crisis. The latter, paradoxically, affected more intensively those countries having made progress in the process of re-linking with the world economy and in domestic reforms, than those lagging behind. On the other hand, even those partial reforms and minor steps toward democratization which were carried out in some of these countries by the late 1960s on, have proved to be important catalysts to further reforms, as highlighting a contrast vis-a-vis other countries in terms of relatively better supply conditions, greater individual freedom, more liberal foreign relations and correspondingly an improved international reputation.

A historical turning point in the reform process and for the transformation was reached only when fundamental changes began in the major power and very center of the Soviet Bloc, i.e. the Soviet Union. Gorbachev's *perestroika*, *glasnost* and "new thinking" has simultaneously undermined such basic pillars of the system as its anti-democratic institutions of power, the (internal and external) closeness of society and the concept of a bipolar world with the related security and military concepts. The mass exodus of refugees from the former GDR has accelerated the political changes in all of these countries. 1989-90 has marked practically the end of state socialism in Europe and opened the opportunity for a full transformation in all the countries of Central and Eastern Europe. It occurred, however, under the conditions of a lasting economic recession, rising political uncertainties and unrest, moreover, in some countries under the circumstances of civil war and/or sharpening regional inter-state conflicts.

5. General Criteria of Transformation and its Major Constraints and Dilemmas

The final direction and result of the transformation are rather uncertain. At best its main criteria can be summarized as in contrast with the fundamental conditions and features of state socialism. The emerging new system is characterized by an increasing openness of the society both internally (in terms of communication, information, labor and capital mobility, etc.) and externally, towards the outside world. The elimination of the "iron curtain," both physical and spiritual, the re-linking with the world economy and society, and demilitarization of the social order and atmosphere. There are positive signs of the appearance (or re-appearance) of the civil society with the autonomous activities of communities, self-organized groups, associations, and a decentralization and public control of the state administration. The disintegration of the monolithic state-party system and monopolistic power structure is accompanied by the rise of political pluralism in the form of a genuine multi-party parliamentary system. A return to or reconstruction of the market economy and a relative autonomy of the economic "sub-system", decentralization of economic management and substantial changes in property right and ownership are in the nucleus of transformation. All of these mean a consistent de-ideologization, i.e. releasing from ideological constraints, of the non-political spheres of public life, and an institutionalized acceptance in society of ideological and cultural pluralism, including religious tolerance.

Even apart from the subjective resistance of those political or social forces still having vested interest in the *status quo*, there are great many constraints and limitations which may set obstacles to a full realization of the above criteria in the individual (if not all) countries. Among others, the unfavorable world market conditions and heavy indebtedness make the full opening of the society and the economic reintegration in the world economy not only difficult, but also expensive and subject to the creditors' conditionalities. The opportunity therefore is missing to improve or even to keep the living conditions, real income and social security on the given level, for the majority of the population. The surfacing of all the nationality, ethnic and religious conflicts, which had been suppressed by the previous regime, makes the (re-)appearance of the civil society a socially painful and risky process with destabilizing effects.

The need of various austerity measures and temporary direct interventions following partly from the unfavorable external economic conditions and the intra-society conflicts, and partly from the historical imperative of modernization, may counteract the progress in economic decentralization and social deregulation, the unfolding autonomy of the economic sub-system and the spontaneous development of the civil society. The lack or weakness of democratic traditions and political culture heavily burdens the development of political pluralism. There are also marked incongruence between the suddenly emerging pattern of multi-party system and the changing actual social structure, causing identity troubles in party politics.

The above-mentioned obstacles are complemented also by those anomalies appearing or remaining in the operation of the market and affecting also the process of privatization, which stem from the conditions of the earlier or still prevailing "shortage economy" with a more or less monopolistic position and behavior of producers (at least of many industrial, commercial and service enterprises) versus consumers, and from various other market imperfections. The consequences manifest themselves in the wide, moreover (due to new foreign business opportunities) widening scope of black market transactions, commodity and currency smuggling, in the survival of many informal channels of economic decision making and some lobbies of the "industrial- bureaucratic complex," in the corrupt practice of passing public assets into private and foreign hands at irrationally low prices, or in other forms of bribery.

There is a lack of tolerance vis-a-vis other views, theories, ideologies, religions and cultures, which characterized state socialism, and may appear now, either as a reaction to the former or as a genuine historical legacy. Consequently, anti-communist often apply Stalinist methods in order to gain dominance and control.

While the enlisted criteria of transformation indicate only the crucial fields and most substantial elements of the required changes without determining their final outcome, the subsequent list of various obstacles is illustrative only and far from being complete.

Instead of venturing an attempt to outline the future scenarios, to predict the development path which results from transformation, we can only recognize the fact of great many uncertainties and the possibility of a variety of scenarios. Even those believing in the over-simplified formula of a "transition from socialism to capitalism" or "from a centrally planned to a market economy", have to ask: which of the so many variants of "capitalism" as manifested in different historical periods and in different parts of the world, or which type of "market economy" can be achieved by the process of transformation? And even if forgetting about the vision (and the hopes of so many who opposed state socialism without idealizing the socio-economic systems of the West) to develop a more just and human society than any of the existing ones, society which is dominated neither by the state nor by the market the question realistically remains: how can these societies of Central and Eastern Europe be transformed to become similar, in terms of economic development and social welfare, at least, to one of the less developed parts of the West? In other words, will the present process of transformation lead these countries, under the given conditions, to the developed part of the world economy or make them only a re-linked dependent periphery or semi-periphery of the latter from a formerly isolated, de-linked one?

Tadeusz Kowalik

The "Big Bang" as a Political and Historical Phenomenon

– A Case Study on Poland –

Isn't it amazing that the hierarchy of nations within the old European civilization has changed so little in the space of millenium? The nations that formed the European Community are the same ones that emerged in the early Middle Ages as the most advanced areas of Western Christianity. Empires have risen and fallen, states have appeared and disappeared borders have been redrawn or erased, everything has changed a hundred times on this small continent, but this arrangement has persisted with only minor changes.

– from Jerzy Jedlicki, a historian

Introduction

The present paper is one-sided in its very concept. Its subject is not only the program of the great leap into market economy, i.e. the Balcerowicz Plan, but the circumstances favoring its emergence and implementation. Both political circumstances and psychological motives standing behind such a choice come into play here. An enormous amount of literature is concerned with this experience. The successes and failures as well as the basic points of the program are well known already. I hope that limiting myself to the formulation of the following assumptions only, defining how I look upon the problems of transformation in the post-Communist world will suffice to explain my way of thinking.

The acceptance of the idea of "Big Bang", conceived not only as a combination of anti-inflationary and stabilizing means but also - and in the first period primarily – as a spring into market, "into an economy regulated by free market – hadn't been at all due to any rigid, 'iron' economic laws or to any historical necessity" offering no alternative. It was a political choice *par excellence*. Political circumstances and ideological convictions – tightly in – had been decisive in this respec[1]. It was due to them that the prescriptions and advice of the International Monetary Fund and World Bank had been so easily accepted. And this was joined with a projection of a swift change of system (regime). I do not maintain that recommendations should have been rejected outright but that they should have become subject to hard, tiring negotiations whose aim would be to determine specific conditions in post-Communist countries (conditions differing from, for example, those in South American countries).

The same may be said about privatization whose shape (form) had been defined by political choice. It has been accepted and finally proved that the market economy, regulated by the mechanism of competition, is more efficient – at least in Europe – than the command economy. The assumption that a market economy dominated by

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[1] Modzelewski, K., *Dokad od komunizmu?* (Whereto from Communism) Warsaw, 1993.

the private sector is more efficient than the market economy with a dominating state sector is much weaker in its empirical foundations, but this too is highly probable. The statement, however, that the private market economy, rapidly introduced by the state, and in the present real conditions of Central and Eastern Europe, is more efficient isn't proven, as yet; though it is often accepted as something self-evident. In this case it is, of course, the question of greater efficiency in the relatively near future. If the social and economic activities of a government are based on this assumption, such policy must bear all the possible features of a great experiment. Joseph Berliner points to this very aptly, though in a somewhat metaphorical form: "The fact that it would be better to have had private enterprises rather than state enterprises in the first place is not an argument for rapid privatization or for slow privatization or even for any privatization at all. It all depends on what funny things might happen on the way to the Forum." [2]

The countries of Central and Eastern Europe are in a state and process of systemic transformation which – as is now clearly seen – will last a whole epoch. The final result of this transformation isn't clearly defined and given in advance, and it was pretty generally assumed in the years 1989–1990. In the first half of the 20th century, new, previously unknown socio-economic systems have come into being, such as the social market economy in the Federal Republic of Germany, the partnership system in Austria, and various kinds of negotiated economy in Scandinavian countries, with the Swedish model as the most distinctive. The Japanese system, followed by the "Asiatic tigers" system, has come into being in the second half of our century. What shape the systems of East European Economies will take and how much will they differ from the systems known up to now is a matter of conjecture. It is quite possible that, even after several decades have passed, it will be difficult – even more difficult than in the case of the Swedish model – to describe these economies, or at least some of them, simply as capitalist ones. Thus, speaking about transition from one system to another in such a way as if we precisely knew in which direction we were going is devoid of sense. We know that we depart from the Communist system. We do not know, however, in which direction we go except for the most general tendencies, such as: more market, less state and state ownership. It is possible, however, to maintain with all certainty that the final result will largely depend on tradition and on the future configuration of social forces, what has been labelled "path dependency" [3].

The Polish case may be regarded as particularly interesting not only because Poland was the first country which embarked on the road to radical systemic changes towards a private market economy. There are at least three other reasons which make this case interesting. First, it experienced one of the largest spontaneously emerging social movements in history – "Solidarity." Its sudden emergence and impact on systemic change in Poland, as well as its quick loss of influence, is an unique phenomenon which attracted the attention of many researchers. Secondly, Poland had implemented the most far-reaching "shock therapy," called "Big Bang", which, for a

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[2] Berliner, J., "The Gains from Privatization." In: US Congress, Joint Economic Committee, *The Economies of the Former Soviet Union*, Washington D.C. 1993.

[3] Stark, D., "Path Dependency and Privatization Strategies in East-Central Europe." *East European Politics and Society*, no 6(1), 1992.

while, became the model for the other reforming post-Communist countries. And lastly, a spectacular victory of the Left in the last parliamentary election (September 1993) and perhaps even a more spectacular defeat of the parties of the (ruling) Right, which were practically wiped out from the parliament.

This event may be another pioneering act initiating a new phase of development in Central and Eastern Europe. This victory puts a big question mark concerning most probably not only the pace of Central European systemic transformation, but its direction as well. For this reason, historians may see autumn 1993 as a *caesura,* and the four years 1989-1993 as a closed period. Let's try, then, to have a general look at these four years of the Polish experience.

1. Political Background and the "Big Bang" Option

The monocentric social order was always rickety in Poland, coping as it was with daunting obstacles. Three factors in particular must be named in this connection. The first fact to mention is that state ownership of property, subsuming co-operatives, which were practically state-controlled, never really got the upper hand in agriculture, a vital sector of the Polish economy which gives a living to more than one out of every four Poles to this day. Thus, if a kind of market mechanism continued to function anywhere, it was in agriculture, despite repeated government efforts to clamp down on it.

Secondly, the Roman Catholic Church managed to preserve, indeed even to strengthen, its already great influence, not only spiritual but also political. The Communist rulers could not possibly ignore the Church, the next best organized institution in Poland apart from the Communist party itself. The Church looked back on a long tradition in Poland. For well over a century before the First World War, when Poland had disappeared from the maps as an independent state, the Church came to be seen as the bulwark of the Polish society's identity, the guardian of the nation's tradition. In the new situation, after the Second World War, as continued efforts were being made to impose a Soviet-style uniformity on Poland, the Church became even closer to the people than before.

The most specific feature of the Polish version of socialism, however, was the extraordinarily active posture of the industrial working class. In that respect, Poland was far ahead of all other Soviet bloc countries. Paradoxically, Poland witnessed one of the main Communist tenets coming true in a twisted way: the officially declared leading role of the working class became a fact in Poland, but not in the way the Communist party had wanted. The working class militancy was directed against the Communist party's "leading role" in the state and society.

Worker rebellions in Poland in 1956, 1970, 1976 and finally in 1980, which got broad coverage across the world, had few counterparts elsewhere in the Communist countries. In a way, they fit in a Polish tradition of insurgency against foreign powers when the struggle for national independence was bound up with a struggle for social and economic rights. The rebellions were only one of many signs of the power of the Polish working class. Inside factories, the shop floor was a force to be reckoned with, which government and Party officials could not possibly dismiss. Poland was the only communist country where pressure for workers' participation continued throughout the post-war years, even though it rarely resulted in the establishment of worker's councils having any serious power. In the 1980's the workers self-management movement was (in the years of and after martial law) the outlawed Solidarity union's legal arm, taking over many union functions. Eventually, it established a national association of its activists, a research institute, and even its own journal. I use the word "movement" to stress Poland's uniqueness in that respect, too, for self management bodies were not designed or imposed by the authorities but grew (in 1956 as well as in 1981) as a spontaneous movement opposing the central authorities. That was completely different from the Yugoslav workers self management system, which was essentially state-imposed and was, from the beginning, steered (if not manipulated) by the Communist Party.

In a broader sense, however, the greatest participatory challenge ever launched in Poland was the Solidarity movement of 1980–1981, which succeeded the Summer 1980 Agreements. The most important of them was the Gdansk Accord between the strikers and the government, instituting Trade Union pluralism. Being independent from both the party and the state apparatus, the Trade Unions did not only get the right to strike, but they were assured to have a "genuine opportunity to express their opinion in public" on the major economic decisions, such as the allocation of social funds, basic principles of calculating and determining wages, long term economic planning, the directions of investment, and even price changes. Needless to say, this "genuine expression of opinion" could have been signified by the power of a strike.

All this was the first fundamental change in the communist system, though the strikers' demands did not go beyond that system. Moreover, the strikers' assurances that they would not contest the leading role of the Communist Party, as well as of the principle of social ownership, could be seen as the legitimization of the Communist system by social contract.

In a short time, Solidarity became not only an alternative society, but, as one sociologist put it, the "real" state, whereas the Communists remained only the "nominal" one. The program ratified by the first congress of Solidarity (October 1981), called "A Self-Governing Republic," has outlined a blueprint (utopia) of participatory social system. It was a program of radical transformation of a socio-economic system, though it did not challenge either the state property or - at least explicitly – the domination of the Communist Party.

During martial law and after it, both government and illegal Solidarity thinking developed towards more marketization, but it was still kept within the same systemic framework. The model which emerged from those agreements could be described as a labour-managed mixed economy. Employee self-management bodies, suspended during martial law and subsequently restored, but curbed in various ways, were to be strengthened. Stressing equal opportunities for all firms regardless of their ownership status as a matter of principle, plans were announced for legislation introducing employee companies and for favouring autonomous co-operatives set free from their previous dependence on the state. Rationing of goods and administrative fixing of prices, exchange rates and interest were all to be lifted or deregulated. Even a stock exchange was to go into service in two years' time. Thus, the Round Table agreement outlined further changes towards a mixed economy which would still, however, be dominated by the public sector. One would describe these guidelines of reform as the transformation of a command economy into a some kind of market socialism.

The first radical step in this direction was the liberalization of almost all food prices, implemented in august 1989 by the last Communist government. The next step was to be the transformation of all state enterprises into Treasury owned joint stock companies. All these steps were discussed by the Polish authorities with International Monetary Fund and World Bank. Many signs could indicate that these two institutions were ready to accept an official economic program, provided that it would find sufficient support in the population. One could also assume that society itself was not against the program itself, which was not radically different from that of the opposition, but that it did not believe the decaying bureaucracy would be able to reform itself.

That was more or less the situation when Solidarity overwhelmingly won the election in June 1989 and after a while was rocketed to political power. "We won but this victory is to our misfortune" – this was Lech Walesa's first comment of the results of the election. He was probably convinced that the opposition was utterly unprepared to take power and that it would run the economy in to disarray, and he suspected that Poland would find itself surrounded by hostile countries of the Soviet bloc, above all by the USSR.

Tadeusz Mazowiecki's government tacitly rejected the Electoral Platform of Citizens' Committee "Solidarity," which was clearly for a continuation of Round Table contract, and launched a completely different economic program. Already in his first expose he declared that he would put into practice not only anti-inflationary stabilization steps, but also a blueprint of a fast-paced creation of a Western-style, private market economy. The projected breakthrough program, which became known as the Balcerowicz Plan, included very dramatic changes, indeed, such as transforming the ownership pattern to restyle it after that of advanced countries, the establishment of a market mechanism of resource allocation, opening up the economy to the world and setting up a real capital market and labour market. And, all these targets of a real "Big Bang" were to be put through "in 1990 and 1991!"

Why did the Solidarity leaders so rapidly give up the program of a self-governing Republic to trade it for a full-fledged private market economy? Why was all this to be implemented so hastily?

Haste was to be, in this case, a socio-economic factor of great and far-reaching consequences. As we see now, the hasty way of introducing the program was much more important than a blueprint of a full-fledged private market economy, from which Poland is still – at least if we think about it in terms of Western style market economy – very far. Just hastiness made the shortest way not only to full shops and convertible money, but also to mass unemployment along with idle production capacity, glaring inequalities and marginalization of a great part of society living blow the poverty line (in 1990 – 20%, 1991 – 25% and 1993 – 39%). Part of this pathology was, of course, hard to avoid, but it would be difficult to deny that the depth of crisis was the result of shock therapy as usually recommended by the IMF, and in this case perhaps first of all, from an attempt to jump into the market private economy in the shortest time.

This purely constructivist approach to the great systemic transformation, as well as the subsequent, current policy of authorities promoted by Solidarity sharply contradicted the set of values for which Solidarity fought. This poses a lot of questions demanding explanation: what was the rationale of the new non-communist authorities? Why was the Solidarity movement giving the authorities free hand for such a radical turn to the Right? It spread, moreover, a protective umbrella over the government's reforms.

I have tried to answer these and related questions elsewhere[4]. Here, it is enough to mention that the Solidarity trade union has been transformed in the years of martial law and after it into an illegal, hence highly centralized, political (anti-communist) organization. Having emerged once again as a legal organization, it was, for quite a long time, absorbed in efforts of reorganization and searching for programmatical self-identity in a radically changed situation. All this happened in a situation when many activists and advisors have left the trade union for government and state administration. That is why Solidarity – as a trade union – was almost absent, in 1989 and at the beginning of 1990, on the political and social scene. In a similar stage of confusion, if not disarray, was another trade union (OPZZ), labelled as post-communist. Thus, in this condition, the government had got free hand in launching its program.

What were the main motives and the inner and external determinants of the new authorities' socio-economic policy?

First, an easily acquired success usually creates strong temptation for another even greater and more spectacular success. The easy "toppling" of Communist power bred among the new rulers a feeling that the old economic system could be equally easily exchanged for the new one. A change of economic system was perceived by the new authorities as the most important way of legitimizing the new authorities. As research has shown, the Parliament members felt they were not so much the representatives of their constituencies' interests as the missionaries of modernization[5].

Secondly, the new cabinet was already, in the moment of its formation, publicly denounced as dependent on the trade unions and dominated by left-wing politicians, hence too weak to implement any radical economic program. Quite naturally, Mazowiecki's team wanted to show their independence of trade unions and their freedom from left-wing tendencies.

The radicalism of the new rulers was also determined by their perception of a Polish economy inherited from the communist past. Leszek Balcerowicz spoke in 1990: "We began that year with sweeping away the rubble that remained of the polish economy after decades of ideological experimenting... We had to start with... dilapidated factories, disorganized distribution, humiliating lines before shops for all goods.[6] With that kind of vision of the economy, the development of a new order was seen as a job to build somethying on the ruins of the old one. Recession was seen as a "sweeping away of the rubble." Schumpeter's concept of crisis as "creative destruc-

[4] Kowalik, T. and Bugaj R., *New Options after the Big Bang: Poland at the Crossroads.* 1993, mimeo.

[5] Bialecki I. and B. W. Mach, "Orientacje spoleczno-ekonomiczne poslow na tle pogladow spoelczenstwa." (Socio-economic Attitudes of the Members of Parliament Compared with the Attitude of Society) In: Jacek Wasilewski and Wlodimierz Wesolowski, *Poczatki parlamentarnej elity.* Warsaw 1992.

[6] Balcerowicz, L., "Juz blizej rynku niz socjalizmu." (Closer to the Market than to Socialism) *Gazeta Wyborcza*, no. 132, June 8, 1990.

tion" was to justify it theoretically. Needless to say, it was illusory to expect that in such different conditions recession would lead to restoring the economy.

Haste in launching the program and only a short time for implementing it could also be seen as the best way of avoiding any serious public debate on the transition problems, which were presented as the tasks to be solved by experts, whereas the society's participation in this process was to accept a simplified explanation of the decisions which had been taken by experts. Rush was also functional in justifying the Government's proposals as having no alternative (it reminds us of Roberto Unger's "false necessity.")[7]

The new Government could have also expected that the initial enthusiasm created by the peaceful revolution would last only for a short time. Thus, the more changes were made in this favorable climate the better. One cannot, also, exclude that, already at that point some political leaders were afraid that the great majority of Polish society, Solidarity's rank and file in particular, would quickly become hostile to the program of restoration of a capitalist economy involving mass unemployment, growing income disparities, etc. That is why Lech Walesa, then the chairman of the Solidarity trade union, hastily accepted the Balcerowicz Plan without any negotiation or even inner debate. Just at that time, he frankly said that strengthening the trade unions and striving for radical economic changes were obviously conflicting goals.[8]

2. A Spring into the West: New System, Old Problems

For all these reasons, the time factor could have been seen as the potential enemy of radical changes. The cult of the West, the irresistible desire to join the highly developed countries, was also one of the subjective determinants shaping the "economic imagination" of the new elite. Many politicians talked at that time about "the spring to Europe" the historian first quoted in this paper says about *Poland's Perpetual Return to Europe.*[9] I would say that it was rather a cyclical temptation, suffering many ups and downs, unfulfilled hopes, and bitter disillusions. The last four years create a rather short-lived cycle, starting with one of the greatest myths of rapid integration within the European house.

Here is an example of rationalizing the option of "the great leap", to Europe, expressed already from the perspective of more than one year of implementation of "shock therapy." It was written by Bronislaw Geremek, another historian, but simultaneously on of the architects of the government's policy: "I understood the difficulties that we faced because of the Balcerowicz Plan, but at the same time I knew that this was the only way that could secure for Poland the chances of getting a place in the European economic order. In other words: without renunciation and self-denials, and a very painful renunciation, too, we had no chances to overcome the distance separating us from the threshold allowing us to start the processes of integration. I was also

[7] Anderson, P., *A Zone of Engagement.* London, 1992.
[8] Lawinski, P., "Ile wytrzymacie." (How much will you Stand) *Gazeta Wyborcza*, September 29, 1989.
[9] Jedlicki, J., "Poland's Permanent Return to Europe." *Cross Currents*, no.12, 1993.

aware that we must move very quickly on this way, because Europe had frankly no intention to wait for us." [10]

There were some real factors pushing Poland into the arms of the West, mainly of the USA, as dependent country. It was simply the logic of a heavily indebted country which, in addition, was desperately seeking to regain credibility and credit worthiness, regarded as a precondition for the material and logistic assistance of the West. Not only the new political elite, but many Poles, were certain that Poland stands no real chance to scramble up from its crisis (or relative backwardness) without the substantial financial support of the West.

Even before entering the government, the leaders of the Solidarity Trade Union released a memorandum called *International Assistance Program for Poland.*[11] Asking for $ 10 billion, authors of the memorandum took it as self-evident that foreign assistance would be conditional, linked to the control of Polish economic policy by international financial organizations. They pre-emptively accepted not only the control of the adjustment program itself but also of systemic changes, such as privatization, bankruptcy regulations, etc. Solidarity linked its call for help with Poland's pioneering role in transforming the "totalitarian Communism" into a democracy, and a command economy into a private market economy. "Changes in Poland – they wrote – may serve as an example for other countries. If successful, these peaceful reforms will alter the existing situation within the socialist bloc and will furthermore have decisive impact on the future shape of East Central Europe.[12] One may suspect that the reasoning behind these words was something like: the more boldly Poles strike the way to a private market economy, the more financial help they will get.

At first the Western governments were really giving the impression that they wanted to have made Poland the model for other communist countries. The most visible manifestation of it was a stream of foreign advisors. The first minister of property transformation proudly said that in his ministry "English has been heard as frequently as Polish." [13] The same could have been said about the Ministry of Finance and other state institutions. In terms of capital inflow, however, these expectations have not been met, or have been met only in a modest degree.

Firstly, the share of grants available through Western assistance is now very scant (several times scantier than it was in the program of Marshall Plan). On the other hand, the programs of "know-how" Western assistance are formally and informally conditioned in such way that the bulk of money received by East European countries goes back in different forms to the donors. The same could be said about many Western credit lines open to these countries.

Secondly, "in 1990 there was a net outflow of financial resources from Eastern Europe, as the withdrawal of funds by commercial banks and large debt servicing by Poland and Hungary more than offset the net inflow of new funds. In 1991 there was a net inflow of $ 4.1 billion with only Poland continuing to have a net outflow." [14]

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[10] Geremek, B., *Rok 1989.* (A Year 1989) Warsaw, 1992. p. 365.
[11] Walesa, L. and Merkel, J., *International Assistance Program for Poland.* Mimeo, dated July 6, 1989.
[12] *Ibid.*
[13] Kuczynsky, J., *Zwierzenia Zausznika.* (Confessions of the Confident) Warsaw, 1992, p. 174.
[14] Trzeciakowski, W., *Transition in Poland.* Mimeo, 1993.

Thirdly, Polish experience shows that even this assistance we are getting from the international financial organizations is not only more than modest but highly uncertain. In 1991, the IMF suspended disbursement of its three years' USD 1.67 bn Extended Financing Facility because the Polish government was unable to keep the budget deficit within the limits earlier agreed upon,[15] although Poland was in a process of implementing an extremely harsh program elaborated in cooperation with, if not under pressure of, the IMF experts, and although Leszek Balcerowicz, a person extremely well received by the West, was still at that time responsible for steering economic policy. This story very well illustrates the glaring "short-termism" on which the IMF conditionality is founded.

Fourthly, purely commercial East-West relations are also far from satisfactory. The share of the former 7 Comecon countries in the trade of EC (now EU) is less than 4%, yet the export of these countries is pestered with many ill-founded, extraordinary restrictions.

What are the reasons for such cool treatment of the East by the West? A partial explanation may be found in the "domino effect" of the Polish victory and in the rapid collapse of the communist system in all Central and Eastern Europe. Many countries now cherish similar expectations of Western assistance, and compete with each other. A political factor, however, seems to play a much more important role here. Namely, the collapse of the Communist Superpower made Poland and the whole region unimportant, if not simply useless, to the West, and particularly to the United States. We shall see rather soon in what manner the West reacts to the victory of the left-wing coalition.

It would be naive to expect a very substantial inflow of capital from the West in the near future even if the present overall recession is overcome. Even if we now have a net inflow of capital, it must be rather modest and probably short-lived, for next year Poland starts to repay not only debt servicing but the debt itself as well. Therefore, the growing burden of debt repayment is still a bitter reality. The prospects for private foreign investments, which were increasing during the last two years, seem only slightly more optimistic. The investors are, however, highly reluctant to engage in production, and especially to bring in new technology. Central and Eastern Europe is regarded as a region of high risk, and that is why Western businessmen prefer to preserve flexibility.[16]

It is not surprising, then, that, after four years of "shock therapy," more and more people are beginning to realize that we have to rely on ourselves and that foreign assistance may play only a secondary role. It was not so much a therapy against "slumpflation" as against the illusions of "the helpful West."

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[15] *Ibid.* It was agreed that a deficit would not exceed 3% of GDP. In fact it reached 3.4%. A year or so later, IMF accepted a deficit of 5% of GDP (!).

[16] Indeed, even the experience of Hungary, usually enjoying a reputation as the most stable country in the region, shows that foreign capital may be vary volatile. After the victory of the Democratic Forum in 1990, which appeared hostile to free market capitalism, several Western investors withdrew their capital from this country (Campbell, J., "Reflections on the Fiscal Crisis of Post-Communist States." In: J. Hausner and G. Mosur, eds., *Transformation Processes in Eastern Europe. Western Perspectives and the Polish Experience*, Krakow, 1993, p. 142.). It is clear that withdrawing capital from trade and from the financial market is usually easier than withdrawing it from production.

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Economic Difficulties and Pitfalls of Transformation

– A Case Study on the Czech, Slovak, Polish and Hungarian Republics –

1. Introduction

The year 1989 and the early 1990s brought about the collapse of the Yalta system. The disintegration of first the Soviet Union then Yugoslavia and Czechoslovakia began. The latter also meant the partial collapse of the post-World War I Peace Treaty system. Political structures regarded as stable for more than forty and seventy years, respectively, tumbled down or softened up. The bi-polar structure of the world political arena disappeared. The collapse of the outdated dictatorship established in the Soviet Union and the satellite state system revolving on its orbit brought to victory the idea of human liberty. This enormous change, however, also upset the international balance of power, created vacuums and opened a new period of adjustment with many of the inevitable uncertainties that go with it.

For a long time, the United States could secure for itself an unquestioned leading position in the developed world, with the concomitant economic advantages, first by its economic superiority and later on by providing a military safety-net above all. With the disappearance of the bi-polar structure, the rivalry of the most developed countries has intensified. Moreover, Russia, a potential superpower, is also expected to recover and to become a significant constituent of the international system after whatever type of power structure is established there.

Political instability is further enhanced by the fact that differences in economic dynamism also point towards a tangible alteration of world economic power relations. One of the most essential driving forces of the world economy today was and is being transferred from Europe and the United States to Asia and especially the Pacific region. Its central unit is Japan, the pioneer of the region, joined by several other countries that give new impetus to the economic dynamism of the region, such as the so-called Little Tigers, and the nearby Philippines, Thailand, Indonesia and Malaysia, and also China, a potential economic great power with a most significant sphere of attraction if only for its enormous population, where contradictory but specific adaptations of the various forms of market economy seem to have been found. In view of its present fast economic growth, especially in the former Soviet sphere of interest, China can also be expected to play a more definite great-power role in the future. All this suggests that humanity faces yet another period of world redistribution.

This unstable power structure pressing on the world brings to the surface nationalistic forces and emotions and religious conflicts in Europe (and, of course, elsewhere, too). In Eastern Europe, this has escalated to destruction to the point of civil wars and mass manslaughter (in several regions of the former Soviet Union and former Yugoslavia), but neither is Western Europe exempt from the amplification of nationalistic trends and tendencies. The widening gap between the uniting European political elite on the one hand and the average people on the other that has culminated in the rejection of the integration concept in Denmark (on the occasion of the first plebiscite held on the issue), and in Switzerland, and the very narrow majority of "yes" votes in France is attributed to this fact, among others. However, there are some much more rude, often brutal, manifestations of the amplification of Western European nationalism. Open xenophobia, anti-semitism, etc., are becoming ever more frequent.

Economically, too, the last decade of the 20th century is characterized by a preponderance of difficulties and uncertainties. The period of rapid economic growth, faster than ever before in human history, has come to an end already in the 1970s. After this the world has been pulled out of its recurrent short recession periods by the American 'locomotive,' at the cost of a budgetary deficit financing without precedent in the previous peaceful era. This made it possible to radically restructure the economy and also to deploy ever new generations of defence forces and also to keep up the development of the relevant research. This road, however, is no longer open. The inflated debt accumulated by the American budget itself would be enough to limit such possibilities. Even more essentially, the arms race, deliberately escalated by both superpowers, came to an end with the disintegration of the Soviet Union. Consequently, the quality of the development of the defence potential necessarily declined in the United States and the developed market economies in general, as does the exploitation of the current military industrial potential and the related research development capacity. This state of affairs points towards a deepening of the already existing recession.

The strengthening of aggressive nationalistic and religious tendencies in politics and the extension of recession factors in the economy provokes economic protectionism in the field of economic policy. One of its manifestations is the voluntary association of countries for whom "regionalization" seems to offer a foothold and a way to protect themselves against the protectionism of other countries or regions (European Common Market, NAFTA, Mercosur in Latin America, etc.). The regional organizations in question wish to assert affirmative action to protect the member national economies from outsiders.

The reorientation of the internal economic policy of the most developed countries is also a topical issue. In the United States, severe monetary economic policy, manifesting itself at the level of philosophy rather than economic practice, seems to give way to one that extends the role of the state in the civilian sphere considerably. It is one of the main revelations of the Clintonian generation that the arrears of human infrastructure and human relations, social policy in general, as compared to the other countries plays a significant role in the loss of ground of the United States. The strongest economic power of the European Community, Germany, whose superior position was further enhanced by unification, was and is obliged to widen the scope of state participation due to the economic and social policy tasks imposed on it by the unification process itself. This, in turn, might mean that a significant proportion of the mobile resources will, in the future, be used both in Germany and in the United States not via the capital markets, but for the budgetary financing of state-initiated development projects.

This bird's-eye view on the global political and economic scenery may illuminate the international framework of the Central and Eastern European transformation. The above rough and oversimplified image of the international environment is meant to show, by way of an introduction, that the external conditions are rather unfavorable. World political and economic power relations are both unstable; the economically most developed countries are engrossed in their own political, economic and social problems, while the world economy faces a protracted period of recession or, in the best case, a very moderate economic growth.

2. Economic Overview, 1989–92

The present paper does not wish to recall the well-known scenario of the 1989–90 change of power. It seems reasonable, all the same, to point out the essential similarities and differences of the turbulent political processes of the three (by now four) countries in question.

Power was handed over peacefully in all three countries. The bargaining process between the opposition forces, some emerging in 1989, others present for some time, and the old regime brought about an agreement that served as the basis for a legal, constitutional change of power in 1990 in the form of parliamentary elections.

There were serious differences, however, as to the degree of preparation of the turnover. It had more serious political antecedents in Poland, and economic ones in Hungary. In Poland, Solidarity, enjoying the wide support of workers, acted as fermentative, whereas in Hungary the (interrupted) economic reform process initiated in 1968 managed to restore quite a number of market economy features in the functioning mechanism of the economy. In Czechoslovakia, the reform process was quelled by the 1968 military intervention. After that, its proponents were forced into internal or external emigration. By the beginning of the seventies, a severe party-state dictatorship oppressed opposition and a planned economy ignored and repressed market considerations. Of course, all that meant a serious handicap for Czechoslovakia. However, of the four countries in question, the Czech Republic (or the Czech part of former Czechoslovakia) is the one with the deepest democratic traditions and level of economic and cultural development, which surpasses the corresponding levels of the other countries discussed here.

As for the similarities, after 1989, political activity in all (that time) three countries was characterized by restructuring and a matching degree of inner instability in the political arena. A major reason for that, to be discussed in detail soon, was the unfavorable economic climate. Another essential factor, however, was the fact that the new elite and rank-and-file of the emerging parties, entering the political scene, were united by their shared tradition of opposition to party-state dictatorship and various forms of dissident activities rather than the representation of the specific interests of specific social strata. This explains why centrifugal forces within both the leading party of the Hungarian coalition and the biggest Hungarian opposition party are the cause of crisis and even disintegration from time to time. The same factor explains why the Solidarity movement in Poland gave birth to as much as fourteen parties, causing in turn the fragility and frequent lack of balance of Polish Parliament and government. In Czechoslovakia, the main factor of instability so far has been the discrepancy between the economically weaker and more vulnerable Slovakia and the economically more developed Czech part, and the conflicts of the political forces intensifying them. Finally, the country underwent a peaceful but still painful separation. Differences within the leading parties of both successor states, however, may surface here, too, and instability due to political restructuring may become more visible and stronger, especially since in the Czech Republic a center-right, whereas in Slovakia a left-wing populist party came to power and is in majority in the government.

In the sphere of economics, the trend of regional macro-economic indices since 1989 indicates that economic depression, which has prevailed for more than a decade by now, tends to intensify. The Central and Eastern European economies have been in a state of agony already in the 1980s: the momentum of economic growth was lost already at that time. After 1982, the countries in question (especially Poland and Hungary) made another attempt to invigorate their respective economies mainly by increasing their exports to and restricting their imports from the West. Vigor, however, gave way to a fast decline after two or three years, and indebtedness (in Hungary and Poland) deepened further.

By the second half of the eighties, the national economies in question were characterized to different degrees, by a certain duality: on the one hand, the state-owned "first economy," dominated by mammoth industrial plants and cooperatives of the socialist sector; and on the other, the "second" (private) economy, and "third," illegal one, which were brought to life to counter the first economy. The second economy is driven to a great extent, by the real market conditions and spreading and flourishing at a fast speed, as opposed to the "first" economy. This dynamically developing and exceptionally intricate (albeit hardly registered) economy, confined within strict limits but evading these with great agility and pursued, in most cases, as a source of secondary employment to supplement a full-time job in the state sector, was been beyond the reach of state control, as has the considerable extra income it has provided for people.

In the 1980s, the economic options of Poland and Hungary above all were further limited by the burdens of debt servicing and the concomitant significant loss of income and net capital outflow. Contemporary economic policy reacted to these by a radical alteration of the rate of accumulation and consumption. Accumulation declined rapidly in Poland and Hungary (and much more moderately in Czechoslovakia) already in 1978, to stagnate at this rather low level thereafter, whereas consumption kept growing slightly all through this period in all three countries. That is, economic policy transferred the burdens of the national consumption cutback as much as possible onto accumulation (i.e. a reduction in investment).

After this economically difficult decade, in 1989 the foreign trade markets of the Central and Eastern European countries faltered. Their main partner, the Soviet Union, was incapable of delivery and became insolvent. In June of 1990, the former German Democratic Republic collapsed, and all former economic cooperation patterns went down with it from one day to the other. The second half of 1990 saw the outbreak of the Gulf War which narrowed down the Middle Eastern markets of the region and made, at least, temporarily impossible to recover claims. No wonder that the macro-economic indices of the countries confronted with a brand new world economic and world political situation right at the time of their change of regime fell back to an extent that can only be compared with the Great Depression of 1929–33.

Economic experts making international analyses, however, warn that macro-statistical data pertaining to the Central and Eastern European countries are often rather uncertain. Caution is well-justified, given the embryonic stage of statistical accounting methods matching the new situation. Moreover, data referring to 1992 obviously contain many preliminary estimates, and the underground economy, impossible to measure statistically, is quite significant in each of the countries. Despite these doubts, however, the available macro-economic data, to be presented here, do provide an adequate orientation basis.[1]

The main conclusion to be drawn from Table 1 are the following: 1) The economies of the countries of the region have been characterized by strong recession since 1989: GDP decreased by 20% to 30%, industrial output by 30% to 40% overall. The decline of agricultural output was much less pronounced, as a matter of course: available data for 1991 suggest 5-10% decline. It should be noted, however, that in Hungary at least, market loss and the 1992 drought together with the difficulties inherent in the process of transformation and, within it, the present uncertainties of land property and land use relations may cause a serious decline of agricultural output in 1992 and even 1993. Recession, of course, is accompanied by the growth of unemployment: at present, the rate of unemployment in Hungary, Poland and Slovakia is around 12%–14% (as compared to the total number of employed). Remarkably enough, the 37% decline of industrial output in Czechoslovakia at the end of 1992 was accompanied by a 3% registered unemployment rate only.[2] Data presented here suggest that unemployment can be expected to spread rapidly and significantly in Czechoslovakia. The macro-economic patterns imply the slow spreading of unemployment and its stabilization at a rather high level in the other two countries, too.

2) Domestic consumption followed the decline of the output. The reduction in investment was larger than that warranted by the decrease of the GDP in Hungary, more or less corresponded to it in Poland and was definitely smaller in Slovakia and especially the Czech Republic, pointing to a certain degree of growth of the accumulation rate. As for private consumption, the only relevant index available is the development trend of real wages showing a decrease exceeding that of the GDP in the Czech Republic, Slovakia and Poland and corresponding to it in Hungary over the whole period. In 1992, real wages are expected to increase in Czechoslovakia and to decrease by 2% only in Poland.

3) Some macro-economic data indicate a certain moderation of regression for 1992. Remarkably enough, the registered growth of the Polish industrial output was nearly 4 percent. Inflation slowed down definitely in all three countries, although changes to

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[1] Many of the available data are unfit for comparison. The present paper relies on publications of the UN Economic Commission for Europe (Geneva) and the statistical bulletins published by the respective statistical offices of the three (four) countries in question.

[2] It seems quite probable that one of the reasons for the low rate of unemployment in the Czech Republic is that the labor demand and fast development of the service sector, a shortage sector before, could counterbalance industrial unemployment for a while.

the system of taxation at the beginning of 1993 made the prices of consumption articles soar in Czechoslovakia.

4) Export and import trends can be traced in Table 2. Let us emphasize the uncertainties of the statistical data and the lack of information corroborating their contents.

As can be seen from Table 2, after 1989, exports to the transition countries decreased by 50% to 60% in the case of Czechoslovakia and Poland, and nearly 40% in that of Hungary. It is worth noting the fact that imports decreased much less in comparison in this relation. This latter instance is due to the fact that energy and raw materials supplies originating from the successor states of the former Soviet Union (especially Russia) and settled in hard currency now still constitute an essential and major item of the imports of the countries in question (especially Czechoslovakia and Hungary, according to the data).

The overall export performance of the countries under scrutiny does not reflect the collapse of traditional exports relations. According to the data of Table 2, the total volume of exports of Czechoslovakia hardly decreased in the period in question, and the export performance of Hungary and Poland even increased by some 10 percent. Other data sources suggest a growth of the Polish and Czechoslovakian volume of exports, and a decrease of a few percentage points in the case of Hungary.[3] Unexpectedly enough, the countries in question have managed to increase their exports to the developed market economies by 50% to 60% in the course of two or three years. The "economic value" of this exports offensive is not quite clear yet given the lack of reliable data concerning the product and service structure of the exports surplus reflected in this value, and the typology of the delivering firms. Neither is there any information as to the measure and sense in which it influenced the efficiency of the economic performance of the countries in question. Data available for 1993 so far suggest, at least for Hungary, that the exports offensive is becoming short-winded: exports have declined quite significantly lately.

The above macro-economic overview requires an exposition of the causes. Why the above-described exceptionally decisive and lasting shrinking of economy? The answer to this question can be summed up in the following: The depth of the recession is explained by the collapse of Comecon and the Soviet market among other things. In the mid-1980s, Comecon-related exports and imports, respectively, of the countries in question equalled 10% to 20% of their respective GDPs. Within the system of relations designed and managed within the Comecon framework, each country developed special capacities directed at this market, whose conversion to other markets was either impossible or entailed enormous losses. The radial structure of the Comecon system increased the importance of the Soviet Union in the export/import relations far beyond its actual value. The final collapse of the Comecon markets occurred when, in 1990–1991, the Soviet Union became insolvent in hard currency and therefore insisted that the former satellite countries pay for its deliveries in hard currency, irrespective of the fact that it could not finance its own imports either. Therefore, all three countries in question had to curtail their exports to the

[3] *Glowny Urzad Statystyszny, Federalnu Statisticky urad,* Hungarian Statistical Office, Budapest, 1992. No. 4. p. 18.; *Glowny Urzad Statystyszny, Cesky Statistisky urad,* Hungarian Statistical Office, Budapest, 1993, No. 1.

Soviet Union quite drastically. As a result, their specific large, but hardly or not at all convertible capacities could only be exploited partly or not at all thereafter. Such failures, of course, had a multiplying effect and generated further "fallow" capacity and contagious unemployment.[4]

In the 1980s, the countries in question all suffered from efficiency problems, large-scale commitments and a performance lagging far behind them. Hungary and Poland tried to bridge this gap at least partly by increasing their indebtedness, whereas Czechoslovakia attempted to "service" it by a severe application of the plan directive system. Social crisis, however, thrived upon the gradual intensification of these very contradictions. After 1989, the deferred and provisionally bridged troubles all came to the surface immediately, together with the debt servicing duties. The sudden emergence of deferred problems of course causes more recession.

In the past forty-year period, the physical structure of the economies in question, together with the institutions managing the economic relations and the human motives and reactions they embodied were all made to comply with the requirements of the planned economy (and the system of plan directives within it). The change-over to a market economy was enough in itself to write off as obsolete at once a (rather considerable) part of the system established and functioning in the old regime. Transition thus necessarily requires and triggers strong process of "creative destruction," to borrow the Schumpeterian term. It goes without saying that the destructive quality of these processes manifests itself abruptly and forcefully, whereas their creative effects may only appear in small steps, slowly and gradually. Therefore, losses and economic decline are to be considered a natural concomitant of the first period of transformation.

The present paper cannot discuss in detail those fields where creative destruction should take its course. It can only point out some of its major aspects with relation to the structure of the economy. It is necessary that the mammoth production units of heavy/defence industrial complexes be destroyed, irrespective of the collapse of the Comecon relations. These huge units performed outdated mass production by outdated technology – they cannot be made profitable and therefore cannot survive in an open economy. Their viable constituents are to be reorganized and adapted to market economy conditions, but the majority is doomed to bankruptcy (and thus destruction). In all three countries, the economy was dominated, in accordance with the demands of the planned economy, by mammoth organizations.[5] Mammoth enterprises located at several sites and employing thousands or even tens of thousands of workers were characteristic units of industrial organization especially in Czechoslovakia, but also in Hungary. In the Czechoslovakian and Hungarian agricultures, state farms and cooperatives established on a compulsory basis cultivated thousands of acres and cooperative members acted as wage-earners, which made efficient agrarian production impossible to organize. (In spite of that, the dual agricultural production structure that

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[4] It is quite easy to show in any macro-economic model that the drastic shrinking of the volume of exports (in the order of magnitude of 10% to 20% of the GDP) has a recession effect that surpasses by far the measure of the loss itself.

[5] For more details, see: E. Ehrlich, "The Size Structure of Manufacturing Establishments and Enterprises: An International Comparison." *Journal of Comparative Economics*, 1985, No. 9.

has finally evolved in Hungary was a more or less rational pragmatic symbiosis between large units on the one hand and small-scale production based on secondary activities on the other.) The rapid destruction of the inverted pyramid[6] of the economic unit structure (few small- and medium-size units, many large ones) is on its way in all three countries, while the transition process carves out small- and medium-size enterprises of the viable constituents of the former great units.[7] The most important single element of "creation" is the fact that, now that the market is open, small and medium-size private enterprises and joint ventures have mushroomed everywhere in the three countries under scrutiny. Luckily, our data, hardly allowing international comparisons and often difficult to interpret, are quite unequivocal in that, by the end of 1992, the number of private incorporated economic organizations was two-and-a-half or even three times bigger than in 1990 in the countries in question.[8] Of course, the production volume, number of jobs etc. associated with this developing economic sector cannot replace what was destroyed in the large units as yet.

The fact that state legislation and the various administrative measures do not sufficiently promote, or in many respects even hinder, the outfolding of "creative forces also contributes to the deepening of the recession. Of course, there are some inevitable initial problems, lack of previous historical-international experience of transition management on this scale, etc. that also play a part, but that is not the whole story: transition threatens important vested interests. The main question behind its management is which stratum and, within it, which elite, will win and lose, respectively, from the process of transition. Therefore, the agreements of the political forces are governed by the rationale of the national economy in minor cases only. As for the rest, the global management of the transition, it is permeated by conflicts concerning power and property relations which often override rational national economic considerations.

Despite all unfavorable macro-economic processes and conditions, some major future-oriented changes promoting the establishment of a market economy also occurred in the economic mechanisms of Poland, the Czech Republic, Slovakia and Hungary. The most essential of these is the progress of liberalization. Beside privatization, to be discussed soon in what follows, the elimination of the severe state regulation and/or control of prices, wages, the quantity and orientation of exports and imports and the banning or significant reduction of the severe restrictions imposed on the management and movement of foreign currencies are the most essential steps for establishing and developing a market economy.

Liberalization, slightly different in practice in each case, figured among the first measures laying the ground for the change of the economic regime in each of the countries in question. So much so that, in Hungary and Poland, some had already been taken by the last "reform governments" of the old regime.[9]

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[6] I. Schweitzer, *Vallalatnagysag* (Enterprise Size), Budapest: Kozgazdasagi es Jogi Konyvkiado, 1982.

[7] E. Ehrlich, "Eltolodasok a feldolgozoipar uzemi es vallalati meretstrukturaban. Egy nemzetkozi osszehasonlitas." (Shift in the Size Structure of Manufacturing Establishments and Enterprises: An International Comparison) *Kulgazdasag*, 1993, No. 5.

[8] *Glowny Urzad Statistyszny*, 1992, Op.cit. pp. 20–24.

[9] In Poland, these were, to a considerable extent, responsible for the 1989–1990 fast acceleration to a three-digit inflation.

Soon after the change of regime, Poland hard-pressed by the burdens of three-digit inflation and the erosion of the monetary functions of the Zloty, implemented a nearly full-scale price and import liberalization program and made the Zloty, seriously depreciated as compared to the purchasing power parity, convertible even for the population. Only a rather soft regulation of the wage outflow of state enterprises was maintained.

In Czechoslovakia, the necessary steps of a practically all-embracing liberalization were taken on January 1, 1991. This again meant a practically full-scale liberalization of prices and imports. As for the wages, certain rather loose regulations aimed at restraining the outflow of spending capacity were maintained and the intra-country trade of the devalued Czech crown was liberated for economic organizations while some restrictions prevailed for the population.

Forceful initial liberalization measures constituted, in both countries, elements of a shock therapy: they made shortages disappear from one day to the next, generated a sudden and large-scale price increase that established the necessary conditions of the rise of market prices, and liberated export/import relations and transferred them to the authority of the economic agents. On the other hand, the same measures, pushing both the economy and society into brand new conditions, precipitated the inevitable, the sudden decline of the standards of living, the need for economic restructuring and (through these) the appearance of unemployment, in a shocking way.

In Hungary the liberalization of the economy occurred gradually. Some of the analyses attribute this fact to the commendable moderation of the new Hungarian government, while others regard it as harmful compromise. Neither view is acceptable. As mentioned earlier, already the last reform governments of the previous regime introduced important liberalizing measures and drew up an action plan for the future. It is worth mentioning the fact that, already in 1988–1989, they made the population, society, accept a two-digit rate (around 20%) of inflation, the introduction of value added tax implying a loss of real wages and of a rather progressive personal income tax, and managed to keep the monetary sphere (the emission volume) within limits all the same. That is, the new government was in no emergency or, rather, it inherited a situation including many already implemented measures. That is, the gradualism they voted for was determined by the given situation. In Hungary, prices, imports and the circulation of foreign currencies[10] were nearly totally liberated in 1991

That is, it is true for all three countries under scrutiny that their above-described and rather poor macro-economic state is not due to the survival of state-imposed constraints, but, as mentioned earlier, to certain other factors.

3. Privatization: a Key Issue of the Transition

Several sets of key economic transition issues can be identified, depending on the chosen point of view. It seems well-justified to investigate – the passive and active

[10] Some constraints remained as to the private circulation of foreign currencies.

institutional systems established to manage unemployment, their social background and the consequences thereof; the introduction of a modern system of taxes and tariff regulations and its foreign economic relevance; the establishment and efficiency of the banking system and the capital market and its institutional system; the tensions of the system of public finances generated by the discrepancy between the former "socialist" state commitments on the one hand and the demands of transition to market economy and the decline of the economic performance on the other and the means applied to drain these; the formation of the legal framework and complete institutional system of a market economy; the development of a system of regulations related to land use and landed property and the agrarian market. This list, of course, could be continued endlessly.

The authors will discuss two of the many possible key issues, the de-nationalization of property and privatization. All four countries consider the transfer of the currently predominantly state-owned economy to private owners in accordance with various scenarios a basic and, in the long run, decisive element of both economic and social transformation.

Irrespective of party affiliation, the political elite and economic experts in general share the opinion that the predominance of private property, the personal interest of the proprietor in multiplying his/her assets and the personal financial liability involved in it alone can put an end to economic squandering, and lead to economic efficiency and competitiveness and a rational modernization of the economic structure. Neither can the recession be overcome without these. In order to attain the predominance of private property, a major part of the current state assets is to be privatized. Moreover, competent circles in all four countries emphasize the fact that, apart from its narrowly interpreted and essential economic effects, the process of privatization also broadens that proprietary stratum (class) without which there is no viable democracy.

3.1 Extension of the Private Sector

The most important index of the spreading of the private sector is the growth of the number of private enterprises, which has taken a leap in recent years (in Hungary and Poland already from the second half of the eighties on). In Poland, (total population: 38 million) at end-1992, beside more than 70,000 incorporated private companies and nearly 20,000 co-operatives, there were some 1.6 million private enterprises that are not legal entities. The corresponding data for Hungary (total population: 10 million) at end-1991 were 65,000, 8,000 and 542,000 respectively. In the Czech Republic, whose population also totals 10 million, 42,000 units were registered as trading companies, 4,000 as co-operatives and more than one million as non-legal-entity private enterprises. The corresponding data for Slovakia (total population 5 million) are 15,000, 2,000 and 300,000 respectively. In Hungary and Poland, 40% of the private economic organizations are active in the trading sector, some 20% in the manufacturing industry, 10% in construction and, finally, 30% perform business and personal services. In Czechoslovakia, the proportion of units providing business and personal services is 40% while the other three branches mentioned in the above are represented equally at 20% in the activity of all private enterprises.[11]

Some of the private enterprises are exceptionally successful: they increase the number of their employees fast and their capital assets grow by leaps and bounds. There are already some that have started out as small enterprises, grew into medium-size ones and now expand abroad with the help of foreign partners (or owners). Moreover, some joint-venture or alien companies are even capable of capital exports. The participation of foreign capital in private enterprises is also on the rise.

In spite of all these, the diffusion of private enterprises in Central and Eastern Europe is still rather restrained, albeit for economic and no longer political reasons. This is mainly explained by the tightness of national investment funds, the embryonic state of the capital market, an atmosphere of general economic uncertainty, inflation tendencies, severe credit terms, lack of market experience guaranteeing successful management and effective consumer demand kept low. Private enterprise is still often carried out on a secondary basis: people tend to keep their primary jobs for greater financial and social security whenever possible.

The establishment and proliferation of the non-official (unregistered) economic sector since the 1980s in the countries under scrutiny has already been mentioned. It seemed quite logical to expect that, with the abolishment of constraints imposed on the private sector, the non-official sector would die out or at least retreat significantly. This tendency, however, asserts itself to a limited degree only: black markets evading taxation are alive and well, flourishing and spreading, thanks to new agents above all.

"Trade tourism," i.e. buying and selling, and profiting from price rate differences, and the related currency exchange proved a most profitable (and non-taxable) branch of business. With the opening of the borders, smuggling, the circumvention of tax and tariff regulations, has become more frequent and widespread and covers, with the contribution of various international mafia active in the European, Arab and Asian market economies, not only articles produced in the Central and Eastern European countries, but also the most various items, including drugs and weapons, originating from the developed and developing countries. The tapping of commodities originating from the state sector and the organized theft, robbery and looting of individual property (valuable items kept in apartments, cars, etc.) to resell them is also on the rise.

In the spheres of production, in the construction, agricultural and personal services sectors above all, registered organizations often leave a major part of their activities out of their account books. Moreover, unregistered private organizations proliferate and quite often foreigners seeking casual work are employed illegally.

The proliferation of these phenomena causes uncertainty, lack of organization and legal chaos in the economy. Moreover, lack of registration makes it impossible to tax a major part of the most dynamic sector of the economy, which intensifies the already acute problems of public financing. Although serious efforts are taken to restrain the underground economy and hinder its spreading, no significant results have been obtained in this respect so far.

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[11] *Glowny Urzad Statistyszny*, 1992, Op.cit.; and *Magyar Statisztikai Zsebkonyv* (Hungarian Statistical Pocket Book), 1992. pp. 100–101.

3.2 Methods and Problems of Privatization

The difficulties and problems inherent in the reduction in the amount of state-owned property are especially pronounced under the conditions prevailing in the Central and Eastern European countries. The main factors are as follows: as opposed to certain market economies such as Great Britain or Austria, for example, property relations are to be altered not in a relatively small section of the economy, but in the dominant sector and, consequently, the principle of "first improve then sell" applies in a very limited way only; moreover, the economies of the region are overpowered by deep and lasting recession, a far-from-attractive feature in the eyes of capital investors; and, finally, the quantity of domestic capital seeking investment opportunities is rather limited. The already-mentioned unfavorable economic climate and certain political considerations explain the fact that the governments in office since 1990 have designed and implemented the most various forms of privatization. In spite of these, however, each of the countries in question is still trying to overcome the initial difficulties of privatization.

Each country makes a distinction between small- and large-scale privatization. The former means privatization in the spheres of retail trade, catering, areas related to tourism, the construction industry and other spheres of private industrial services above all. Small-scale privatization aims at the elimination of state (council) monopolistic units consisting of relatively small entities capable of individual operation (shops, for example), united by administrative measures and active in the abovementioned fields, and their transfer to private owners (e.g. lease of premises, small plants). By large-scale privatization is meant the transformation of big and mammoth enterprises occupying monopolistic positions, the crushing of the latter and the transfer of the firms in question to private (national, foreign or joint) proprietors. The most important forms and ways of privatization are the following:

a) Small-scale privatization was, in general, carried out first by breaking down networks (business networks, for instance) and selling the resulting units (shops, workshops, etc.) after an open bidding. In Czechoslovakia, restitution, that is, the physical restitution of state property to its former owner, played a major part in small-scale privatization above all. Within that framework, former owners or their direct relatives could reclaim real estate nationalized after February 1948[12] that still existed physically.

In Hungary those entitled to compensation or their direct relatives were given compensation vouchers for properties nationalized after 1948 or forced into cooperatives. A rather strong digression was applied: the maximum compensation value given to a single owner or for a single property is 5 million Forint (roughly $ 55,000). The vouchers in question can be used to purchase state or co-operative property sold by bidding (the land demand of former owners and their direct progeny is to be satisfied by state-farm or co-operative holdings in the given area), to guarantee credits to start a new enterprise, for the preferential purchase of state-owned apartments, to round off the pension above the age of 70, etc.[13] A secondary trade of compensations vouchers

[12] Big factories, landed estates and banks were nationalized before 1948.

[13] The total value of the compensation vouchers issued so far equals approximately 10% of the total annual labor revenue.

evolved: their market value is well below par. The partial restitution of former church property (some schools, priories etc.) is also on its way. As for Poland, we know of no restitution or a solution similar to the Hungarian compensation vouchers there.

b) The legal framework for the transformation of state companies into joint stock companies, or, in certain cases, limited liability companies had been established in all three countries (in Hungary and Poland already before the change of regime). The transformed companies are entitled to attract capital, foreign capital above all. Already in 1989 and especially in 1990, the management of many state enterprises producing good business results took the necessary steps, with the help of their old business connections, to sell the company or part of it or to attract foreign capital. Such actions of so-called spontaneous (or "nomenclatura") privatization were, of course, used by the management to promote their own interests and preserve their positions (maybe at a somewhat lower level and/or with a more limited scope of authority). In the majority of the cases, however, company transformation governed by the interests of the management also served the modernization of the production unit or parts of it, the adaptation of business policy to the new market conditions and the preservation of (quite a number of) jobs. Government agencies established to manage privatization between 1989 and 1991[14] first suspended this process and later took full control of it mainly for political and power political reasons (especially in Poland but later on in Hungary as well).[15]

c) Within the framework of "nationalized privatization" the responsible government agency usually invites closed, in some cases open, tenders to privatize companies formerly in state ownership, in accordance with a program adopted by the administration. The participants and winners of these tenders represent, for the most, foreign capital, although some domestic buyers with solid capital assets and capable of mobilizing significant bank credits also appear on the scene. In the Czech Republic, in Slovakia and in Poland, there is a certain fear, not shared officially in Hungary,

[14] These agencies were meant to design the methods of privatization under the supervision of the government, to mark out the companies remaining in state ownership, to supervise the assessment of the property value of state companies or, if necessary, commission a (local or foreign) auditing firm appointed or approved by the agency to do so, to control the whole process of privatization (including the selection of potential local and/or foreign buyers) or, if considered necessary, to manage the process and, finally, to review and incidentally denounce posteriorly privatization initiated by the given state company and/or the auditing firm (with the participation of foreign buyers) and maybe even sanctioned by contracts.

In the Czech Republic and Slovakia, privatization is carried out by the Ministry for Privatization and Administration of National Property, in Hungary by the State Property Agency and in Poland by the Ministry of Ownership Transformation.

[15] A decisive majority of the decisions relating to large-scale privatization is in the hands of government offices (ministries) assigned to this task. Owing to the management and control exercised by these government offices (in Slovakia, for example, Prime Minister Meciar is the Minister of Privatization), administrators (not businessmen), without any special knowledge of their field and mostly ignoring the social losses implied by the protraction of privatization, spend precious long months, sometimes years, by a quest for (mostly foreign) buyers "offering the potentially best" conditions and the examination thereof. At the same time, the progress of privatization initiated from below is jammed. In the meanwhile, the property of state-owned enterprises is devalued and some companies try to survive by consuming their own assets.

concerning the buy-out of national property by foreigners. There are some definite signs (in Hungary, too) suggesting that foreigners only wish to gain new markets via these purchases rather than promote the activity of the company in question.

d) The distribution, or most preferential sale of part of the former state property in the form of property vouchers was meant to accelerate privatization and to create proprietor-citizens. Both actions are "justified" by the fact that state property, or a considerable part thereof, is actually the result of the work of these very citizens done in the past 40 years. "Voucher privatization", a form belonging here, was initiated in Czechoslovakia in the fall of 1991: each and every citizen was entitled to buy property coupons, i.e., vouchers, for a fraction of the nominal value. The action turned out a success when investment funds were created, on state initiative, to take over citizens' vouchers and purchase shares of state-owned companies and, especially, when the funds in question undertook to guarantee that, on demand, after the exchange of vouchers for shares, they would pay the citizen the market value, at least ten times the purchase price, of the vouchers in question.

Poland designed a special construct approved by the *Sejm* in April 1993 for the distribution of state property. According to that, some 20 state holding companies will be established, and more than half of the shares of the companies involved in the action, the majority of all state enterprises, will be divided among these. Some 10 percent of the company shares would be allocated free of charge to the employees of the companies in question; the rest would go to the treasury in the beginning. According to this concept, the shares of the holding companies would also be distributed, on the basis of citizenship, among the citizens. That is how the citizen would receive his/her property share of his/her own company and of the total company property of the national economy.

The distribution of property shares among citizens is a rather unpopular idea among experts in Hungary, who emphasize the fact that small share packets possessed by average citizens are inadequate to generate any kind of proprietary attitude and to raise a strict system of proprietary demand. Moreover, the guaranteed purchases of property vouchers distributed for free (or bought at a preferential price) at some later date is a considerable inflation risk. The investment funds established by the state may, in the future, grow into organizations concentrating such an enormous economic potential that, united with the political sphere, they would (might) trigger further and further state intervention in their capacity of units of power, rather than market, rivalry. This is all the more important to prevent since recent historical conditioning makes the former socialist states especially prone to this kind of deformation.[16]

Experts in Hungary proposed another form of property distribution. According to that, part of the share block representing profitable state property should be allocated to budgetary public services institutions and societies on the model of the historical public services fund. (Parliament has already passed a bill according to which Social Security should be allocated 300 billion Forint worth of business property.) This is expected to alleviate the burdens of public finances on the one hand and to strengthen

[16] Despite the expert opinion outlined here, the Government of that country has recently contemplated a property distribution among citizens based on credit constructs, but not yet formulated in concrete terms.

the economic autonomy and discipline of the beneficiaries (e.g. old-age-pension funds, big universities and hospitals, some municipalities etc.). The problem with implementing this concept is that the Hungarian economy suffers from a shortage of profitable state property which makes the options for establishing profitable public services funds rather limited.

e) The method of employee buy-out is discussed separately, despite its being a special case of "nationalized privatization", carried out with the approval of and under the control of state agencies of privatization. Its treatment as a separate category is justified by the fact that, as a result, self-managing (or co-operative) economic units may be established. Employee buy-out is most popular in Poland, but it is an existing, though minor, form of privatization in Hungary and Czechoslovakia as well. It can be efficient and give a competitive edge in cases where the activity to be continued is transparent for the employee, and the operation of the company in question requires special skills and a special know-how. Results obtained so far are positive in those instances where transition led to the profit-oriented performance of a management functioning in a framework of workers' self-management or co-operative adapted to the market conditions.

Small-scale privatization has, for the most, come to an end in all four countries under scrutiny. Privatization obviously improved the quality, efficiency and assortment of the trade and services. This, however, was due not only to the privatization of what used to be the property of the state, but to a considerable extent also to the fact that, as described in connection with the spreading of private enterprises, new enterprises gathered a "bounteous harvest" nearly instantaneously in these shortage areas.

As for the realization of small privatization, it was and still is a severe problem, especially in the larger towns, that since most of the premises suitable for private enterprises are still the property of the state (or the city municipality), "privatization" is limited to the acquisition of the lease right of such sites. Lease law and especially lease terms, however, are rather unstable: they can be altered year in, year out, often quite drastically. Therefore, private enterprises based on lease rights are often short-term, temporary ventures, an unfavorable phenomenon from the point of view of market development.

Large-scale privatization, on the other hand, is in an initial stage. The total value of the assets privatized so far, i.e. given over to private persons (not just state corporations), is estimated at 10% to 20% of the total assets awaiting privatization. In the former Czechoslovakia, the exchange of vouchers for company shares is on its way. (But their exchange for cash was postponed by six months.)

The above presentation of the ways and means of privatization was an attempt to give a general image of the methods favored by each country and of the philosophy behind them. Only the future will tell what combination of privatization methods will become dominant later on, and what other new methods, techniques and solutions will proliferate. Experience so far suggests that both the political elite and a major part of the economic experts were over-optimistic with respect to the possibilities and duration of large-scale privatization: "within-five-years" prophecies have already vanished in the air.

Transition strategists have realized already in the first, ecstatic moments of the turnover that large-scale privatization is an extraordinary task. They did not, however, count on the fact that the former markets of the large state companies established in the period of planned economy would collapse and make their situation even more unfavorable. They did not take into account the conflicts of the various strata provoked by the execution of "nationalized privatization". Neither did they realize the fact that the clashes of the political forces would undermine the sense of security of enterprise management and make it a drag on the process of privatization. The concrete aspects of privatization would be handled best by experts who command a thorough knowledge of the activity in question and its possible markets and have the right contacts, but these people, alas, are considered unreliable by the new regimes.

It seems that large-scale privatization will take a decade at least, and even after that, the state-owned share of the national economies in question will still be above the standards characterizing the historically developed market economies now.

What can already be termed the illusory estimate of the time-span of privatization diverted the attention of even larger circles of experts from the problem of what would happen to state-owned large companies until finally a buyer is found for them. How could these large-scale companies that might remain the property of the state for years to come be operated in the long period of the establishment of market economy in a market-friendly way?

Closing Remarks

Throughout their historical past, the Central and Eastern European countries have always been located in the buffer zone of whatever political and military powers actually prevailed. Their past is, accordingly, characterized by discontinuity and instability. Most of the countries of the region became independent states in the 20th century only, and this is the fourth time they had to alter their political and economic orientation, regime and economic growth and development patterns since then.[17]

After World War I, they found themselves in a brand new political and economic situation if only for the disintegration of the Austro-Hungarian Monarchy that called for a new orientation.

At the end of the 1930s, they were forced to develop an economic structure conforming to the interests of German Nazism and to operate it.

After World War II, they were attached to the Soviet sphere of interest and forced to adopt a Soviet-type state socialist party and economic system which disregarded their national endowments and characteristics.

Finally, in the early 1990s, following the collapse of state socialism and overpowered by the burdens of an onerous heritage, they must return to the market economy and find their place in Europe and a new and rather instable world political environment loaded with recession and governed by novel world economic power relations.

Many a sign suggests that the economically developed countries of the world are seeking ways and means to assist the peaceful transition to a market economy of the

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[17] "Economic Growth in Eastern Central Europe after World War II." In: A. Szirmai, B. var Ark, and D. Pilat (eds.), *Explaining Economic Growth*, Elsevier Science Publishers, 1993.

"repeatedly crest-fallen" Central and Eastern European countries. Recent experience in this field, however, is not particularly promising. It is a characteristic feature that the party capable of providing assistance does not do so until a really shocking crisis, a social-political "earthquake", occurs in its neighborhood that threatens to escalate and proliferate and requires billions of dollars to stop. Preventive international aid, assistance to avoid great "earthquakes" is extremely rare: the Marshall Aid is the only example that comes to mind.

The Central and Eastern European countries must have realized by now that no assistance on the order of magnitude of the post-World War II Marshall Plan can be expected. It would be, however, high time that the developed market economies elaborate their long-term strategy concerning the Central and Eastern European countries. Without a strategy taking into account the present discrepancies in the level of economic development of the transition countries, their inherited and present-day characteristics, the developed countries, too, can only watch and register events, with no real option to influence them. We witness such a tragic situation in Yugoslavia now. It may seem easier and cheaper to leave the countries of the region to their own resources as far as transition is concerned, and let them manage as best they can. However, undisturbed peace in Europe and the developed world depends, to a considerable extent, on what happens to these countries in the middle of Europe: whether any of them would be successful, or the region, or certain parts of it would be forsaken and doomed to agony or else drift into local wars. It goes without saying that such a situation would cost hundreds of times more than the required assistance and it might also take a heavy toll of human lives. It is in the best interest of all concerned to avoid it.

Basic Economic Indicators, 1989-1992
(Percentage; preceding year = 100)

Indicator	Czech-Slovakia	Czech Republic	Slovak Republic	Hungary	Poland
Gross Domestic Product					
1989	100.7	102.4[1]	101.1[1]	100.4	100.2
1990	98.5	99.2[1]	96.2[1]	96.7	85.1
1991		85.8	84.2	88.1	92.4
1992		92.9	94.0	95.5	101.0
Index 1992/1989		79.1	76.1	81.2	79.4
Industrial Output					
1989	100.8	101.7	98.7	97.5	99.5
1990	96.5	96.7	96.0	95.5	75.8
1991		75.6	82.2	80.9	88.1
1992		86.3	86.2	90.2	103.9
Index 1992/1989		63.1	68.0	69.7	69.0
Agricultural Output					
1989	101.8			98.7	98.5
1990	96.5			95.5	97.8
1991		91.1	92.6	84.3	98.4
1992		87.9	86.1	66.4	87.3
Index 1991/1989		77.3[2]	76.9[2]	53.5	84.0
Gross Investment					
1989	101.6	101.8	101.3	107.0	97.6
1990	106.1	106.5	105.3	91.9	89.9
1991	72.8	73.2	71.9	88.4	95.6
1992		117.0[3]	107.4	92.0	91.3[3]
Index 1992/1989		91.2	81.3	74.7	78.5
Unemployment rate (%) at the end of the year					
1990	1.0			1.7	6.3
1991	6.6	4.1	11.8	8.5	11.8
1992	5.1	2.6	10.4	12.3	13.6
Consumer Price Index					
1989	102.2			118.8	259.5
1990	110.0			128.9	685.8
1991		156.6	161.2	135.0	170.3
1992		111.1	110.0	123.0	143.0
Real wages					
1989	100.1			101	
1990	95.3			96	78
1991		65.7	75.7	90	100
1992		104.9	98.1	95	97
Index 1992/89		65.7[2]	70.1[2]	82	76

Notes:
1 Net Material Product
2 Calculated from 1990 by the Czechoslovakian index
3 Calculated by growth rate of GDP and by the ratio of gross fixed capital formation in GDP (Data of Bulletin 1993/1)

Source:
GDP 1989-1990: ECE (1993); 1991-1992 Bulletin 1993/1
Industrial Output 1989–1990 ECE (1993); 1991–1992 Bulletin 1993/1
Agricultural Output 1989–1990: ECE (1993); 1991–1992 Bulletin 1993/1
Gross Investment 1989–1992: ECE (1993)
Unemployment rate Bulletin 1992/4 and 1993/1
Consumer Price Index Bulletin 1992/4 and 1993/1
Real wages 1989–1990 Own estimations based on ECE (1992) p. 297 and Gabrisch, H. et al (1992)
1991–1992 Bulletin 1993 No.1. and Bulletin 1992/4 and 1993/1.

Value Indexes in Foreign Trade (calculated in USD)
(Percentage; preceding year = 100)

Country and trade partner groups	Exports					Imports				
	1989	1990	1991	1992	1992/89	1989	1990	1991	1992	1992/89
Czechoslovakia										
World	96.8	89.5	105.6	103.2	97.5	97.6	100.3	92.8	114.6	106.7
Transition countries	88.3	72.6	106.8	67.0	51.9	93.1	82.9	100.3	89.8	74.7
Developed market economies	110.7	113.4	106.9	126.4	153.2	98.4	124.6	86.3	139.6	150.1
Developing countries	100.1	89.1	94.0	127.4	106.7	117.0	88.0	95.6	79.6	70.0
Hungary										
World	96.7	100.6	105.4	104.1	110.4	94.6	99.3	130.2	96.8	125.2
Transition countries	90.5	78.5	73.2	103.2	59.3	85.6	81.2	102.8	101.8	85.0
Developed market economies	105.6	127.9	121.4	109.1	169.4	107.7	108.6	144.3	96.6	151.4
Developing countries	93.2	87.2	121.8	72.6	77.1	78.0	47.1	129.0	83.4	40.4
Poland										
World	100.6	124.7	81.5	109.7	111.5	98.9	97.5	124.3	106.1	128.6
Transition countries	97.5	114.9	38.0		43.7[1]	94.3	101.8	57.2		58.3[1]
Developed market economies	105.3	140.0	113.7		159.2[1]	107.1	95.3	171.7		163.6[1]
Developing countries	96.4	103.2	84.5		86.6[1]	91.2	82.9	151.0		125.2[1]

Note:
[1] 1991/1989.

Source:
1989: ECE (1992).
1990–1992: ECE (1993) pp. 85. and 114.

FRANZ-LOTHAR ALTMANN

Economic Transformation

– A Case Study on the Balkans –

Introduction

All of the countries of post-1989 Central and Eastern Europe have announced their intention to set up market economies. There were, however, great differences in the preconditions for their starts, in the various policy-packages they adopted, and in the progress they have made in achieving the first economic targets (e.g. macro-economic stabilization, reduction of budget deficits, slowdown of inflation, etc.). There were, furthermore, differences in the new legal and institutional structures which the new market economies require.

In 1992 a further widening of the gap between Central and Eastern Europe and the former Soviet Union could be observed[1] but the differences among the individual smaller Central and Eastern European countries also became greater as far as their economic performance and their (domestic) political environment were concerned. In particular, a clear difference emerged between the Central European countries – Poland, Czechoslovakia (now the Czech and the Slovak Republics) and Hungary – on the one hand, and the South-East European countries – Albania, Bulgaria, Romania, and the successor states of former Yugoslavia – on the other. This suggests, in effect, that as the transition proceeds, these differences will become more and more pronounced and decisive.

When serious reform debates began in Central and Eastern Europe in the second half of the 1980s, the various countries of the region were at very different stages of preparation and development. First of all, the theoretical foundations for reform discussions had developed quite differently. Hungary and Poland had a long lasting tradition of studying Western economic theory and of discussing alternative concepts for (and within) the existing state socialist model. For example the ideas of competitive market socialism of Oscar Lange, and the contributions of Michael Kalecki and Janos Kornai were discussed. Unlike in isolated South-Eastern Europe, there have been extensive exchanges of scholars with the West, and access to Western economic literature was not restricted in these two reform-oriented Central European countries.

As a consequence, today the number of possible candidates for filling important positions in the economy or in politics is by far smaller in Albania, Bulgaria or Romania – and, of course, also in the successor states of the former Soviet Union – than it is in Hungary or Poland. The fundamental principle of state socialism, (i.e. the superiority of "socialist" – state and cooperative – over private ownership of the means of production) could more easily be questioned in Hungary and Poland (in Poland the greater part of agriculture had remained in private hands, even under com-

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[1] Economic Bulletin for Europe, Vol. XLIV, 1992, ECE, p. 26.

munist rule), and the effectiveness of market mechanism could implicitly be acknowledged. Demands for decentralization and for liberalization of prices were not such absolute novelties there as they were in Albania or Romania.

The situation in the former GDR and also in Czechoslovakia was somewhat more complicated. Ideological positions impeded unorthodox economic thinking, although, in particular in these two most developed countries of the former Soviet Bloc, a revitalization of old market traditions should have been easier. Despite strong ideological barriers and isolation from the West in Czechoslovakia during the years of state socialism, many economists could acquire a high level of education and knowledge which they were unable to apply in practice because the restrictive political conditions would not allow it.

This lack of earlier theoretical debates and preparedness as well as the relatively small number of experts capable of taking charge of the political and economic responsibilities placed the countries of South-Eastern Europe at a disadvantage once the moment of dramatic change arrived. It turned out to be extremely difficult to develop schemes of systemic transformation appropriate for the specific conditions in the respective countries. This then led to what in effect was the copying of the general transformation programs that either have been outlined by economists in the Central European countries (e.g. the Czech voucher privatization plan) or which have been proposed or, even dictated by Western advisers and institutions (stabilization policies) as preconditions for receiving further financial assistance. We can speak of a Polish, Hungarian or Czech path toward transition, but there is no such "tailored program" for the Balkans.

Another disadvantage of South-Eastern Europe should be mentioned in this context, although this is even more difficult to quantify and verify. That is the lack of constant ties between the homeland and the diaspora which, in the case of Poland and Hungary and to a certain extent also for Czechoslovakia, nowadays plays an important role. In particular, state socialist Poland and Hungary had cultivated rather close relations with their emigrants throughout the socialist years. These emigrants produced strong lobbies that exerted considerable influence on the attitude of the West towards these two countries. Such assistance is not at all apparent in the case of Albania, Bulgaria or Romania.

1. In the Footsteps of the Pioneering Countries

The policy-packages adopted by the countries in economic transformation consist mainly of two groups of policy measures: macro-economic stabilization policies and transformation policies proper. Stabilization policies were directed towards controlling inflation, which would inevitably result from the liberalization of prices and towards reducing state budget deficits. Both measures were combined with general attempts to establish order in the new monetary system. The results so far have been mixed and differ widely in the region, reflecting to the depth of the initial macro-economic imbalances as well as the effectiveness of individual stabilization programs.[2]

[2] *Ibid.* p. 32.

In 1991 all countries in South-East Europe, except Romania, registered budget deficits exceeding the targeted levels which had been set by the International Monetary Fund (IMF) and whose attainment was linked to the disbursal of IMF loans. In Albania, the fiscal situation had deteriorated markedly as early as 1990 when the deficit exceeded 16% of GDP. In 1991, however, it already reached a record high of 44%. For 1992, the figures range from a 0.3% surplus in Slovenia (which managed to overcome the relatively small deficit of 2.6% in 1991) to a deficit of more than 10% in Bulgaria, and 22% in Albania. In 1993, the best performance, again, was achieved by Slovenia with an estimated deficit of 1.7%, whereas Bulgaria improved to 8.5%. A clear improvement, moreover, a real success compared to 1991, is expected for Albania with a budget deficit that should not have exceeded 16% of the GDP in 1993.[3]

In all of these countries budget revenues have been consistently overestimated, because fiscal reforms need much more time than anticipated and because the recession has turned out to be much more severe than expected. Not only did enterprise profits fall substantially, but tax evasion also became widespread in the new private sector, which in Hungary, and even more in Poland, is rapidly gaining importance. Budget deficits in the successor states of former Yugoslavia (other than Slovenia) are large and growing, mainly due to the impacts of the ongoing war and, in the case of Macedonia, Serbia and Montenegro, the United Nations sanctions on rump Yugoslavia.

As a more or less expected outcome of price liberalization inflation was high throughout Central and Eastern Europe, although again with considerable differences between countries. Whereas in Czechoslovakia and Hungary a slowdown in the rate of inflation can already be observed, developments in South-Eastern Europe are not uniform: Bulgaria's rate of inflation in 1992 was 80% which reflected an improvement compared to the preceding year (338%). Estimates for 1993 put the rate of inflation again at approximately 80%,[4] although in the second half of the year an improvement seemed to develop. Rumanian consumer prices may well increase by 210% in 1993 as was the case in 1992, compared to 165% in 1991.[5] High rates of inflation had to be expected also for Croatia and the Federal Republic of ("small") Yugoslavia where annual rates of inflation rose from 123% in 1991 to 664% in 1992, and from 121% to 9,237% respectively. For 1993, estimates of the rate of inflation for Croatia are close to 1,200%, whereas in rump Yugoslavia the monthly rate of inflation surmounted the 200,000 mark in December 1993.[6] In Albania, where some prices were liberalized in November 1991 (those for basic consumer goods have remained under state control), consumer prices had risen by more than 70% until June 1992.[7] The peak was reached in end 1992 with a rate of inflation of 237% against end 1991. However, until December 1993, this annual rate was reduced to 31%.[8]

[3] *IMF Survey*, May 16, 1994, p. 157.

[4] *PlanEcon Report*, Nos. 34-35-36, October 12, 1993.

[5] H. Gabrisch, "Im Zeichen westlicher Rezession. Die Wirtschaftslage der post-sozialistischen Länder im ersten Quartal 1993 und Ausblick 1993-94." *WIIW-Forschungsberichte*, No. 197a, June 1993.

[6] *Frankfurter Allgemeine Zeitung*, December 27, 1993, p. 3.

[7] *ECE:* Op.cit.*ff* p. 33.

[8] *IMF Survey*, May 16, 1994, p. 157.

Fiscal and monetary policies were relatively restrictive in all the countries concerned in the early nineties, but fiscal policy, in particular, very soon came up against the problems inherited from the old regime: for instance, cuts in subsidies for non-competitive industries. Most of Central and Eastern Europe's industries are not competitive on the world market. Furthermore, tight monetary policies cause large-scale closures of state enterprises, where the majority of workers are still employed. Consequently, high rates of unemployment emerged: 9,3% in Romania, 14.4% in Slovenia and 17% in Bulgaria (all by mid-1993). The situation was worse still in Albania, where only very vague estimates oscillate between some 30% and 50%, and war-affected countries such as Croatia (17.2%) and rump Yugoslavia (between some 20%, as officially stated, and probably 40% in fact). The new governing parties in these countries are very cautious to make measures which may further increase unemployment. Thus one cannot expect further substantial cuts in state expenditures.

Monetary policy was rather tight in all countries, at least in the beginning of the transformation period, but market rates of credits became too high for enterprises seeking finance. Banks are very reluctant to lend money when profit prospects are dim, and securities very often cannot be provided because ownership conditions are still uncertain. In the meantime, inter-enterprise crediting has undermined the role of the "normal" financial system which is controlled by the state. As soon as bankruptcy laws are adopted, the number of enterprises being forced to close will increase rapidly, as the Hungarian example has shown. Some softening of monetary policy has been observed in Bulgaria and Albania.

Liberalization policy was also applied in foreign trade in these countries. In general, governments resort less and less frequently to formal control of trade flows. This phenomenon is partly explained by the rapid increase in the number of firms engaged in foreign transactions. Quotas or licensing in exports exist only for fuels and raw materials in Albania and Bulgaria, and for some foodstuffs in Romania. For imports, some global quotas still are applied for consumer goods in Albania, whereas only Romania still makes general use of quotas or licensing for its imports.[9]

Some sort of control of the access to foreign exchange still exists in South-Eastern Europe. Slovenia at present seems to be the most liberal country in this respect, not only offering internal convertibility but being fairly close to full convertibility. Bulgaria uses a system of limited internal convertibility. Romania declared internal convertibility in November 1991, but de facto suspended it in May 1992, a result of the great imbalance between supply and demand for foreign exchange. The Albanian experience also demonstrates that limited internal convertibility of currency works. In spite of the small hard currency reserves, the Lek (Albanian currency) did well in 1993 – the exchange rate could be revalued by 15 % compared with December 1992.

2. Privatization as the Essence of Institutional Transformation

The liberalization of prices and foreign trade, and the introduction of new taxation belong to institutional changes as well as deregulation of private sector activities,

[9] *Economic Bulletin for Europe*, Vol. XLIV, 1992, ECE, pp. 55, 57.

anti-monopoly legislation and various other changes in the legal field. Most attention, however, seems to be devoted to the privatization of state-owned enterprises.

Compared to the countries of Central Europe the process of privatization started later and is proceeding rather slowly in South-Eastern Europe. This holds true mainly for the transformation of the former state- or cooperative-owned enterprises. The possibility of setting-up new private firms ("grassroots privatization") was allowed also in these countries very soon after 1989.

Bulgaria, which at the beginning was rather successful with its monetary stabilization program and therefore also received rather good evaluations from the international organizations, was for some time hampered by the strong position of the former Communist (now Socialist) Party. Only in spring of 1992 did restitution laws come into force. They regulated the return of enterprises and real estate that had been expropriated by the Communists. According to the Deputy Prime Minister of the Dimitrov Government (which resigned in November 1992), almost 80% of the municipal properties (houses, shops, storehouses) in the Sofia region, earmarked for restitution, should have been returned by the end of September 1992.

Reprivatization of agricultural land had already been initiated with a new law in spring 1991, but gained momentum only after an amendment of the respective law one year later, when restrictions concerning the number of hectares to be available for restitution had been lifted.[10] By the end of 1992, some 27% of agricultural land had been returned to private owners.

More important, however, was the passing of the law on Transformation and Privatization of State-Owned and Municipal-Owned Enterprises in April 1992. However, not very much has happened so far. As late as in November 1992, the first two enterprises were in fact privatized. In mid-1992, the share of private firms in manufacturing was only 1.3%, whereas the share of private entrepreneurs in retail trade turnover (mainly new small businesses) had already reached 41.7%.

In August 1993, the Berov Government finally decided to introduce the principle of mass privatization. According to the decision, the state will issue vouchers in a total value of 200 billion Lewa (about $6.5 billion). Each Bulgarian citizen above the age of 20 will receive vouchers worth 30,000 Lewa, offering two possibilities: participation in the privatization of a group of enterprises and/or a bank, or participation in the direct privatization of one enterprise. Parallel to this mass privatization, the privatization agency will also try to sell state enterprises through auctions.[11] As of the end of 1993, however, not much had happened: in 17 auctions conducted by the Ministry of Agriculture only 4 state properties could be sold.[12] Vice Premier Karabashev reported that out of a total of 32 privatization cases, 20 were accomplished by the Ministry of Trade, 8 by other ministries and only 4 by the privatization agency.[13]

Romania also has lost much time which it could have spent on transforming the economy because of its intricate political structure. In contrast to the other former state socialist countries Romania started privatization with the return of agricultural

[10] *Neue Zürcher Zeitung*, November 26, 1992; and *Nachrichten für Außenhandel*, June 6, 1992.
[11] *Radio Sofia IS*, August 4, 1993.
[12] *Bulgarisches Wirtschaftsblatt*, December 1993, p. 4.
[13] *Ibid.* November 1993, p. 4.

land on the basis of a law which was adopted by the parliament in February 1991. It declared that by the end of 1992, 82% of agricultural land had already been transferred into private ownership. This figure, however, must be taken very cautiously. An increase of agricultural production by approximately 11% in 1993 seems to indicate that some relief in this sector has been achieved as a result of land-privatization.[14]

The law on privatization of enterprises was enacted by the parliament at the end of July 1991. This law established five Funds for Private Property which would administer 30% of the capital stock of some 6,200 enterprises, representing approximately 55% of the stock value of state-owned enterprises. The remaining 45% (some 330 large firms) belong to the so-called strategic sector and will be kept in state ownership as self-administrated state enterprises *(régies autonomes).* So far only some 1,650 smaller industrial units have been privatized. A new start for the larger enterprises was planned with a voucher system which was supposed to come into operation in late 1993. However, another delay is to be expected. According to official Romanian estimates, about 400,000 registered private firms already cover approximately 40% of retail trade turnover and some 20% of industrial output. They also employ half a million persons. The Statistical Office claims a share of 25% of private activities in Romanian GDP.[15]

Slovenia needed two years of political debates before the privatization law was enacted by the parliament, just one day before the elections in December 1992. A first revision of the new law occurred in June 1993. It is a complicated compromise of sale and cost-free distribution of state-owned property. The basic scheme provides that 10% of the shares of each enterprise will first be given to the state pension fund. Another 10% will go to the restitution fund, 20% will be distributed among the employees, and 20% will be spread through investment funds (which have to be established) over the population. The remaining 40% of the shares will be sold through standard methods.

The former Yugoslav self-managerial system, i.e. the quasi ownership of the firms' employees (instead of state ownership) caused special problems for Slovenia. By mid-1993 the evaluation and formulation of privatization programs of some 2,700 enterprises should have been elaborated. Privatization models include internal distribution of shares as well as international tenders. Former owners might also bring in their claims, but only within a two-months period. At last, a version of voucher privatization became the predominant method of privatizing public properties in Slovenia.

By November 1993, only 59 privatization proposals had been presented to the privatization agency and 23 of them have been approved, which means that the procedure of realization could start. Yet, not all necessary enforcement decrees accompanying the privatization law have been issued. For example, the law on investment funds did not pass parliament until the end of 1993. Therefore, the privatization time limit for enterprises has been prolonged. The enterprises had been requested to compile opening balances by the end of December 1993 in order to speed up the ownership reform. It is obvious that many managers as well as workers councils, who are supposed to work out the opening balances, are not very interested in a rapid

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[14] *Frankfurter Allgemeine Zeitung*, December 14, 1993.

[15] *Ibid.* February 15, 1993.

change of ownership rights, because they are afraid of loosing their former privileges. It pays to note that among the 59 privatization proposals presented so far, management and employee buy-out solutions prevail.

Privatization of some 100 large enterprises which, since October 1992, are directly subordinated to the State Development Fund *Sklad,* (the Slovenian equivalent of the German *Treuhand*) became somewhat easier. Some of these enterprises were facing enormous financial problems and had therefore been assigned to the Fund in order to be restructured. Others joined it voluntarily. The Fund tried to stabilize these enterprises by short-term financial support, but also by slimming down. If this turns out to be impossible, the liquidation of the firms will be the final solution. So far the losses of these enterprises have been cut by 50%, and employment was reduced from a former total of 52,000 persons down to 35,000 by the end of 1993. When the firms become more attractive, they will be offered for acquisition. By the end of 1993, 15 enterprises and 5 subsidiaries had been sold to their managers and to domestic and foreign investors.[16]

As in Slovenia most of the enterprises in *Croatia* were self-managed which meant that management was not responsible to the respective ministries but to the employees, and they were also subject to the control of the Communist Party. Croatia, too, had adopted a privatization law in mid-1992, establishing a Privatization Agency and a State Development Fund. Until the end of 1992, applications for autonomous privatization could be submitted by the enterprises themselves, but the war in the second half of 1991, which extended into 1992, hampered privatization attempts substantially.

Divided into two phases, 3,900 enterprises were foreseen for privatization: First, former and present employees of the respective enterprises were given the option of purchase at discount prices and with the possibility of installment payment for 50% of the shares. Two thirds of those capital shares, which did not find purchasers in this way, and enterprises, which had not elaborated their own proposals, were transferred into the ownership of the State Development Fund. The remaining one third of the shares was given to two state pension and insurance funds. The State Development Fund then took care of further privatization in the second phase of the ownership reform. This was done either through sales and/or by satisfying restitutions claims.

By mid-1993, 2,800 enterprises had submitted their privatization proposals and some 1,600 had finished the first phase of privatization by 20 March 1993. In most cases, partial take-overs by the former directors and the employees took place who made use of the installment payment possibilities. Most of these privatized firms were smaller units, and as before, the managers and the state funds were able to preserve their dominating influence on the enterprises. The state itself collected only 276 million German Mark from privatization sales. Since private citizens in Croatia have very little disposable capital, and foreign enterprises are understandably reluctant to come in, one can expect that the Croatian state through its Development Fund will remain the biggest capital owner for the foreseeable future.

As in the other former state socialist countries *Albania* has great difficulties with the privatization of large enterprises. Albania's first successes can be seen in agri-

[16] *Neue Zürcher Zeitung*, November 12, 1993.

culture where about 80% of the land (90% of the land of the former cooperatives and one-third of state farms) has been reprivatized. The rest of the state farms were supposed to be privatized by the end of 1993. After decreases in gross agricultural production of 25% and 24% in 1991 and 1992, a 12% increase was reported for 1993. It must be recalled that in Albania approximately 60% of the population of 3.2 million lives from agriculture. Also, approximately 80% of retail trade and 60% of transport services are now in the hands of private business.

Thus, the sales of smaller trade and service units from state into private ownership have been remarkably rapid and successful, but large privatization finds itself in a kind of blind-alley. On the one hand, the former Communists, now Socialists, reject the privatization program of the ruling Democratic Party, because they are afraid of being excluded from the purchase of shares. On the other hand, investors are not interested in the acquisition of middle- and large-scale enterprises. In addition, in some cases, restitution claims have been raised because the legal situation is still not clear. Therefore, a state agency with rather far-reaching competence has been established under the supervision of the Council of Ministers to control the management of the 30 largest state enterprises.[17]

Conclusion

In South-Eastern Europe, at present, great differences can be observed when we look at the various attempts of transforming the economic systems. Slovenia, although the last country to enter the transformation process, seems to be taking the lead due to relatively few structural problems inherited from the former regime. Also the higher level of economy, education and skills in Slovenia, and the fact that it borders on Austria and Italy, along with its traditional economic ties to other Western developed market economies, must be seen as likely contributory factors to its development. The smaller size of the country, which often had been adduced as a negative factor, may be rather conducive to mastering the difficult situation, because the dimensions can be surveyed easier.

In the Balkans various domestic and external factors have led to belated starts of the transformation programs. This has brought about additional economic problems which have already generated growing reluctance (and sometimes even opposition) among the population to accept radical transformation schemes. At the same time, however, one should not neglect the fact that some countries already have achieved stabilization successes in some areas., For example, slowdowns of inflation, cuts in the state budget deficits, improved supply of basic consumer goods, and, growing sectors of private economy illustrate some of these stabilizing successes. One might only hope that the more advanced countries of Central and Eastern Europe will soon be able to report their real economic successes in order to provide some moral backing for the transformation of South-Eastern Europe.

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[17] *Frankfurter Allgemeine Zeitung*, August 20, 1993; *AFP*, August 25, 1993; *Ostwirtschaftsreport*, November 12, 1993.

MICHAEL KASER

From Market back to Market via Central Planning

– Russia 1917–1993 –

1. From Russia Back to Russia Via the Soviet Union

Systemic transformation and its analysis by economists and historians are not of course new. The prime exponent of an analysis which embraces all known such processes is of course Marx. His dialectical interpretation of historical materialism, in formulating a political superstructure upon a set of fundamental economic relationships, distinguished itself from all other theories by postulating the unity and unidirectionality of political and economic system change. Rostow's stages of development might be cited as the other extreme in being purely economic. While some thereby praised him as the *Fidei Defensor* of capitalism[1] others criticized him for neglect of political and historical conditions for his "take-off" – as embodied in his debate with Kuznets.[2] Political institutions were for him but a likely contributor to systemic change: "in many countries there are important political changes as well in the pre-take-off decades which are necessary before take-off can begin."[3]

Between the Marxian interpretation of political structure as dependent upon the economic system and the Rostowian view of political receptivity for economic change lie many analyses of combined politico-economic transition. To name the giants of the debate – Röpke, Schumpeter, Sombart and Weber[4] – is to focus on a debate about the "genetics of transition" by thinkers of German origin, whereas the "teleology of transition" has been most saliently implemented by Russians[5]. This paper describes the six constituents of systemic transition imposed by Russians on their own country between the start of the First World War and the end of the threat of

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[1] W.W. Rostow, *The Stages of Economic Growth*, Cambridge and New York, 1960. The contemporary review in *The Economist* (London) proclaimed the book as capitalism's equivalent of *Das Kapital*.

[2] S. Kuznets, 'Notes on the Take-off' and W.W. Rostow, 'Introduction and Epilogue' and 'Leading Sectors and the Take-off' in W.W. Rostow (ed.), *The Economics of Take-off into Sustained Growth. Proceedings of a Conference held by the International Economic Association*, London, 1963, pp. 22–43, xiii-xxvi and 1–21 respectively.

[3] W.W. Rostow, *Op.cit.* p. xx.

[4] Their critical importance, especially in opposition to Keynes' *General Theory*, is of course of systemic change within capitalism. The issue is concisely noted in R. Skidelsky, *John Maynard Keynes*, vol. 2, *The Economist as Saviour 1920–1937*, London, 1992, pp. 581–2, and at greater length in R. Swedberg, *Joseph A. Schumpeter: His Life and Work*, London, 1991.

[5] There is of course no empirical connection between the interpreters of systemic change and the parties to the Soviet Russian policy confrontation of the 1920s (for a profound analysis of which see A. Erlich, *The Soviet Industrialization Debate*, Cambridge, Mass., 1960) but the parallel may illuminate the 'teleological' nature of the revolutions by political *dictate* which was characteristic of Lenin, Stalin, Khrushchev and Gorbachev.

a Third World War. It was also, of course, Stalin who imposed Soviet rule on Central and Eastern Europe and Gorbachev who relaxed it, but the present paper selects only the Soviet experience. Its selection for exposition of a single country in the Twentieth Century – Russia and the former Soviet Union – is not to ignore the significance of other system transformations, of which two attract enormous interest. The first is that from feudalism to capitalism, especially in Western Europe[6] and the second that from feudalism (or variants thereof) to state socialism in East Asia[7]. The mere mention of the cases which may be studied as systemic transformation draws attention to its importance in economic history, but it has only very recently come to be termed the economics of transition. The concept did not figure at all in *The New Palgrave* (1987),[8] and the first public use seems to have been in the title of an agency of the OECD, Paris, in February 1990. Commentators on the situation arising from the collapse of communist government in autumn 1989 were at one in noting that, against the many instances forward along Marx's progression, there had been no previous passage backward. The reestablishment of a market economy after six decades of marginalization or illegality (five decades in Central and Eastern Europe of wartime rationing and state direction are included) had hitherto been neither a function of government nor an imperative for companies and households. That process takes place in the three spheres of economic activity identified in this paper – briefly characterized as politico-economic, domestic operational and external economic. The transition in each sphere to the Soviet-type system is discussed in section 2. The resources mobilized for economic activity under a centralized monopoly-ownership are described in section 3 and a combination of low efficiency and resource degradation is shown to have made inevitably an end to that system. A contrast is drawn between the political factors which determined the first Russian transition (1917–32) and the economic factors which brought about the second one (1985–91). Finally, in section 4 the present decentralization is analyzed in the corresponding three spheres, pertaining to politics, the domestic economy and external relations.

Economic transition – into state socialism and out of it seven decades later – was made more difficult by a concurrent process of nation-building; each could have been, but was not, eased by the gains from international trade or by assistance from wealthier states.

The section title draws attention to the return of Russia to being Russia (albeit within boundaries that excluded 25 million Russians) when Soviet central power was withdrawn. The creation of the USSR in 1922 and the establishment of the successor states in 1992 each had an economic cost. To such costs must be added those of political change – the stifling of emergent parliamentary democracy at the start and its

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[6] An important collection of analyses of that transition was organized by P. David for the Moscow Congress of the International Economic Association (August 1992) and will appear in A. Aganbegyan, O. Bogomolov and M. Kaser (eds.), *System Transformation: Eastern and Western Assessments*, Macmillan, London, 1993, pp. 115–97.

[7] China, Indochina, Korea, Mongolia and the Asian republics of the former USSR experienced variant modes of proletarianizing the peasantry, for most of which the propositions of Mao Tsedung are relevant. It can be argued that a Maoist line was followed in Castro's Cuba 1959–80.

[8] J. Eatwell, M. Milgate, P. Newman (eds.), *The New Palgrave. A Dictionary of Economics*, 4 vols, London 1987. See index, vol. 4, pp. 1022, 1023.

fostering at the end. History has not shown, as it does in Russia today, the coincidence of rapid change in the economic system, in state formation and in political sensitivity. Most other ex-Soviet republics are less afflicted than Russia by state and political issues. It is by no means certain that Russia can remain a Federation: Boris Yeltsin's abolition of the Congress of People's Deputies in September 1993 exacerbated fissiparous tendencies, and two autonomous republics, Checheniya and Tatarstan, never signed the 1992 federal treaty. Four of the smallest independent republics are riven by civil war (Azerbaijan, Georgia, Moldova and Tajikistan) and have involved Russian troops. Contemporary Russia is also more affected by another fissiparity – leading to bloodshed at the Russian legislature in October 1993 – and splits of both kinds threaten Ukraine; in Central Asia power remains concentrated in a few political hands, even if no longer termed a Communist Party.

Neither at the birth nor at the death of the Soviet Union were external conditions favorable. By their separate Peace of Brest-Litovsk with Germany the Bolsheviks had alienated the Western Allies and by the renunciation of Imperial debt and the nationalization of foreign assets without compensation they had forfeited the inflow of foreign capital. The *cordon sanitaire* with which the Allies ringed the Soviet western border originally bore its true meaning, a barrier to infection and other health risks, but was soon a term for the constraint of normal traffic. Even the relaxations within the USSR brought by the New Economic Policy (1921–28) failed to revive trade or capital movement to anything near their pre-revolutionary level.

There was little succor from external economic relations when the USSR was closing down. The Cold War had intensified before Gorbachev, arriving as General Secretary in March 1985, sought to lessen East/West tension: Afghanistan had been invaded just five years previously and President Reagan had castigated the USSR as an "empire of evil." Neither trade nor foreign capital had responded in significant magnitudes to the devolution of the Soviet foreign-trade monopoly or the authorization of joint ventures which were among the early offers of *perestroika*. Just a month before the abortive coup of August 1991, G–7 governments at their London Summit declined to provide the massive aid linked by a Soviet 'Grand Bargain' to a 'window of opportunity' for a five-year program of transition to capitalism.[9] After the Soviet break-up, the same Western governments compiled a support package of $ 24 billion, but by October 1993 only one quarter billion had been released. Over the same period trade had collapsed all round – within the Russian Federation, between the ex-Soviet republics and with the former states of the Comecon.[10]

2. *The Transition to Economic Centralism*

The dominance of political – indeed, military force in the Russian conversion of a market into a planned economy so belied Marx's forecast for the first country to

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[9] Grigory Yavlinsky's program envisaged the denationalization of 60 to 70 per cent of state assets by 1995.

[10] In Russia in 1992 internal trade was reduced by the decline in production (industrial to 81 per cent of 1991 and agricultural to 91.5 per cent) and external trade (other than with former Soviet republics) was 78 per cent of 1991 (*Ecotass*, 18 January 1993).

embrace socialism that Isaiah Berlin called 1917 a "hot-house" revolution – the seeds of a marxian transition were artificially nurtured to flowering. The soil of democracy was patently thin, but had been enriched by its demonstration during the First Duma of 1906 and the February Revolution of 1917. Lenin's forcible dispersal of the 1918 Constituent Assembly was only the first of the repressive actions which assured the oligarchy of the Communist Party and under Stalin the autocracy of its leader. The Civil War of 1918-20 and the subjugation of the peasantry in 1929-33 ensured a political and economic monopoly by overt violence, but the no less physical repression of individual opponents (real and supposed) was covert and was authorized by every Soviet leader until Gorbachev. Its incidence fluctuated but never disappeared.

The argument for a political monopoly to obtain the advantages of an economic monopoly was well put by Dobb who spelt out the gains from scale economies and the like if consumers' goods and services were offered "(as it were) a *table d'hote* meal rather than the more complicated task of catering for a lengthy *a la carte* list in proportions adapted to consumers' requirements".[11] As Brus and Laski recently put it, "in our understanding of Marxism the ethical superiority of socialism over capitalism is supposed to go hand-in-hand with economic superiority, the two reinforcing each other."[12] Following in particular Lange, they referred not only to the "'internalization of externalities'", that is in the possibility of taking into account costs and benefits outside the purview of micro-units, but also in elimination of inefficiencies on a macro-scale caused by pursuit of objectives rational only from the microeconomic point of view'.[13] Both the ethical and the welfare arguments postulate a political expression of personal preferences, since by definition any economic expression must be coordinated within the social plan. The rapid evolution of the Soviet "partocracy" and its absorption into Stalin's dictatorship eliminated that political channel of plan formation. Stalin was well aware of that implication for economic analysis and ordered his economists throughout the 1930s to claim that economics under (his form of) socialism was limited to the description and facilitation of whatever the state agencies decided should be done. One or more of his advisers (probably Nikolai Voznesensky) convinced him that such "voluntarism" disregarded the marxist goal of an "objectively-determined process of development" and from 1943 (already adumbrated in 1941) a "modified law of value" was declared operative under socialism.[14] When he made his own views known in 1952[15] (having had Voznesensky executed and with the latter's deadly rivals in power under him), Stalin limited money-valued exchange to the operation of assets not owned by the state, specifying cooperative farms and foreigners trading with a state-socialist entity.

The Soviet identification of state ownership with socialist planning subsumed the nationalization of productive assets and the overwhelming dominance of state enterprises in aggregate capital formation. The primary purpose of a single state ownership

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[11] M. Dobb, *Soviet Economic Development since 1917*, 4th ed., Routledge, London, 1957, p.5.

[12] W. Brus and K. Laski, *From Marx to Market: Socialism in Search of an Economic System*, Clarendon Press, Oxford, 1989, p. 3.

[13] *Ibid.* p. 5.

[14] M.C. Kaser, 'Le debat sur la loi de la valeur en URSS. Etude retrospective 1941-1953,' *Annuaire de l'URSS 1965*, CNRS, Paris, 1965, pp. 555–69.

[15] J.V. Stalin, *Economic Problems of Socialism in the USSR*, Politizat, Moscow, 1952.

was to compel the compliance of microeconomic decision-making by converting economic directives into administrative law: for state entities the "plan is law" was a much repeated dictum. But it had an effect on the regional distribution of productive assets which was to become dysfunctional when the USSR broke up. Engels in a late work (the "Introduction" to the Finnish translation of *Das Kapital* had noted the potential benefit of dispersing productive assets which capitalism seeking externalities tended to locate at "centers" (Perroux was to term them *"poles de croissance"*) rather than at the "periphery". Such centripetal tendencies limited the spread of the proletariat, whereas dispersion could ensure a sound proletarian majority throughout the regions of a socialist state. When the USSR was set up with a federal constitution, the government desired the distribution of investment to the less-developed Union-Republics not only to proletarianize (under the slogan "national in form, socialist in content") but to bring lagging regions up to the level of the more advanced. The latter objective was after the Second World War to be used for the Council for Mutual Economic Assistance (CMEA). Against such a policy in operation was the objective of gaining economies of scale. When the USSR split up, 77 per cent of the product subgroups in the Soviet industrial classification were being produced by one enterprise alone.[16] The imposition of barriers to trade among the Soviet successor states and the power of monopolies emerged as major problems in 1992.

Dictation by the central government of microeconomic decisions was partly motivated by one of Lenin's political exigencies – to subordinate workers' control (exercised by factory committees after prerevolutionary owners were displaced) to his Petrograd Government: the slogan "all power to the Soviets" meant precisely that – no power to anyone else, however good the proletarian pretension. The broad nationalization of 1918 was its manifestation. The still more comprehensive nationalization of 1920 can properly be attributed to "War Communism" under which systemic change was accelerated. At its peak in 1920 the country was further away from the operation of a market than at any later period of its history: relations between enterprises were virtually moneyless (named "glavkism" after the designation of the "chief administrations", *glavnie upravleniya*, which effected transactions); the vast bulk of wages were paid in kind or as rations (94 per cent of wages); townsfolk took their surplus goods to barter in the villages; (*meshechnichestvo*, from *meshok* the sack they carried), and farmers were compelled to deliver produce to state agencies, sometimes at bayonet point.[17] The hyperinflation that lost the country any standard of exchange or store of value (one stabilized rouble was to exchange for 50 billion pre-1921 roubles) and the accompanying recession – industrial output fell to a mere fifth of the 1913 level – remains an awful lesson for Russia in 1993.

After Lenin's readmission of market relationships among both private and public transactors in his New Economic Policy, there were further periods when the micro-

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[16] Khrushchev drew attention to a contrary trend when in advocating industrial management by regions he showed the cost of cross-hauls and small-scale production induced by "departmental (ministerial) barriers".

[17] The traumatic consequences of the abandonment of the use of money (which was on the point of formal replacement by "labor units") was a central feature of M.C. Kaser, *Soviet Economics*, Weidenfeld and Nicolson, London, 1970, esp. chs 4–7.

economic use of money was restricted. The longest (1930–87)[18] was of course that of the Five-year Plans when money transactions were divided into "cash" and "non-cash" (often termed "bank-money") or into "active" and "passive". The former was for household use and allowed individuals choice among the goods and services made available by the plan (for planners' preferences replaced consumer sovereignty) and the latter enabled enterprise allocations to be made (on "material balances") in physical units, with "finance following the plan" as the phrase then was. The next longest (1930–65)[19] was the severance of monetized links in agriculture, that is within the microeconomic unit (a state or collective farm) and between it and the state procurement or supply agencies. The other lengthy period of money marginalization was of rationing (1918–35 and 1941–47)[20]. There was, finally, a short period (1930–31) when an abortive attempt was made to return to glavkism and to Lenin's scheme of the economy run as "one big factory", that is accounting rather than payment between enterprises. The only lasting consequence was the conversion for a decade and a half of the Central Statistical Administration into the Central Administration for Accounting for the National Economy.

Throughout the Five-year Plan period microeconomic decisions were substantially (but never wholly) made without reference to price signals: the various administrations ranked their allocations from the supply side. The objective of moving still further to supply-side allocation was implicit in Khrushchev's Third Party Program of 1961: the abundance of consumers' goods postulated for "communism" was, it avowed, attainable "within a generation" and would ensure "from each according to ability, to each according to need".

The suppression of property rights and of the price mechanism were necessary conditions for Soviet "mono-archy"[21]: ownership by others than "the state" (the ultimate power in which was the Party or its leader) would require such assets to have a price based upon the use that could be made of them. It was the necessary condition for the politico-economic and operational-economic transitions just described. But each suppression could be applied neither to foreign-owned assets nor to world markets. The logic of War Communism and of Stalinism hence required the exclusion of both external ownership of assets on Soviet territory and of international trade.

Under War Communism the nationalization of assets was of foreign and domestic property alike; the absence of compensation and the (previous) renunciation of Imperial debts together with support of anti-bourgeois revolutionary forces alienated foreign corporations and governments and led to the so-called "gold blockade" (not buying Soviet gold) and "credit blockade" (not offering loans). The exigencies of war and the collapse of civilian industry and agriculture allowed few exports, the current earnings from which could have purchased imports.

[18] The closing date is that of the Law on the Enterprise.

[19] The closing date is of Khrushchev's money advance system on collective farms and Brezhnev's procurement reform but many elements persisted afterwards.

[20] Although wartime rationing was lifted in December 1947 in association with a confiscation of much of the inflationary overhang, informal and local rationing was widespread in the 1980s when the overhang regained its importance. Rationing remained throughout for housing and holiday resorts and many goods and services were available only on privileged access.

[21] Brus and Laski's term for the concentration of economic and political authority (ibid.).

It is significant that when Lenin launched NEP he began a series of trade treaties with major commercial partner-countries and offered to pay compensation on expropriated assets.[22] Just as appositely, Stalin terminated NEP with the abrogation of concessions (joint ventures in mineral extraction and in industry) and the diminution of external trade. A state of foreign-trade monopoly had been established in 1918, was relaxed during NEP but was reimposed under the First Five-year Plan. The rouble had become inconvertible through devaluation and exchange control, was made externally convertible between 1924 and 1928, but reverted to service as a domestic unit alone. With capital movement barred and trade whittled down to near-autarky (only 0.5% of GNP was exported at the 1937 nadir), international labor movement was prohibited. After the Whites and the various "nationalists" had been put to flight,[23] there was virtually no emigration (except from German-occupied territory during the War). Immigration was limited to the temporary admission of foreign experts (for technology transfer was a significant input to industrialization in the 1930s) and tourists (for whom cloistered facilities, such as Intourist services and Torgsin shops, were set up). "Socialism in One Country" was not only the political bar to Trotsky's "permanent revolution", but resignation to the absence of the aid he expected from a revolutionized West and hence to self-sufficiency[24] Stalin thereby imposed.

Choice among trade and technology partners could, by virtue of the state monopoly, be on either commercial or political criteria. That the USSR allowed itself to be as exploited as the Balkan states by the German Reich by the accumulation of frozen Reichsmarks was political. After 1945 the tying up of Central and Eastern Europe and between 1949 and 1961 the alliance with China broadened the range of economic partners which could be selected on political grounds. The political gamut for trade widened when – following the visit of Khrushchev and Bulganin to India in 1955 and to Yugoslavia in 1956 – political affinity was recognized in any government of a poor country (Western Europe was excluded) which called itself "socialist." Under Khrushchev and still more under Brezhnev the perception of the Western alliance of "Soviet imperialism" was strengthened by the many trade and aid deals with the Third World. The selection of partners with the "First World" became as much a choice by the partner as by the USSR. The Western strategic embargo restricted sales by NATO members and other sympathetic governments[25] in comparison with which Soviet preferences among Western states were pale.[26] The Soviet invasions of Hungary, Czechoslovakia and Afghanistan elicited a variety of economic sanctions, particularly by the United States.

As central planning emerged from the shadow of Stalin's "voluntarism", it became economically more rational. Khrushchev's reform of 1957–65 was the sole period of

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[22] For the negotiations with the Allies and in particularly the UK see M.C. Kaser 'Trade Relations: Patterns and Prospects', in A. Pravda and P.J.S. Duncan (eds.), *Soviet- British Relations since the 1970s*, Cambridge University Press, Cambridge, 1990, pp. 193–214.

[23] Notably from Central Asia, the Transcaucasus and Ukraine.

[24] Michael Ellman, 'Stalin', in Eatwell et al, *Op.cit.*, vol. 4, p.475, saw the concept as the autocrat's main contribution to economic policy.

[25] The United States Government deployed political and diplomatic weaponry against neutral states which it perceived to be "soft"' on the embargo.

[26] Kaser in Pravda and Duncan, *Op.cit.* pp. 205-11, showed much wider fluctations in trade (1960–8) with inimical countries such as Japan and the UK than with others such as France and Germany.

Soviet history in which there was a positive gain in total factor productivity (that is, output increments which cannot be attributed to more capital and more labor inputs): it is damning evidence of Soviet inefficiency that in 1987 factor productivity was only 46% of its level in 1928.[27] The last two decades of that Soviet five-year plan regime that was rightly termed Brezhnev's "stagnation". Benefiting from the quintupling of oil prices in 1973 (in Comecon from 1975) and from oil exports available from the giant Siberian wells, the Brezhnev administration kept the USSR from total industrial output decline by importing foreign technology. Such transfers temporarily substituted for economic reform, for the decline in labor inputs due to demographic causes, and for the rise in the capital-to-output ratio as remoter natural resources, usually in severe or hostile climates, had to be opened up, and as waves of funds were wasted in agriculture (to a peak of one-third of all state investment) vainly to reduce dependence on imported grain.

The moderate rationalization of planning embraced also the external sector. Comecon was endowed with a Statute, gained an Executive Committee and a large network of coordinating agencies for industries and services and its own "collective currency". The financial relationships remained bilateral despite the opportunity to multilateralize current payments through the "transferable rouble" accounts in the International Bank for Economic Cooperation (IBEC) and for structural transfers (for the political aim of "equalization of economic levels") through capital via the International Investment Bank (IIB).

3. The Inherent Inefficiency of the Soviet Economy

The "tinkering" with the economic system under Stalin's successors was quite inadequate to offset the inadequacy of "productive relations" to "productive forces". Marx's prediction based upon his dialectic of economic history was implemented that a system incapable of mastering new resources or technology had to cede to a system which could. Whether or not that was true in the past is not at issue: that is what happened to the Soviet economic system.

Evidence of the failure of the Soviet economic system can be seen in its inability to provide a level of living aligned with that of other industrial countries and in its rejection by all the post-Soviet successor states. The territory that constituted the USSR between 1922 and 1991 had vast human and natural resources and comprised zones which in historical perspective ranked among the most developed in the world of the time. Yet it was economic weakness which chiefly contributed to the Soviet political demise. Ironically termed "a Third World country with rockets", the USSR was overburdened with military expenditure undertaken in confrontation with much more successful economies, led by the United States. But it was the system itself which precluded achievement of Stalin's objective for rapid industrialization "to catch up with and surpass the level of the leading capitalist countries." Central

[27] The estimates, based on previously-unavailable statistics provided by Goskomstat to a World Bank mission, are in W. Easterly and S. Fischer, 'Growth Prospects for the ex-Soviet Republics: Lessons from Soviet Historical Experience' in Aganbegyan et al. *Op.cit.* p. 68

planning and political monopoly could not furnish the multiplicity of incentives to mobilize resources and to innovate for efficient production and distribution; instead industrial growth was derived from large increments in the quantity of labor and the exploitation of natural resources. In the 1980s demographic additions to the working population ceased in the industrialized Soviet republics, at a time when diminishing returns were the response to the reckless utilization of the wealth of the sub-soil. Reliance on cheap (and hence wastefully used) domestic energy for consumption and export turned adverse in the same decade under a combination of sacrificing exploration to exploitation, costlier production and transportation, and declining world prices.

Soviet investment in general and technical education and in scientific research yielded poor returns in economic growth and welfare because the system impeded the enterprise needed to diffuse and implement their outcomes. The Western restriction of the transfer of technology to the USSR and its allies was a further constraint on a more productive use of resources and compelled the diversion to defence requirements of the greater part of Soviet research capacity.

By 1987 Gorbachev and his advisers were sufficiently convinced of the inefficacy of central planning to begin to devolve some of the economic powers held formally by the government and informally by the Communist Party. As it turned out the latter was more of a cohesive force than the former and to that extent "reform from above" effected by the Party, as Gorbachev desired, might have allowed the release of a private sector and market transactions for the state sector as in China after 1978. But time had already run out for the basic Soviet strategy of reliance on labor as the mainspring of growth. A combination of large demographic inflow into the workforce and of occupational transfers – raising to a virtual maximum female participation and moving people out of agriculture after collectivisation – would no longer offset the system's inadequacies in the efficient use of resources. One measure of the growth of the non-farm labor force during the Soviet period is the rise in the urban population from 22 million in 1922, when the USSR was formally established, to 169 million in 1982, when Brezhnev died. The number of wage-earners (that is, the gainfully occupied excluding collective farmers, the armed forces and their directly-administered factories, students and independent traders) rose between those dates from 6 to 115 million.

A calamitous decline in the natural demographic increase from 18 per mille in 1960 to 9 in 1970 (at which point it levelled out), and of the crude birthrate, from 25 to 17 per mille, should have warned the Brezhnev administration of an impending reduction of the active population as the lower birthrates came to be reflected in numbers of school-leavers. A deterioration in health conditions – partly due to the neglect of the infrastructure of the health care service – was evident from the rise in infantile mortality; the USSR was exceptional among industrial countries in exhibiting such an increase, as it was in showing a fall in life expectancy. The increased mortality affected particularly the younger working age-groups (from alcoholism, industrial and road accidents and occupational disease). No measures were taken to enhance labor productivity or incentives in advance of the workforce decline that had become inevitable for the 1980s. Rather, when Soviet arms had crushed the Czechoslovak reformist leadership in 1968, a process of recentralization began, on the premise, noted above, that economic liberalization could generate political pluralism.

The option was also closed of transferring labor from low-productivity agriculture to higher-productivity industry and mining, a policy which Stalin brutally imposed both by collectivization and enforced labor. In 1963 the USSR had to begin importing grain from the West and from 1972 imports, chiefly of fodder, became the mainstay of Soviet livestock. Despite a large diversion of investment into agriculture, a further run-down of the population engaged in agriculture would have required more hard currency to make up the food loss than Soviet exports could muster.

Finally labor productivity was adversely affected by repressed inflation. Earnings in the capital-good and defence industries and by the military were not matched by corresponding rises in the availability of consumer goods and services. But retail prices were not allowed to respond to income (the price index in 1980 was only 3% above 1970) and queues and empty shelves reduced incentives to earn. Incentives were further vitiated because access to many purchases was by privilege – housing, motor cars and goods and services through "closed shops."

Labor was also a bottleneck for the still greater exploitation of natural resources. Deposits near the long-settled zones became exhausted or too poor for continued use – Krivoi Rog iron ore, the Donbas coal basin and oil in Azerbaijan and the Urals-Volga fields were the salient cases – and climatic conditions were harsh at the new deposits – Siberian permafrost or Central Asian deserts – and the costs of settlement were correspondingly enlarged. The reckless use of natural resources was the second major contributor to Stalinist-style growth. Deliberate underpricing of minerals, fuels and agricultural produce in what was in any event a passive price mechanism (in the supposed interest of promoting industrial growth) exacerbated wasteful consumption. If revalued at world prices, a recent calculation showed that the export value of all primary products produced was double the value of GDP, which of course incorporates those products as inputs[28]. With an input of raw materials far above the average of industrialized market economies, yielding negative value-added on that calculation, Ricardo's rule on the increasing marginal cost of land use loomed large. Since raw material exports, especially hydrocarbons, had become under Brezhnev the most important earner of hard currency (and under Stalin and Khrushchev the earner of soft currencies), increasing cost and/or decreasing output threatened the purchase abroad of the technology which staved off the effects of domestic inefficiency. In the final twenty years of Soviet power total factor productivity continually declined: the end of the system[29] in economic terms was inevitable.

4. Back to the Market

There is no ambiguity about the economic objective of the Russian governments under Boris Yeltsin's Presidency to restore a market system. Controversy and uncertainty relate to the paths and speed of that restoration. At the time of writing (October 1993), the administration under Viktor Chernomyrdin (and in particular Deputy Premiers Boris Fyodorov and Yegor Gaidar) has formulated a thorough program for

[28] *The Economist*, 5–11 December 1992, 'A Survey of Russia'
[29] Easterly and Fischer, *Op.cit.*

macroeconomic stabilization and substantial privatization. Its implementation depends, however, on a resolution of political relationships, the prognosis of which lies outside this study. In the present context, that systemic transformation into the market economy may be regarded in the same three groups as that out of the market.

Mikhail Gorbachev could never have changed the political system by "revolution from above", that is by using the Communist Party as the vehicle. He maintained his hopes of democratizing the Party so that it could restructure the economy even after the abortive coup of August 1991. The impossibility of such a goal was quickly borne in on him, but his expectations and leadership were at an end.

Nevertheless his actions under perestroika were a preparation for political-economic change. The elections to the Congress of People's Deputies of the Union in March 1989 were the turning point in beginning the democratization of the legislature, but, because that assembly was dissolved with the Union in December 1991, the Republican Congresses, elected in May 1990[30], brought more persistent *sequelae*. The medical simile is apposite because the viral strain of Communist Party nominees was carried into the legislatures of each successor state until new elections. In Russia these were not due until 1995 and the inability of the executive to implement macroeconomic monetary control was largely attributable to a hostile majority in the legislature until it was dissolved in favor of a wholly new Duma (to be elected in December 1993). The division was not the sole factor, for another was the government's need to take account of public and media opinion. As has briefly been indicated, the wastefulness of Soviet productive processes, the diversion of resources to military uses and the inadequate influence of consumer demand on product-mix required, once the system changed, the closure of many lines of production or of whole enterprises. The collapse of exchanges among the new Republics and with Comecon states strengthened the recessive pressure. For reasons considered above, the directors of state enterprises resisted rundowns of output and of employment and the President of the Central Bank, Viktor Gerashchenko, long chose to subsidize them. The directors as an interest group had a political voice in the Russian Congress *via* Civic Union, but party groupings were too embryonic to systematize debate, negotiation and the passage of consistent legislation. In the Russian case monetary instability arising from a deep budget deficit and unrestrained inter-enterprise indebtedness was aggravated by the use of the rouble in other Republics for their own massive credit expansion. By mid-1993 most had separated into their own currencies. Russian retail prices, liberalized on January 2, 1992, had risen thirty-fold during the ensuing year (wholesale prices rose faster, wages considerably slower) and the Ukraine was already over the brink into hyperinflation. Just as market relationships were destroyed by the hyperinflation during War Communism, so restoration of the market in 1992–3 was in danger in Russia of being eroded by the same factor.

That same price liberalization throughout the former Soviet Union provided price signalling of the conditions of demand and supply; monetary disequilibrium – the

[30] In March 1990 the crucial battle for change was at the all-Union level hence many apparatchiki and non-reformers got into what was seen as a second-rank legislature, leading to the forcible dissolution of September–October 1993.

subsidies and unpaid invoices and the lack of a bankruptcy sanction – muffled the microeconomic effect.

The changes at the state enterprise level had begun under perestroika in 1987 by the grant of financial autonomy, but without the exit compulsion of lossmaking leading to bankruptcy. Ostensibly aimed at hardening the 'soft budget constraint', the Law on the Enterprise (Association) – corresponding measures were passed for the farms – failed to prorogue state subsidies, for wholesale prices remained controlled and their arbitrary relativities could be invoked to claim central funding. Enterprise directors were subjected to election by the workforce and the strike weapon began to be used (as the repressive power of the police and Party was reduced): they yielded to pay demands and by 1991 wages had risen since 1985 one and a half times that of retail prices and by more than that on productivity. Financial decontrol gave free rein to what is none-too-fancifully described as a feudal relationship between Russian management and its workforce, or between the collective-farm director and the membership: protection is exchanged for duty, quiescence for slackness. Once prices were freed, directors, many in a monopolistic position enhanced by the division into 15 republics, seized upon what can be termed a "soft price constraint," raising prices to protect inefficiency or pay higher wages. Because few took the road of firing staff as demand fell (as wholesale prices rose faster than retail prices and the latter faster than average incomes), productivity fell as fast as production.

The fault – some would say unavoidable – of the "shock" program of January 1992 was its lack of measures on the supply side. Monopoly has just been mentioned, but the excessive concentration into large enterprises and lack of a competitive private sector was not – some would say could not then be – tackled. Privatization began of intermediaries (shops and banks) rather than of producers, the private entrepreneur flooded into speculative trading rather than production. In August 1992, however, a serious program of denationalization commenced and by the end of the year the operations of commodity exchanges had begun to thin down and a few sizeable private farms had started up. By the date of Yeltsin's coup of October 1993 many of the institutions of a market were in place but property rights were in many cases more nominal than real.

On the eve of its dissolution exports constituted a mere 7% of GDP and the inflow of foreign capital and outflow of labor were both negligible. The starting point of systemic transformation was hence low in external economic relations. The steps taken by late 1993 can be considered under the categories of trade, payments, capital transfer and migration.

The liquidation of the state foreign-trade monopoly was in fact Gorbachev's first significant measure of economic perestroika (1986), but current payments were not decontrolled until mid-1992. "Internal convertibility" was accorded as the rouble sharply depreciated, but although Russia ended 1992 with a trade deficit in convertible currency terms, it had a more than offsetting surplus in trade with inconvertible-currency partners. Despite a catastrophic fall in exports of oil, the country's visible balance weathered the crisis of convertibility. The unstated cost was considerable capital flight ($15bn in 1992) and a devaluation even faster than domestic inflation, which in turn and suitably lagged, it fuelled.

In so parlous an external position and substantial international aid and stabilization funding withheld until the reforms were more definitive, foreign private capital was reluctant to enter. Too little of the legal structure had been set up. Joint ventures with foreign capital had been authorized (after an absence since the closure of NEP) as early as 1987 and these and wholly-owned foreign investments were protected by a Russian law of 1991. But land could not be owned, equity purchase in privatization schemes was restricted, and the private institutions and public regulators to facilitate the smooth and competitive working of asset markets were exiguous. On the other hand, a financial and commercial press was beginning to emerge, foreign agencies and consultancies were being established and a modest start had been made on modernizing the telecommunications and financial transfer systems that have globalized transactions throughout the rest of the world.

From 1 February 1993 Russian citizens could obtain passports for foreign travel on demand. The barriers between the ex-Soviet republics were, save into the Baltic States, porous so far as concerned labor. Any external emigration will doubtless be controlled by the potential recipient nations but migration within the Commonwealth of Independent States was unrestricted. Some 25 million Russians were left in the other successor states at the disappearance of the USSR and of official equality between Soviet nationalities. Civil unrest in some republics – the Caucasus and Tajikistan – and eponymous nationalisms everywhere brought significant repatriations into Russia. Most re-emigrants – many long settled outside the present boundaries – spoke of ethnic tension as motivation. But if economic conditions severely deteriorate or hostilities break out in Russia itself, not only might such re-emigrants seek a life abroad (as many Jews, Germans and Poles already have) which has not been the case in the past, but much more dangerously large numbers could seek to move from Russia itself. The disruption that could be caused in the West is only one of the fears which evoke hopes for a rapid and successful completion of the momentous cycle, from market back to market.

Yuri Rosaliyev

Transition to a Market Economy in Turkey

– A Case Study on the Near-East –

Introduction

The development of a market economy in Turkey has attracted increasing interest. The reasons are manifold: undoubtedly there are certain specific features in the Turkish path to a market economy; the country has for a long time been seeking to join the European Community; the case of Turkey is also part of the international experience of transforming backward economies into modern ones. The question has also arisen as to in what way Turkey can become a link between the economically advanced Western countries and the newly-established states in Central Asia and the Caucasus. A study of Turkish economic history may help to give a clue to understanding the specific features of Turkey's historical development, its economy, societal structure, and the organization of political power. This will also shed light on Turkey's achievements in comparison with a number of nations and the causes of its lagging behind the Asian success countries, bearing in mind the fact that Turkey had embarked on a path of transformation long before the latter.

1. The Historical Background: State Intervention, Mixed and Planned Economy

The economic crisis of 1929-1933 demonstrated Turkey's deep-rooted economic backwardness, the low level of agriculture (the mainstay of the country's economy), its lack of a well-developed credit system and dependence on foreign investment. In early 1930s President Kemal Ataturk and his aides were keen to speed up the establishment of big industrial enterprises and state farms by using primarily governmental sources and by giving priority to the provision funding and assistance to industry and agriculture. That period saw the appearance of etatism, which became the main thrust of the government's economic policy. The state undertook the task of eliminating (or at least alleviating) the degree to which the country trailed behind economically developed nations. The economic policy was aimed at strengthening the leading sectors of industry and agriculture and the banking and insurance systems.

The principal method of state intervention at that time was in the form of priority allocations of funds earmarked for the construction of advanced (by the standards of that period) industrial enterprises such as the Karabuk iron and steel complex, Kaiseri and Nazilli textile factories, military production plants at Ankara, and for the creation of state trading companies for agricultural produce, such as the Agricultural Produce Department, State Agricultural Enterprises Society, Imported Agricultural Equipment Society. Organizationally, etatism was propped up by big banks which fulfilled, in addition to credit, planning and controlling functions. The biggest such organizations were the Agricultural Bank, the Sumerbank (in manufacturing) and Etibank (extractive industry). The ruling elite's main funds were concentrated in the Business Bank, which moved into a dominant position among the country's private banks shortly after its foundation in 1924. This was facilitated by the fact that Djelal Bayar, the bank's founder, a prominent politician, joined the cabinet as a Minister of Economy in the 1930s.

Before the Second World War, etatism contributed to reorganizing the Turkish economy in a number of fields, accelerating and strengthening large-scale business. Thus, from 1927 to 1938, the share of agriculture in the country's national income shrank from 67% to 47%, while that of industry rose from 10% to 16%, and that of the service sector expanded from 23% to 36%. Per capita income increased by nearly a third.[1] Turkey was able to pay off a significant part of the so-called Ottoman debt, overcome the foreign trade deficit, increase exports of cereals, animal produce and mining products, expand road building, etc.

The state, however, failed to industrialize and modernize the country. In effect, state intervention created the basis for a dual economy, in which free competition was confined to narrow margins and traditional low-productivity economic forms were quantitatively the most numerous. In a backward economy an enclave of a small number of state enterprises was created, benefitting from government privileges and having a special system of raw material supplies, credit, control and connections with foreign companies, etc.

The interaction and intertwining of state and large private companies (mainly in banking) contributed to the use and consolidation of a specific type of monopoly state-private-bureaucratic institutions which had neither a basis in history nor a modern industrial base. In the conditions characterized by a lack of mature market relations and the prevalence of a state sector, in Turkey huge monopolies emerged, first and foremost in the credit, financial, and commercial spheres. The tendency toward monopolization was not hindered by the fact that some investments were not large in absolute terms, because they had become concentrated within a narrow circle of individuals who relied on government assistance and had access to state funds. As a result, the political factor acquired special importance for investments since bureaucracy and corruption served as its breeding ground.

Although Turkey was not directly involved in the Second World War, the latter left a big impact on the country. The Turkish government strengthened state-monopolistic tendencies in the control and regulation of the national economy by directing its main efforts towards edging out non-indigenous (mainly Armenian, Jewish, and Greek) entrepreneurs out of the local market and replacing them with Turkish business. In January 1940, a special "Law on National Defence" gave the government unlimited economic powers. The State obtained the right not only to control the output of local factories but to determine the range of products to be produced. It also received the right to introduce compulsory labor conscription in rural and urban areas, to determine the price and volume of purchased agricultural products and industrial goods, to

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[1] *The First Five-Year Development Plan 1963–1967*, Ankara: Central Bank of the Republic of Turkey, 1983, p. 8

establish control of raw material supply and sales of manufactured products, to nationalize enterprises owned by private and non-indigenous entrepreneurs, to regulate exports and imports, profit margins, to impose additional taxes on producers, to reduce consumption of foodstuffs and industrial goods, etc.

Implementation of this and other regulations expanded governmental influence in the national economy. As a consequence, in 1938 the state factories employed only 12.6% of the labor force. In 1948 the percentage rose to 30%.[2] The state sector increased production of electricity, textiles, pig iron, steel, glass, paper, etc. The growth of output was chiefly stimulated by military orders. Consumer goods were mainly sold in the "black market", where the price level exceeded the official one by more than 4-5.[3] The state also received considerable earnings from the sale of strategic raw materials, consumer goods, and agricultural products to the warring countries. In the period from 1940 to 1945 the cumulative balance of Turkey's trade with the countries of the Axis and Allied blocs produced a surplus of 332,000,000 lire (Turkey's exports in 1945 were 219,000,000 lire).[4] Turkey received weapons and loans on favorable conditions from Germany, Britain, and the United States.

The favorable Turkish economic situation during World War II and the government's policies encouraged the growth and consolidation of local private entrepreneurship. As the magazine *Turk Ekonomisi* put it in 1951:

"We can definitely say that the capital accumulation in today's Turkey is sufficient to start industrialization in the private sector. But the accumulated capital is not in the hands of enterprising persons, or rather not in the hands of entrepreneurs who would wish to invest them in the industry."[5]

Still, supported by the state, namely by the Turkish Bank of Industrial Development which was set up in June 1950, and foreign investors, industrial growth continued. Prior to 1940, 344 large manufacturing enterprises (employing more than 10 workers), existed in Turkey while another 368 such enterprises were established in 1940–49, 556 in 1950–54, and 784 in 1955–59.[6] A number of big private firms (N. Edjadjibasi, H. O. Sabanci, V. Koc, D. Yasar, etc) acquired a leading position in the Turkish business community during and immediately after World War II.

The growth of the state and private economy was manifested in the way in which the problem of changing the country's model of development was addressed after the War. The change in Turkey's links with the world economy also had its impact. The Cold War brought Turkey closer to the West, with important military, political, and economic consequences. Of considerable importance was the aid to Turkey under the Truman Doctrine and the Marshal Plan. The total amount of American military aid to Turkey between 1948/49 and 1951/52 came to $ 687 million.[7] However, despite foreign aid and assistance, the Turkish economy progressed quite slowly. The Law on

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[2] *Turkiye'de ozel sector ve kalkinma*, Ankara: Turkiye Ticaret Odalari, Sanayi Odalari ve Ticaret Borsalari Birligi, 1966, p. 36.

[3] K. Boratov, *Turkiye iktisat tarihi 1908–1985*, Istanbul: Gercek yayinevi, 1989, p. 68.

[4] *Yeni Turkiye*, Istanbul: Ant, 1959, p. 267.

[5] *Turk Ekonomisi*, Ankara, No. 105, 1951, p. 89.

[6] D. Avcioglu, *Turkiye'nin duzeni (dun-bubun-yarin)*, Istanbul: Tekin yayinevi, Ikinci kitap. 1976, p. 729.

[7] M. Singer, *Economic Development in the Context of Short-Term Public Policies: The Economic Advance of Turkey 1938–1960*, Ankara: Ayyildez Matbaasi, 1977, p. 56.

Giving Land to the Peasants adopted in 1945 produced rather modest results and did not alter significantly the traditional system in the Turkish countryside. Based on this law, in the period from 1947 to 1950, 20,200 peasants purchased from the state only 90,900 hectares (nearly 230,000 acres) of uncultivated land. This should be compared to the fact that in 1963 over 413,000 of Turkey's 3,500,000 peasant households were landless. Additionally 2,000,000 peasants owned small plots of land whose output was not sufficient to support a family of four to five persons. Archaic economic relations survived in the countryside such as metayage, a barter economy, and artisan production. The yields of the main field crops were extremely low.[8]

The bulk of industrial output was produced by small scale artisan and low mechanized shops. Only about 2% of enterprises covered by the census could be classified as big industrial establishments. These employed some 37% of the industrial work force. Labor productivity remained at a level far below international standards. The value added index at state enterprises was growing by a mere 0.7% per annum, while the growth rate in the private sector reached 4%.[9]

A new political force representing the advocates of modernisation came to power in 1950 after a long spell of one-party dictatorship. The ten years during which the Democratic Party was in office saw many government attempts to adopt the Western system of free enterprise, to turn Turkey into "little America", to obtain aid and support from abroad on favorable conditions and, to modernize industry and agriculture. The fact that the Turkish economy had a mixed character was not taken into account.[10]

The state sector, however, remained strong. Investments in the state-owned economy grew seven fold and represented 48% of all investments. The state sector controlled as much as 35% of manufacturing capacity, 32% of the total volume of industrial output and 10% of the national income. More than two thirds of the country's bank assets was concentrated in state banks.[11]

Turkey also received a significant amount of foreign investment mainly from the United States. Several joint Turkish-foreign ventures came into being based on the altered Foreign Investments Law. In July 1958 the country took the first step to gain entry to the Common Market, by making a formal application. Foreign aid contributed to improved labor productivity. The value of agriculture, chiefly in Turkey's western regions rose by 69% in 10 years.[12] As a consequence, the characteristics of the dual economy and the gap between traditional and modern sectors increased.

The private sector continued to grow chiefly through increased business activities of corrupt bureaucrats, as well as large intermediary companies and firms whose management had close links with the government. During the decade-long rule of the Democratic Party, the number of registered companies exceeded those set up during

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[8] *Turkiye istatistik yilligi 1968.* (Statistical Yearbook of Turkey), Ankara: Devlet istatistik enstitusu maatbasi, 1969, pp. 166-67.; R. Aktan, "Turkiye ziraatinda produktivite," In: *Turkiye ekonomisinde produktivite meseleri.* Ankara: Iktisadin arastirmalar enstitusu, 1958, pp. 31–35.

[9] M. Singer, *Op.cit.* pp. 71–72, 74.

[10] Y. Rosaliev, *Ekonomicheskaya istoria Turetskoy Respubliki,* Moscow Nauka, 1980, pp. 179–184.

[11] *Ibid.* p. 191.

[12] *Turkiye'de ekonomik yapi degismeleri 1913-1988,* Ankara: TUSIAD, 1989, pp. 22–24.

the twenty-seven years of People's Republican Party domination by five times. While in 1950 the country had only 802 companies, in 1960 their number rose to 3,996.[13]

Although Turkey still lagged behind developed countries, large-scale companies gained ground. The share of the top 10% of plants and factories in industrial output reached nearly 75%. A few companies came to dominate Turkish business. In 1952, 4% of all companies took 70% of total company profits. In the early 1960s, 5% of all taxable firms enjoyed 86% of total company income. The rest of the companies (95%) had to be content with the remaining 14% of all profits.[14]

High revenues were accruing to the Business Bank which was headed by the President of the Republic and served as a center of gravity for top businessmen and politicians. According to our estimates, this bank had accumulated assets equalling nearly 50% of private banks' assets, 70% of the shares in joint-stock companies, and about 50% of deposits, and 40% of profits by the 1960s.[15] Thus, the degree of modernization was quite extreme. The dual character of Turkey's economy, however, survived. The drive to get rid of the traditional economy failed to create a modern market mechanism of economic growth in a country which had retained remnants of semi-natural economic forms and effects of a long-practiced policy of etatism. Private firms found it more profitable to invest not in the industrial sector but in banking and commerce. A developing modern economic sector remained an island in the sea of a self-sufficient traditional sector. Underdeveloped market relations had disrupted the sequence of development and interaction of various economic forms, thus creating a real threat to the living standards of a wide stratum of people generating their means of existence in the traditional economy. This, in turn, exacerbated social tensions.

The high rates of growth registered in the first years of the Bayar-Menderes government were followed by an economic decline. By 1956, production started to contract and commodity circulation to fall. Imports declined by 18%, and in 1958 they were dropped another 20%. By 1958 exports had plunged by 28%. The average annual growth of real per capita income had slowed from 8.8% in 1952 to 0.7% in 1956 and to 1.1% in 1959.[16] National and foreign debt soared. From 1950 to 1960, prices increased approximately three times. Inflation raised its head. Under-utilization of industrial capacities reached significant levels. The spread of unemployment was unprecedented. The state budget deficit widened and the foreign trade balance worsened.

The difficulties experienced by the entire economy aggravated the internal political situation. An anti-governmental movement gathered momentum. It was in this context that top generals carried out a coup d'etat on May 27, 1960. The country's government was placed under arrest and later brought to trial.

The coup produced significant changes. The thrust of the policies pursued by the military authorities (The Committee of National Unity) was directed at an attempt to embark on transformations in the interests of numerous small enterprises in towns and

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[13] *Turkiye istatistik yellegi 1964–65*. Ankara: Devlet istatistik enstitusu, 1965, p. 362.

[14] Y. Rosaliev, *Osobennosti razvitiya kapitalizma v Turtsii*, Moscow: Nauka, 1962, pp. 199–200.

[15] *Turkiye'de ekonomik yapi degismereli 1913–1988*, Ankara TUSIAD, 1989, pp. 24–25.

[16] Y. Rosaliev, *Klassy i klassovaya borba v Turtsii*, Moscow: Nauka, 1966. pp. 9–31. V. Danilov, *Politicheskaya borba v Turtsii*, Moscow: Nauka, 1985. pp. 45–55.

villages, to reduce the huge gap between top layers of corrupt bureaucratic finance and the bulk of entrepreneurs, to eliminate, or at least, to place under the control of public opinion, red tape, corruption and bribery and to stop the country's slide towards economic collapse. In sensing the necessity of correcting the process of development of a market economy so that it would not do harm to the bulk of the population, the Committee of National Unity adopted a number of stabilizing measures. The state sector, however, continued to serve as the basis for the adopted policies, receiving additional privileges and funds, under the conditions of intensified political contradictions, debates, and attempts made by representatives of rival parties to bring pressure on the government.[17]

However, the end of the "transitional period" and the adoption in 1961 of a new Constitution of the Turkish Republic (the previous one had been adopted in 1924), which gave more rights and liberties to the population and political parties, failed to bring peace and accord to the country's politics. On the contrary, the internal struggle intensified, often drawing in large masses of people. Successive coalition governments, attempted coups, referendums and elections, and mutual accusations of "poor leadership", patronage of extremists and links with imperialism and communism, etc. did nothing to clear the way for a new economic model and produced a negative impact on the development of a market economy. The country's politics did not focus attention on the cardinal problems of long-term modernization of Turkey, but highlighted short-term problems such as inflation, wage levels, government debt, budget and foreign trade deficits, etc. Successive governments did not set for themselves the task of switching to a market economy. In fact, past history seemed to repeat itself, with the governments attempting, by the use of old methods, to improve economic performance. Plans drafted by governments of various orientations on the whole envisaged state sector-based development, while also luring private Turkish and foreign investment, although the desired level of foreign participation was limited. The plans did not pay much attention to market relations (apart from the capital market), to inter-links and interactions of the various economic sectors. Problems of everyday life and the survival of the majority of the population employed in the traditional economy were not taken into account by planning officials. It was believed that the growing large-scale production would by itself raise labor productivity in all fields of industry and agriculture, level growth rates in different regions and economic zones, and improve the living standards of the entire population.[18]

Concentrating the planned efforts of state and large-scale firms in selected directions produced positive results at first. In the first five-year plan the annual growth of GDP averaged 6.7%, in the second – 7.2%, and in the third – 8.5%, in spite of the devastating oil crisis. However, at the same time Turkey was running into serious economic difficulties caused by disproportions in the shares of existing economic sectors in the national economy, the flood of impoverished peasants into towns, and the decreased consumption. Shortcomings in the planning process had an extremely

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[17] *Second Five-Year Development Plan 1968–1972*, Ankara: Central Bank of the Republic of Turkey, 1969, pp. 4–5.

[18] O. Ozbek, "1982'den 1983'e gecerken tarim ekonomisin sorunkari ve cozum yollari," In: *1982'den 1983'e Turkiye ekonomisi semineri*, Ankara, 1983, pp. 209–216.

adverse effect on agriculture: none of the planned targets in the fourth plan in this sphere was reached. Moreover, output declined. Small-scale agriculture was faced with higher prices of machinery and agricultural tools, marketing difficulties, and the lack of cheap credits, fertilizers, fuel, etc.[19] The dual rural economy, the co-existence of modern and traditional forms, dynamism and stagnation, cash crop production and natural economy – the latter constituting over half of all agricultural households – continued to exist. The urban areas and industry also continued to find the going very hard. By the end of 1979 internal public debt had reached 240 billion lire, with accumulated interest equalling as much as 236.8 billion lire.[20] The country's foreign debt totalled $ 8.8 billion. To service the foreign debt during the period between 1960 and 1979, Turkey had to allocate 18% to 39% of its export earnings. The annual deficit of foreign trade balance increased from $ 359 million in 1970 to $ 2.8 billion in 1979. The imports exceeded the exports by 30% to 40% annually.

Turkish analysts reported that technology used in the Turkish industry continued to be inferior to modern standards by 30 to 40 years.[21] A large proportion of city dwellers (21.8%) still inhabited *gedjekondu*, i.e. buildings built during one night. In 1975–1979 the annual average inflation rate increased between 33% and 60%. The index of peasants' income in 1978 fell to 74.2%, that of employees to 65,7% and that of industrial workers to 57% compared to 1970.[22] The economic difficulties experienced by the country and the aggravation of the social climate were important factors in the political uncertainty and continual threats of military coups. More than twenty governments were in office between 1962 and 1983. Especially frequent changes in government followed the military coup of 1971.[23]

However, the process of the formation of a nation-wide market economy, which had already begun, continued to unfold. Prices of commodities and, especially important, the price of agricultural commodities were gradually and slowly levelling across the whole country. Production of investment goods increased. In the period from 1970 to 1985, the wheat crop index rose to 160–170 points, that of potatoes to 150–200, of cotton to 130, of tobacco to 120, of beets to 220, of sunflowers to almost 200, etc. However, production of a number of traditional agricultural commodities did not rise appreciatively, while that of others like rice, olives, grapes, nuts saw a decline. The range of fluctuations in the annual growth of agricultural output was considerable (0.1% to 2.8%; valued at 1968 prices). Only in 1982 did the growth rate reach 6.4%, to be followed by another decline.[24] More stable growth rates of 3.4% to 6.3% per annum characterized the industrial sector. Yet a slowing of growth and even a decrease of output were more frequent and deep in a number of industries. The share of industrial goods in the total volume of exports increased from 18.5% in 1964 to 30.4% in 1976.[25]

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[19] *Iktasadi rapor 1980, Turkiye ticaret odalari, Sanayi Odolari ve Ticaret Borsalari Birligi*, Ankara: Ayyildez Matbaasi, 1980, p. 361.

[20] O. Oguz, *Turkiye – Ortak pazar andlasmanin ozel sektore yukledegi gorev ve mukellefler*, Istanbul: IAT, 1967, p. 17.

[21] *Second Five-Year Development Plan*, p. 56.

[22] *Economic rapor 1978*, Ankara: Disk Arastirma Enstitusu yayinlari, 1979, p. 42.

[23] *Turkey 1988. An International Comparison*. Istanbul: DEIK, 1988, p. 21.

[24] *The Turkish Economy 1986*, Istanbul: TUSIAD, 1986, pp. 4, 30.

[25] *Turkey. An Economic Survey 1977*. Istanbul: TUSIAD, 1978, p. 151.

A larger volume of business transactions carried out at commodity exchanges testified to a greater spectrum of goods entering the sphere of circulation. In 1977–79 trading increased by 31.6%. Even allowing for inflation, the rise in the volume of trading was remarkable.

Thus, during the 1970s the rate of Turkey's economic growth was relatively slow and uneven. It was becoming increasingly obvious that drastic measures were needed to speed up the country's economic modernization.

2. Marketization and Privatization in the 1980s

Beginning in 1979, Turkey's leadership began to draft a new strategy of economic modernization. On January 24, 1980, the main propositions of the new economic program were published.

The new course of "economic stabilization" differed in principle from previous projects. The novelty was that a deliberate attempt was to be made to create a "genuine market economy" by "reducing state interference in economic affairs and subordinating it to a price-setting and market mechanism,"[26] as well as by lifting limitations on entrepreneurial activities, liberalizing foreign economic operations, allowing free price formation for state enterprises, privatizing state property, leaning towards foreign standards and integrating the country into the world community. Account was taken of the experience gained in the developed and newly industrializing countries of Asia.

The program ran into some opposition in parliament, the press, and at the Second Economic Congress held at Izmir. Main objections centered on the complexity of transforming the state sector, the prospects of attracting foreign capital, and overcoming economic difficulties within a short time. The process of transformation was also delayed by the coup d'etat of September 12, 1980, which led to the formation of the National Security Council, the dissolution of parliament, the ousting of the government of Suleiman Demirel, and the suspension of political parties. The new course became a real possibility only when the Motherland Party headed by Turgut Ozal won a victory in the 1983 elections and formed a civilian government.

The growth of real GDP during the 1980s was as uneven as in the previous years and was lower than in countries such as Thailand and South Korea.[27] The annual growth of industrial production between 1980 and 1990 averaged 6.7%. In 1991 industrial production grew by 2.6%, agricultural output by 1.5%, and the service sector by 0.9%.[28] The shares of different sectors in the GDP saw a marked change: that of agriculture decreased from 29.6% to 19.6%, while that of industry increased from 23.5% to 27.8%. The contribution of the service sector remained at about 52% to 53%. However, the growth of industrial output had not influenced significantly the progress of market relations nor the volume of commodity and services exchange. In

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[26] *Economic report 1983*, Ankara: Union of the Chambers of Commerce, Industry, Maritime Trade and Commodity Exchanges of Turkey, 1983, p. 1.

[27] *Turkey 1992. An International Comparison*, Istanbul: DEIK, 1992, pp. 41, 90.

[28] *Turkey. Fortnightly Economic Newspaper*, Istanbul, April 15-30, 1992.

part, this is accounted for by the structure of the Turkish industry: while in the EC countries investment goods make up 40% of industrial production, in Turkey the corresponding figure is only 15.7%.[29] Turkish exports mainly consist of textiles, ready-made clothes, foodstuffs (20% of the total volume of exports), leather and steel. On the whole, Turkish industry exports only 10% of its output, as compared to the 25% exported by the EC countries.[30] The competitiveness of Turkish goods on the world market is quite low.

Per capita national income reached $ 1,370 in 1989. This was higher than in Tunis ($ 1,260) or Thailand ($ 1,220), but was eleven times less than in Italy, nine times less than in Spain, and four times lower than in Greece.

The purchasing power of a Turkish citizen (based on purchasing-power parity) in 1984–1990 increased from $ 2,270 to $ 3,316 (a growth of $ 1,046). The corresponding figures for the same period in the EC countries were $ 11,052 and $ 15,608. The growth of purchasing power of a Japanese citizen was twice as high as the total purchasing power of a Turk.[31]

It would seem impossible to reduce this gap without improving labor productivity across-the-board and securing a harmonious development of all the economic sectors. However, in Turkey this is unlikely in the foreseeable future. What seems more likely is an increase in the confrontation between various sectors of the economy.

A majority of Turkey's population (57.1%) is still employed in agriculture while industry gives employment to 17.5%, and the services to 25.4%. Thus the employment structure still represents a pre-industrial stage.[32] While during the 1980s per capita agricultural output increased significantly in countries such as Indonesia, Portugal, and Spain, in Turkey the 1990 figure was 96.8% of the 1980 level.

Mechanization of the Turkish agriculture remained backward. Turkish economists have pointed out that although the country has 672,800 tractors, the number of tractors per 1000 hectares (roughly 2,500 acres) of cultivated land is only 23, while in Germany it is 199 and in Italy 101. In the use of fertilizers, Turkey is well behind Portugal, Spain, Greece, Indonesia, not to mention more developed countries.

The main reason for the slow development of agriculture appears to be tenacity of the backward social structure in the countryside. The Turkish authors have stressed the extreme diversity of farming, and the level of output and money-commodity relations in Turkish agriculture. The dual nature is a common phenomenon.

"In agriculture one can daily see co-existence of modern and traditional forms, of dynamic development and stagnation. The part of market-oriented agriculture and the part of agriculture which goes to meet personal consumption have shown differences in the level of production and development. These two parts of production have quite different producers, equipment, and production technology, different sources and means of financing, different marketing organization and different objectives of production."[33]

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[29] *Iktisadi rapor 1989*, Ankara: Ayyildiz Matbaasi, 1989, p. 98.
[30] *Istambul Sanayi Odasi Dergisi*, Istanbul, November 15, 1989, p. 16.
[31] *Turkey. An International Comparison*, Istanbul: DEIK, 1992, pp. 38–39.
[32] *Iktisadi Rapor 1989*, Ankara: Ayyildiz Matbaasi, 1989, p. 37.
[33] *Ibid.* p. 81.

These differences appear to be the determining factors behind the diversity of agricultural productivity and foodstuffs consumption.

According to our estimates, only 15% of rural households in today's Turkey can be defined as market oriented farming supplying the urban and rural population with the bulk of agricultural goods. On the other hand, 58% of rural producers possessing roughly 20% of arable land practically do not bring their product to market barely, making both ends meet.

The rest of the small landowners and landholders engaged in semi-natural farming market from 20% to 40% of their produce. In addition, nearly a third of the rural population is landless. They are obliged to sell their labor power or to carry out community duties often being paid in kind.

Drawing a majority of rural producers into market relations can take place by increasing the share of production of small farms, intensifying their farming, supplying them with machinery and equipment, overcoming the multi-layer structure and disintegration of production, and integrating them in large-scale production units with sufficient land plots. Resolving these problems would require a huge input of investments, know-how, training, and a long period of readjustment.

Solving the problems of intensifying the rural and urban economy is closely linked with the privatization of state property, which still makes up a considerable share of Turkey's economy. The program of privatization began to be drafted in 1984. It became part of new economic policies. The required transformation was institutionalized by the laws of February 29, 1984, May 28, 1986, and April 10, 1990. Practical implementation of the proposed plan started only in 1988 after the problem had been closely examined by Turkish and American (Morgan Bank) experts.

After an all-round examination, the Commission of the Association of Turkish Industrialists and Businessmen concluded that the state sector continues to absorb considerable sources thus feeding the huge bureaucratic machinery, and halting reconstruction.[34] State economic organizations (SEO) shielded from domestic and foreign competition were blamed for mismanagement, a series of wrong investment decisions, a mistaken choice of technology, organization of research, and practical use of their results. They concluded that only privatization could compel the Turkish industry to embark on reconstruction and modernisation already taking place in the world economy.[35]

In the late 1980s the private sector was dominated by 300 to 500 companies (about 2.5% of total) which owned 90% of industrial equipment, employed 60% of the labor force, and produced 80% of output. The remaining 19,400 firms, of which 36,2% employed less than 50 workers, had to do with a very small share of all the revenues.

In today's Turkey there are 25 to 30 companies which control the country's economy. At top of the list is the Turkish Oil Company (1984 sales $ 4.8 billion) Koc Holding AS ($ 2.6 billion), H.O. Sabanci AS ($ 2.5 billion), Turkiye IS Bankasi AS ($ 3.8 billion), Akbank AS ($ 1.7 billion), etc. These companies belong to the largest corporations of the world.

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[34] *TUSIAD Report on Privatization. (The Special Conditions and Framework for a Successful Implementation).* Istanbul: TUSIAD, 1987, pp. 1–2.

[35] B. Kuruc et al., *Birakiniz yapsinlar birakiniz gecsinler. Turkiye ekonomisi 1980-1985*, Ankara-Istanbul: Bilgi yayinevi, 1987, pp. 16, 98–100, 117, 130.

The holding companies are organized on quite modern lines. Thus Koc Holding AS (30,000 employees) has interlinked by mutual participation around 130 companies operating in main industrial branches, banking, insurance, show business, etc. The group's 1985 sales totalled 35% of the national income derived from trade; the company controlled 20% of Turkey's foreign trade. Turkiye IS bankasi AS (Business bank) is closely affiliated with the Koc group.

The H.O. Sabanci Holding AS Corporation owns shares of 100 companies (30,000 employees) operating in main industrial branches, textiles being its most important business (subsidiaries Bossa, Sassa, Tekssa, Yunssa, Insa, Pilsa, etc). The Sabanci textile companies group holds the third place among the world's ten biggest textile companies. The group has four banks – Yapi ve kredi bankasi, Akbank AS, Pamukbank AS, and Interbank AS. The Sabanci Corporation controls around 15% of Turkey's export-import transactions and is among the world's biggest companies.

Enka Holding AS group consists of about 50 industrial, construction, trade and ther companies (25,000 employees). It is engaged in various projects in Arab countries, Russia, Belarus, etc. It controls about 25% of Turkey's foreign transactions and holds the thirteenth place among the world's top twenty construction companies.

In 1990 about half the assets of all the 62 Turkish banks were concentrated in 9 state banks, of which the Agricultural Bank was the biggest, with 20% of all assets. Among the 53 private banks, five had assets in excess of $ 4 trillion lire. These banks held 62% of all private bank assets and generated 60% of profits.[36]

Business Bank was Turkey's biggest private bank controlling 20% to 22% of all banking operations, with 15% of all deposits and 950 branches across the country, i.e. twice as many as all other big private banks. It also had 1,100 branches and correspondent's facilities in a large number of countries. The bank received 11–15% of all banking revenues.[37] Among the biggest banks were Yapi ve kredi bankasi AS, Akbank AS, etc.

The growth of economic strength and the influence of domestic monopolistic capital were running into a conflict with the archaic system of the state sector, the red tape and corruption engendered by it, the slow evolution of market relations, the unequal terms of conducting business in different sectors, and the disorganizing influence of state enterprises on the country's economy. Privatization was acquiring wider support in Turkish society and ideological justification within the country. On the other hand, privatization is increasing the gap between the modern and traditional small-scale sectors.

Privatization began with the sale of shares of big state companies: Sumerbank, a long-time leader of state enterprises in the manufacturing industry, Petkim, a leading shareholding company in petrochemicals, Turkish Airlines, 15 other companies, 5 banks and state participation in 64 other companies. The sales of shares were arranged through large private companies and banks. Thus Business Bank was in charge of handling the selling of shares of Arcelik Co, Eregli demir ve celik fabricasi AS, Cukurova elektric AS, etc. 1990–1992 saw the sales of companies dealing in the trading of oil, packing, Turk tracter group of factories, etc. Although privatization is

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[36] Author's calculations based on S. Abac ve IBAR grubu, *Turkiye'de bankalar ve bankacilik sistemi 1990*, Istanbul: TUSIAD, 1990, pp. 296, 300.

[37] *Economic Dialogue. Turkey.* Ankara: S. Ozgencil, July 1990, pp. 30–33.

underway, however etatism is holding ground, which impedes the creation of a modern market economy.

The way of transformation is also blocked by the lack of macro-economic stabilization. Inflation, a huge deficit in the country's foreign trade and state budget, runaway growth of public domestic and foreign debt, bureaucracy, corruption, unemployment, and poverty is suffered by a large part of Turkey's population.

A number of official data which are often refuted or supplemented by the press which considers them an understatement could be given to illustrate the above point. The state budget deficit widened from $ 4 trillion lire in 1988 to $ 32 trillion in 1991, making up 32% of the budget. The official exchange rate of the dollar to the lira grew from 160.9 lire to 6,605 lire to the dollar. Turkey's foreign trade balance has been in continual large deficit. In 1989 it was $ 4.2 billion, in 1990 – $ 9.6 billion, and in 1991 – $ 7.3 billion.[38]

In comparison to Greece, South Korea, Portugal, Thailand, and Tunis, Turkey had the greatest volume of foreign debt – $ 41.6 billion.

According to official data, Turkey has one of the highest unemployment rates — 10–12% of the work force. 1.5 million Turks are currently employed outside Turkey.

Despite all government efforts, generous aid and assistance to Turkey from the West, the country's economic difficulties have continued.

The switch to a market economy in Turkey has run into old institutions and inertia. A serious obstacle is the excessive and ever growing monopolization of industry and banking. Monopoly means restriction of free competition, the suppression of the initiative of small and medium-size business, and interference with the interaction of various economic sectors. Being the main component of a market economy which has so far been rested in the upper layers of Turkish society and has not penetrated its inner layers, the Turkish market system is more a result of external influence rather than an organic internal development.

The formation of a modern market economy in Turkey has also been impeded by political instability, the continual threat of army intervention in the nation's politics and economic affairs, which the country witnessed a number of times in the past. The sad traditions of using the army to "bring order" and compel the government to "change its policies in the required direction" are a factor of uncertainty and testifies to the complexity and strength of the obstacles with which the chosen road is strewn.

The same should be said about the dual character of Turkish society, the still large number of self-sufficient peasants, and the extreme income gap between the different economic sectors which are the cause of limited consumer markets and continued social instability.

Vestiges of paternalism and the order of seniority are still found even at the biggest enterprises. The introduction of state-of-the-art methods of production organization has given rise to a peculiar synthesis of old and modern types of industrial relations many of which are outside the scope of the labor laws now in force.

The conclusion that can be made is that Turkey appears to have already left behind a significant part of the way leading to the creation of a modern market economy. It would seem that the country's leadership is set to continue the program of transformation, paving the road for a dynamic modern market economy while paying due attention to Turkey's historical and economic background.

[38] *Turkey 1992. An International Comparison*, Istanbul: DEIK, 1992, pp. 20, 71.

BELDONA V. RAO

Transition to Market Economy: India's Experience

– Transformation "With a Human Face"? –

Introduction

Four decades of planning plunged the Indian economy in dire distress thereby leaving no choice for the new policy makers but to think of alternative models of development. The balance of payments crisis in mid-1991 may be described as the worst of its kind in the post-independence era and warranted a quick and effective management. The minority government led by Prime Minister P.V. Narasimha Rao of Congress Party had to seek urgent financial assistance from International Monetary Fund and World Bank (Fund/Bank) to deal with this crisis, and they agreed on condition that the government adopted the stabilization and structural adjustment program. The liberal reforms suggested by Fund/Bank would throw open the Indian economy to privatization, marketization and globalization. In the first section an attempt is made to show how the Indian economy had become "inward-looking" (or turned to import-substituting industrialization) under planning; the second deals with the problems of transition to a market-friendly economy; the third briefly discusses the likely impact of the market economy on vulnerable sections of Indian society.

1. Import-substitution, Planned and State-controlled Economy and its Collapse

After India achieved Independence (1947), the Indian statesmen and policy makers were faced with the problems of a colonial legacy – economic backwardness and social injustice.[1] Jawaharlal Nehru dreamed of India's planned economic development to achieve socialism. He rejected the Western capitalist model and also a Stalinist-type of regime as unsuitable for India. Instead he preferred the Fabian approach.[2] The leading industrialists joined the policy makers in evolving a mixed economic system to achieve the goal of a socialist pattern of society. They arrived at an understanding, known as the Bombay Plan, in which the government was given a paramount role, and the private sector a minor role in directing, controlling and supervising industrial development. The leading industrialists tacitly gave consent to restrictions imposed on private enterprises. In the course of time, the private sector got side-lined, and planning and policy makers evolved "a planned system more

[1] For a review See: B. Chandra, "The Colonial Legacy." In: B. Jalan (ed.), *The Indian Economy: Problems and Prospects*, Delhi, 1992, pp. 1–13.

[2] See: D. Lal, *The Hindu Equilibrium: A Cultural Stability and Economic Stagnation*, Clarendon Press, Oxford, 1988. pp. 232-33.

suited to a command economy and an economic administration more suited to regulation and control."[3] The Planning Commission was established in March 1950 and the second Five Year Plan (1956-61) got off the mark on the basis of Nehru-Mahalnobis model in spite of its limitations.[4] This model set the future pattern of India's industrial development without any hesitation from the leading industrialists.[5]

The Industrial Policy Resolution of 1948 envisaged the working of the public sector under government patronage and the private sector by leading industrialists for the progress of India's industrial development. The Planning Commission, under the chairmanship of the prime minister, decided the overall savings and investment, the size of the plan and sectoral allocations. The elements of regulation and control may be traced to the Industrial (Development and Regulation) Act of 1951. The Industrial Policy Resolution of 1956 prepared a blueprint for the undertaking of rapid industrialization thanks to the ideas of Mahalnobis. The state-owned enterprises producing capital goods were given a commanding role capturing the "commanding heights of the economy" while the private sector was satisfied with production of consumer goods and agricultural products, all catering the needs of a planned economy.

The planning commission realized the paramount necessity of state intervention in determining the pattern of public investments, production pattern, and redistribution of economic benefits to the masses on the principle of "growth with social justice." The second Five Year Plan further envisaged a rapid expansion of the public sector which was given the task of building the industrial infrastructure, "which the private sector is either unwilling or unable to undertake." The plan documents of the first three Five Year Plans expressed the desire of achieving more equitable distribution of income, "raising living standards," national income and employment," and granting the "benefits of economic development to the relatively lessprivileged social classes" to establish "greater equality of opportunity and bring about reduction in [social and economic] disparities." All the objectives of the plan could not be achieved, and it became clear at the end that "concurrence of growth with equality has had to be abandoned in favor of growth alone, with little emphasis on distribution."[6]

The policy makers and planners conceived the idea of a price mechanism that would suit the objectives of the plan rather than the principles of the market. The price mechanism would be controlled by the state bureaucracy. Thus the "market failures," found so common in the Western capitalist economies, would not occur in India. It was believed that efficient bureaucrats who understood the signals of the market would accomplish the twin objectives of resource mobilization and allocation for the plan outlays. Their hopes were belied within three decades, since market principles

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[3] R. Mohan, "Industrial Policy and Controls." In: B. Jalan (ed.), *Op.cit.* p. 93.

[4] On the limitations of the Mahalnobis model and strategy see: S. Sarkar, "Growth Perspectives of the Eighth Plan: A Two-Sector Open Economy Framework." *Economic and Political Weekly,ff* Bombay, Vol XXVIII. Nos. 27 and 28, 1993. p. 1453. Also see J.W. Mellor, *The New Economic Growth: A Strategy for India and the Developed World*, Ithaca: Cornell University Press, 1976. pp. 3–4.

[5] See: P. Bardhan, *The Political Economy of development in India.* Oxford: Blackwell, 1984, p. 40.

[6] D. Banergee and A. Ghosh, "Indian Planning and Regional disparity in Growth." In: A. Kumar Bagehi (ed.), *Economy, Society and Policy: Essays in Political Economy of Indian Planning.ff* Calcutta, 1988. p. 105.

could not be thwarted. In the end it became evident that like "market failure" there could be "government failure" or "bureaucratic failure" too.

The private sector, which was assigned a minor role, was to operate in areas other than that designed for the public sector and was subjected to an industrial licensing system. It was to invest in areas specified in the government's list of priorities and these included grains, agricultural products, consumer goods and some capital goods. The licensing control system became more restrictive in outlook with the passages of Monopoly Restrictive Trade Practices (MRTP) of 1969, and Foreign Exchange Regulation Act (FERA) of 1973. The former prevented large business houses from establishing monopolies, the latter restricted all kinds of imports and exports. There were other restrictions which hindered private initiatives. An application to establish a private enterprise required various licenses causing not only delay but additional expenditure in view of rising costs.[7] lthough these controls were introduced with good intentions, they became useful tools in the hand of vested interests and corrupt bureaucrats for "rent seeking", and instead of promoting industrial development they hampered it. Eventually the control system became rigid with pernicious effects on investments. Some 836 industrial products were reserved for small-scale enterprises thus preventing successful small firms from competition.

The deleterious effects of the regulation and the licensing system were felt by the industrial sector as early as the late 1960s. Four committees were set up to examine the issue, but the recommendations, with a few exceptions, were not implemented.[8]

To insulate domestic industry from undesirable foreign competition, the government extended a ring of protection by building a high tariff wall. The growth in industrial production, however, generated a need for importing raw materials. Unfortunately, import policy, till the mid 1970s aimed at reducing the need for imported raw materials, foreign capital, and technology. The policy of "domestic production for domestic market" in the name of "self reliance" engendered what is known as "export pessimism." India's exports declined considerably in the 1960s, resulting in a recurrence of a balance of payments crisis. This was at a time when the volume of world trade was increasing by leaps and bounds.[9] In the 1980s India's share in the world trade showed a steep decline down to 0.4%. Indian products lost their competitiveness in foreign markets due to poor design, low quality, and high costs resulting from outdated technology.

Foreign investments in India played no significant role due to the MRTP, Indian Patent Act (1970) and FERA. Foreign enterprises were allowed 40% of the equity capital and permitted to operate in restricted areas of trade and commerce. There was a fear that foreign investments would bring about foreign interference and foreign domination in industrial and business sector; it was this attitude that discouraged the inflow of foreign exchange and technology transfer.

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[7] Mohan, "Industrial Policy and Controls." In: B. Jalan (ed.), *Op.cit.* pp. 96–97. Also see his, "De-licensing." In: *Seminar,* New Delhi, 1991; A. Heston, "Indian Economic Reforms: The Real Thing?" *Current History.* Vol. 91, No. 563, 1992. pp. 113–14.

[8] R. Mohan, *Op.cit.* pp. 97-99.

[9] For export policy and lost opportunities see: J. Bhagwati and P. Desai, *India: Planning for Industrialization.* London: Oxford University Press, 1970, p. 370.

In 1989 a communist country like China allowed $ 3 billion foreign direct investment, where India permitted only $ 100 million. During the premiership of Shri Rajiv Gandhi, the tight hold on inflow of foreign capital was relaxed. He believed that foreign investment would bring superior technology to the industrial sector, and, in the long-term, become instrumental in bridging the widening trade gap. He even conceived of a large role for the private sector in view of the dismal performance of the public sector.

The expansion of the public sector was phenomenal, and by 1991 there were 246 units, of which 236 were operating with a capital of Rs.101,797 crores. They showed a net profit of Rs.2,368 crores, a paltry 2.3%, and the bulk came from the oil sector. Regarding the share of the public sector in the gross domestic savings, it declined from 20% in 1981 to 8% in 1990; and with reference to the GDP, it declined from 4.6% to 1.7%. With regard to departmental enterprises of all the states and union territories of India, they incurred loss estimated at Rs. 1,827 crores in 1991–92. The State Electricity Boards and State Road Transport Corporations incurred a further loss of Rs. 4,169 crores and Rs. 470 crores respectively in 1990–91.[10] Besides, a large number of sick public sector units received subsidies amounting to Rs. 15,000 crores annually in recent years. Therefore the poor performance of the public sector, which had captured "commanding heights," came under scathing attacks for showing low-rates of return, poor capacity utilization, and declining contribution to national savings.[11]

The regulations and licensing system deterred investments in the private sector which was also not showing considerable improvement in spite of its motive being profit-maximizing and efficiency. The number of profit making companies declined from 1,368 in 1985–1986 to 1,164 by 1987–88, and gross profit as a percentage of sales also declined from 9 % to 7.8 %.

While the public sector showed poor returns, government expenditure had been enormously growing since the 1980s and it had resorted to borrowing. Persistent and growing fiscal deficits placed the Indian economy in terrible distress, thus causing stagflation and balance of payments crisis. In 1990–91, it was running at Rs. 43,331 crores, i.e. at 8.4% of the GDP. As for inflation, it began in October 1990 at a modest 7%, rapidly rose to 13.7% in February 1991, and finally reached its peak at 16.7% in August 1991. The Gulf crisis coupled with import liberalization in 1990–91 plunged the Indian economy to the verge of bankruptcy. Non-resident Indians withdrew their deposits on an average of $300 million a month from their accounts in India, and international commercial institutions lost their faith in the viability of Indian economy. The foreign exchange reserves declined to Rs. 2,383 crores ($ 1 billion). As mentioned earlier Rajiv Gandhi's economic liberalization remained short-lived and could not halt economic decline.[12] India's external debt stood at the staggering figure of $ 70 billion in 1991. From an international perspective it 'reflected the lack of confidence and "Government inability to manage the situation."[13]

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[10] *Economic Survey 1990-91*. Part II. Ministry of Finance, Government of India, New Delhi, 1992, pp. 20–22.

[11] D. Lal, *Op.cit.* p. 284.

[12] A. Kohli, "Politics of Economic Liberalization in India." *World Development*, Vol. XXVII, No. 3, 1989, pp. 305-28.

[13] *Economic Survey 1990-91*. Part I. p. 6.

2. Stabilization, Liberalization and Privatization: Towards a Market Economy

The International Monetary Fund and the World Bank reiterated their willingness to assist the newly-formed Congress Party minority-government, which assumed office in June 1991, if their conditions were accepted. Moreover the minority government of P.V. Narasimha Rao and Finance Minister Manmohan Singh realized the futility of pursuing the industrial policies of the 1950s in the current context. The New Industrial Policy of July 24, 1991, occupied the center stage of the New Economic Policy, stating: "many of the public enterprises have become a burden rather being an asset to the government." [14] With regard to the private sector, it referred to "major policy initiates and procedural reforms are called for in order to actually encourage and assist Indian entrepreneurs to exploit and meet the emerging domestic and global opportunities and challenges." [15]

The Trade Policy reforms were intended to achieve a "rapid growth of exports to overcome our persistent balance of payments problems, restore international confidence and achieve true self-reliance with an expanding economy." [16]

Anne O. Krueger rightly says that "One of the major difficulties with liberalization is that it is usually undertaken in the midst of an exceedingly difficult situation, and often in crisis atmosphere." [17] Forty years of planning policies and strategies under the Congress Party government had nurtured groups of vested interests, and attempts to liquidate them through new policies would encounter opposition. The New Economic Policy of Narasimnha Rao's government has challenged the wisdom of Nehru's Fabian Socialism and Mahalnobis's theoretical vision. Hence, the problems of the new dispensation stem from ideological differences.

The Indian economy which was now poised for marketization, privatization, and globalization has had to contend with criticism relating to the conditionalities attached by the Fund/Bank for releasing the much-needed economic assistance. Indira Gandhi had rejected the Fund's assistance in 1981 in order to avoid the undesirable conditionalities. The Fund/Bank policies of reform have been subjected to serious scrutiny in recent years, and its inadequacies have been pointed out before when implemented in the Third World countries in general, and India in particular.[18] While the Fund/Bank contends that their package of reforms would release the "unsuspected and unknown energy potential" of the Indian economy, many still suspect that it will benefit only the 10% to 15% well-to-do sections of the population and land India into a serious "debt trap." [19] Manmohan Singh allayed the fears of the Indian economists about the conditions but it did not have the desired effect.

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[14] Statement on Industrial Policy. Paragraph 31.

[15] In: B. Jalan, *Op.cit.* p. 82.

[16] *Ibid.* pp. 82–83.

[17] In: A.C. Harberger (ed.), *World Economic Growth: Case Studies of Developed and developing Nations.* San Francisco, 1984. p. 412.

[18] For a critique of the IMF model see: R. Sau, "Financial Programming for Stabilization: Some Notes on the IMF Model." *Economic and Political Weekly,* Vol. XXVII, Nos. 10 and 11, pp. 531–34.; K.P. Levitt, "IMF Structural Adjustment: Short-Term Gain for Long-Term Pain?" *Economic and Political Weekly*, Vol. XXVII. No. 3, pp. 97–102; M. Rakshit, "The Macroeconomic Adjustment Program: A Critique." *Economic and Political Journal,* Vol. XXVI, No. 34 pp. 1977–88.

[19] A. Gosh, "Management of Economy and IMF Conditionalities." *Economic and Political Weekly,* Vol. XXVII. Nos. 1 and 2. pp. 14–15.

The Fund/Bank strategy of dealing with balance of payment crisis, i.e. stabilization program, was accepted and carried out by the Indian government. A sharp devaluation of the exchange value of the rupee to the extent of 20% was put into effect in two stages during the first week of July 1991. It was followed by changes in the import policy which aimed at reducing imports and encouraging exports. These immediate measures fetched the Indian government \$ 2,260 million as standby credit from IMF, which, to a great extent, restored international confidence. In presenting the 1992–93 budget, the Finance Minister boldly announced that the crisis was over. But what was the impact of stabilization? Though inflation was brought under control, industrial output and exports suffered setbacks. The GDP reached a low level, indicating that the economy was in recession. The devaluation pushed up the cost of debt-servicing by another \$ 1.2 billion thus making it a total of \$ 5.9 billion. As for the balance of payments crisis, it posed no immediate threat to the government.[20]

The new economic policy of the government includes the Fund/Bank prescriptions of structural adjustments and reforms in a phased manner after completing the stabilization. In tune with the new policy, the industrial licensing system, with some reservations, was virtually abolished. Similarly, the MRTP Act placing restrictions on large business houses was scrapped. The FERA was amended to allow foreign investments a larger equity (51%) in a large number of industries, moreover, in some export-oriented industries up to 100%. Approval procedures in foreign cooperation were liberalized. Exports were encouraged through incentives. In the second budget, presented by Manmohan Singh, steps were taken for de-subsidization, government disinvestment in public sector, partial convertibility of the rupee, reduction of customs duties and so on. Due to these measures, the growth rate increased from 1.2% in 1991–92 to roughly 4.2% in 1992–93. The current account deficit was reduced from 2.89% to 1% of the GDP, and export growth registered 24% on average by quarters. The inflation rate decreased from 17% in 1991 to 6% in August 1993. The trade deficit, during this financial year, in all likelihood, would be reduced by about \$ 1 billion, compared to 1992–93. Agricultural and industrial growth would reach 6% and 4.5% respectively during the current financial year. The budget deficit, according to recent budget estimations, is declining from 8.4% (two years ago) to roughly 5%. Speculation is rife that external debt will go up to \$ 91 billion in 1997–98 and debt payment will be larger than the foreign currency reserves by 1998. The above statistics reflect a slow recovery from the 1991 crisis and show that India is on the path of growth. Recent statements made by the Minister of Finance at the time of the presentation of the third successive budget were very optimistic. He stated that if the present process of economic reforms was continued, India would be a major "Power House" in Asia in a couple of years. His optimism is, however, not shared by many economists, for the problems of adjustment and transition are going to be too painful to bear in terms of social costs. What problems will India get during the period of adjustment and transition? For India, there is no respite from dithering because the Fund/Bank is always prodding the country to carry out structural reforms. The government has not achieved considerable progress in matters like public sector reforms, privatization, de-subsidization, tax and banking reforms.

[20] V.M. Dandekar, "The Economy and the Budget." *Economic and Political Weekly*, Vol. XXVII. Nos. 15 and 16, 1992, p. 815.; *Economic Times*, Bombay, March 22, 1993, p. 9.

The industrial policy of 1991 envisaged a low profile for public enterprises since investment decisions hereafter will be handled by private entrepreneurs based on their commercial judgements. But public enterprises in the sphere of defence industries and infrastructure shall receive due attention. They will receive less subsidies and the sick and loss-making units will be referred to the Board of Industrial and Financial Reconstruction (BIFR) for disposal, but the process is going to be very slow.

In the euphoria for socialism, previous governments neglected accountability and profitability in running the public sector. Frequent government interference in their working led to inefficient management, and vested interests played an important role.[21] The present government therefore has decided to withdraw from running enterprises. A policy of disinvesting the government's share of capital holding up to 20% was introduced. Meanwhile public firms are gaining autonomy by decentralization.[22] The government's biggest hurdle in reforming public enterprises stems from the opposition of labor unions. Privatization is thus not likely to achieve success in spite of the government's effort at setting up a National Renewal Fund to help retrenched employees.

Government's philosophy behind privatization policy is to reduce the role of the state in investment and production so as to make room for market forces to determine. Initially, the government thought of privatizing successful public enterprises, but stubborn resistance from the employees, vested interests and corrupt bureaucrats have emerged as a stumbling block. The government has not formulated any exact policy in this direction, only vague statements that lack coherence. However, privatization policy is kept alive probably to convince international financial institutions on India's desire to achieve privatization as a long-term goal. Thus the government's "preference continues to treat it as a policy of last resort."[23] Industrialists and businessmen have appreciated the privatization policy of the government, but they have yet to make up their minds about the event that some public enterprises are offered them to operate. Scooter India and UP State Cement Corporation have resisted privatization, whereas Maruti Udyog (automobile company) has become private.

Government subsidies constitute the single largest non-development expenditure of central and state governments. These governments granted subsidies amounting to Rs. 10,624 crores in 1990-91. The underlying assumption behind reducing the subsidies was to develop the spirit of self-reliance and improve efficiency. In recent years the agricultural lobby has offered stout resistance to the cuts in fertilizer-subsidies. It should be noted that fertilizer-subsidies, meant for helping the poor, have benefitted rich farmers in the green-revolution belts. In the Union budget of 1993–94, the government has provided for cuts in the subsidies amounting to Rs. 980 crores.

The World Bank's Country Economic Memorandum (May 1990) had, among others, suggested improvements in the Indian financial system. Nationalized banks need to be toned up to increase their efficiency, viability, profitability, accountability, and customer services. The current reforms aim at "easing external restraints, such as

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[21] A. Kohli, *Op.cit.* pp. 305–28

[22] S.L. Rao, *Public Enterprise Reforms.* Forum of Free Enterprises, Bombay, 1993. pp. 12–14.

[23] P. Triveti, "What is India's Privatization Policy?" *Economic and Political Weekly,* Vol. XXVIII, No. 22, 1993, p. 76.

the administered structure of interest rates, and reserve requirements of banks, exploring indirect ways of monetary control, prescribing prudent regulation and 'norms, strengthening supervisory apparatus, and facilitating the entry of new institutions." [24] One of the most crucial tests faced by Indian and foreign banks is the capital adequacy norm set according to international standards. The bank employees have resisted attempts at de-nationalization of the banks. The government is not keen on allowing new private banks to be set up in the country. The request by foreign banks to the Indian government to permit them to open new branches in several cities has not materialized. The present attitude of the government is to reform the banking system, according to the recommendations of the Narasimhan Committee Report, rather than privatizing it. One of the recommendations is that succesOsful banks on a selective basis could have access to the capital markets, in other words, opt for partial de-nationalization. Bank employees have also thwarted attempts at automation for fear of retrenchment. The financial sector needs disciplining, and banks have to function now in an atmosphere of competition. How long can the burden of providing enough capital to the banks be born by the budget? Manmohan Singh has provided Rs. 5,700 crores in the recent Union Budget to meet the banks's doubtful and bad advances. The Statutory Liquidity Ratio has been reduced. Fixing of interest rates has been left to the discretion of the banks.

The government abolished the office of the Controller of the Capital Issues, and set up what is known as the Securities Exchange Board of India (SEBI), clothed with legal authority. The main purpose of setting up this establishment is to bring order in the capital market and safeguard the interests of shareholders. Recent steps of the SEBI evoked protests from the stockbrokers because they aimed at punishing the stockbrokers for their lapses and corrupt practices.

The main purpose of introducing reforms in the labor market is to relax its rigidities. The government is of the opinion that the "protected labor force...is an 'obstacle to employment expansion and output growth." [25] The privatization policy in the industrial sector has drawn much flak and opposition from labor unions and vested interests. The union budget continued to provide monetary assistance to the National Renewal Fund to help the retrenched workers. The scheme of "golden handshake" of the government is yet to get off the mark. Since labor laws have become rigid, it is difficult to make headway.

One of the recommendations of the Fund/Bank to the Indian government is to restructure the taxation system and procedures. The government has to garner untapped resources to offset the growing public debt which has increased from 50% of the GDP in the 1980s to the unsustainable level of 70% in recent years. The Chelliah Committee was appointed to simplify the tax system and procedure, and its recommendations have come into force on a selective basis. The committee has recommended reduction in the levels of both fiscal and primary deficits, progressive tax system, simplified procedures, and subdued rates; voluntary compliance with tax laws have been implemented.

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[24] C. Rangarajan, "Financial Sector Reforms and Banking Industry." In: S.D.J. Pandian (ed.), *Reserve Bank of India Bulletin*, Bombay, 1993, p. 987.

[25] M. Swaminathan, "Structural Adjustment and the Labor Market." *Economic and Political Weekly*, Vol. XXVII, No. 8, 1992, p. 409.

The government has launched a full scale liberalization of foreign trade aimed at bringing about globalization. Tariff reforms have been implemented, and all controls on the licensing system have been abolished. A unified exchange rate of the rupee on "trade accounts" has been announced. Exporters are encouraged to step up exports and 10% of the Bank advances have been assigned to the promotion of exports. Foreign investments and joint ventures have been encouraged. The investment climate in India has improved, but political disturbances in the country discourage foreign investors. The bureaucrats are still good at setting up bottlenecks, and until there is a change in their attitude foreign investors will hesitate to invest in India. Recently, Motorola experienced this problem in India. It should be understood clearly that if trade policy reform fails in India, the policy makers will be permanently confronted with the balance of payments crisis.

One is inclined to agree with the opinion of Kaushik Basu when he stated that "India's problem is really one of activating the free market in relevant realms." [26] Unfortunately India does not have sound markets giving strong signals, and this situation mainly stems from price distortions.

3. Market and Society: Attempts to Lessen Social Pains

The ideological debate that is currently in progress is whether "Market" and "Socialism" are compatible economic categories in the onward march towards rapid economic growth. While some Western scholars have more or less come to the conclusion that they are not,[27] some state socialist countries such as Hungary and China have been making such experiments. China's "Market Socialism" is underway and hopes to include elements of the market to serve the interests of socialism. The transition is, no doubt, going to be painful.

In India's case, it has committed itself to carrying out the reforms recommended by the Fund/Bank with some reservations. It is imperative that it builds a safety-net to protect the interests of the poor, in fulfillment of the constitutional obligation. The third successive budget presented by the Government has provided for these safety-nets in the form of subsidies, employment opportunities, fiscal incentives and rural credit.

The budget of 1993-94 has provided substantial support to the development of agriculture and agro-based industries thus creating greater employment opportunities and income for rural areas. The government intends to remove all bottlenecks on the trade of farm produce so that farmers can take advantage by selling anywhere in India. The agricultural credit extended to farmers has been increased by 20%. The activities of the National Bank for Agriculture and Rural Development (NABARD) have been strengthened. Import of farm machinery, tools, implements, spare parts and other inputs attract

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[26] K. Basu, "Markets, Laws and governments." In: B. Jalan (ed.), *Op.cit.* p. 342.

[27] For rhetoric on this, see: G.E. Schroeder, "Economic Reform of Socialism. The Soviet Accord."; B. Ickes, "Obstacles to Economic Reform of Socialism: An Institutional Choice approach."; J. Winiecki, "Obstacles to Economic Reform of Socialism: A Property Rights Approach."; L. Popkova-Pijasheva, "Why is Plan Incompatible with the Market?"; J.S. Prybyla, "Economic Reform of Socialism: The Dengist Course in China." All in: J.S. Prybyla (ed.), *Privatizing and Marketizing Socialism*, The Annales, AAPS, Philadelphia, Vol. 507. 1990.

less customs duties now. The NABARD intends to set up a Venture Capital Fund to help new investments in farm sectors. The budget intends to further strengthen the agricultural credit system which would improve agricultural productivity in the long run.

The budget hopes to ameliorate the conditions of the weaker sections by achieving a lower rate of inflation; by bringing improvements in rural areas, primary education and primary health with increases in "social spending"; by giving a boost to employment opportunities; and by paying special attention to the welfare of female population. The food subsidy is not being slashed and the public distribution system is being toned up.

However, it is not yet clear how long these concessions will continue in view of the deep disequilibrium in the economy. The Fund/Bank would like India to go the market way if she needs large-scale economic assistance, i.e $ 5–7 billion in the near future. The present adjustment and "transformation with a human face" cannot continue for ever.[28]

Conclusion

India is in the process of transition to market economy and all "transformational economies" have had to encounter numerous problems. In India, the painful process started with the stabilization program which brought devaluation and import compression. The recession-hit industries further suffered. The structural reforms began before the end of the stabilization program. But what is interesting to note is that stabilization and structural reforms went on simultaneously. This was hardly expected since the economy had not been put on rails.

The strategies employed to set the economy on the path of rapid recovery need to be commented on. The first strategy employed to improve the economy was reliance on borrowing. This borrowing was subject to conditionalities imposed by the financing institutions abroad. Fund/Bank serves the interest of the great powers in the financing of Third World countries. In the long-term, borrowing from abroad may have terrible repercussions.

The second strategy involve dependence on the skill and knowledge of the management personnel. It is well-known that Indian bureaucracy is ill-suited for crisis management. Political interference and vested interests have always hampered the economic development of the country. The eighth Five Year Plan, it is said, is indicative and bureaucrats continue to operate the levers of economy. Another strategy employed to put the nation on the path of rapid growth is to increase the pace of reforms even before determining whether the situation permits. Some of the trade policy reforms may be cited as examples.

Wrong strategies would have disastrous effects for the country, and the people who have to bear this most, will be those living below the poverty line. The present government has done well in evolving a safety-net to cushion the burden of adjustment and transition. India may be cited as an example of success story, if all things go well. The transition process is not yet over, and therefore the Government should leave no room for complacency. If population growth can be checked, India's prospects will brighten, and it can step into the 21st century with legitimate pride.

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[28] M. Ravallion and K.S. Subba Rao, "Adjustment and Human Development in India." *Journal of Indian School of Economics*, Vol. IV, No. 1, 1992, pp. 55–67.

RICHARD POMFRET

The Chinese Model of Market Transformation

– Can Eastern Europe learn from Asia? –

Introduction[1]

During the 1980s economists studying the process of economic reform in China did so in a vacuum. There was little reference either to the literature on economic development or to reforms in other centrally planned economies. The reason for this lack of comparative analysis appears to have been a belief that the Chinese case was sui generis: too different from the market-oriented economy assumed in the non-Marxist development literature and from the feeble reforms occurring in the USSR or other communist countries – except Hungary, which highly influenced Chinese reforms with its 1968 reform – before 1989. Partly reflecting this inward-oriented intellectual approach students and policy-makers elsewhere paid little attention to the Chinese experience.

In the early 1990s this splendid isolation started to change. Influential policy-makers at international institutions began to argue publicly that other countries in transition from centrally planned to more market-oriented economies can learn from the Chinese experience.[2] Meanwhile, researchers on the Chinese economy since 1979 are starting to relate that experience to the wider economic development literature. Nevertheless, there still appear to be substantial walls separating subdisciplines.[3]

This paper addresses the question of whether China's experience with economic reform is helpful in understanding and providing lessons for the European economies in transition.

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[1] An earlier version of this paper was presented as the invited lecture at the Chinese Economic Association of Australia 1992 Annual Conference, "Chinese Economy in Transition", held in Adelaide on 12–13 November 1992, and a summary appeared in *Access China.* The paper was completely rewritten while I was on leave in Bangkok as Regional Adviser on Macroeconomic Management and Economic Reform at the United Nations Economic and Social Commission for Asia and the Pacific. The views expressed are my own and are in no way endorsed by the United Nations.

[2] *Two articles which stimulated discussion were "Is there Schizophrenia about Socialist Reform Theory?" in Transition.* The World Bank. July 1991, by Inderjit Singh of the World Bank and "East Europe should learn from Asia" in the *Financial Times*, 24 April 1991, by Stanley Katz, a former Vice President of the Asian Development Bank and at the time a consultant to the European Bank for Reconstruction and Development.

[3] Such unwillingness to learn also extends to policymakers. A caricature which recurs frequently is that Chinese policymakers point to their high growth rates and abundant consumer goods in contrast to the economic stagnation and chaos of the former USSR and Central and Eastern Europe, while European policymakers after recognizing China's rapid economic growth point to the continuing poverty and authoritarianism of China. One does not learn much from a society which one looks down upon.

1. The Chinese Model of Economic Reform

The central features of the Chinese model of economic reform have been an initial emphasis on agriculture, combined with gradualism in other areas. Advocates of applying the Chinese model elsewhere see it as having provided rapid economic growth and political stability

Agricultural reform was in practice sudden rather than gradual, because the introduction of the contract responsibility system in 1978-9 immediately changed incentives. Although land ownership was unchanged, farmers now had claim to any additional output over and above that contracted to be supplied to the state marketing agencies at the official price. The supply response was immediate and large; agricultural production grew rapidly between 1980 and 1984, despite the diminishing area of land under cultivation.[4]

Because China was overwhelmingly a rural economy, this translated into a large increase in GNP and in demand for consumer goods. Lack of available goods (and of savings opportunities) led to a substantial part of the agricultural surplus being channelled into small-scale industrial activities (township and village enterprises), which have been the dynamic part of the manufacturing sector for the past decade.[5] The non-agricultural labor force in rural areas increased by 6% per annum between 1978–83 and then by 20% per annum during 1983–87, creating over thirty million jobs. Nominal output increased at an annual rate of 20% from 1978 to 1983 and then by an incredible 55% in 1984 and 46% in 1985 before dropping to a mere 32% in the recession year 1986.[6]

The dramatic beneficial effect of agricultural reform reflects the size of the agricultural sector (Table 2) and the particular unsuitability of Chinese agriculture to collectivization. As the Chinese communist regime pursued an extreme strategy of public ownership, total factor productivity in agriculture fell over the three decades after the 1949 revolution. The huge post-reform gains in disposable income for a large part of the population could not be matched in more industrialized economies with less repressed agricultural sectors, such as Poland where private plots and off-farm employment were already common before 1989. Moreover, rice-farming is much less-suited to collectivization than is farming of wheat or other grains where scale economies from using indivisible machinery are significant. Thus, the agriculture-first strategy may yield similar benefits in Vietnam, but would be far less dramatic in effect in Central and Eastern Europe or the former USSR.

The other salient feature of the Chinese model of economic reform has been the process of gradual and partial reforms.[7] Introduction of the open door policy towards

[4] *China: Reform and the Role of the Plan in the 1990s*. The World Bank, Washington DC, 1992, pp. 52–53.

[5] Strict control over residency also favoured the growth of rural manufacturing because surplus agricultural labor could not migrate to the cities.

[6] Figures from *World Bank Report*, No. 7267-CHA, "China - Rural Industry: Overview, Issues and Prospects", March 1989, pp. 11–13. The report cautions that the official figures used are lower-bound estimates because some of the TVE expansion was unreported.

[7] The agricultural reforms were also introduced on an experimental basis in a few provinces in 1978 and formal rules were only changed gradually over the following years, but the economic impact was sudden because farmers took the initiative in ensuring the most fundamental change (ie. that after meeting a fixed commitment to supply the state any marginal output could be sold for the farmer's own account) was widespread.

foreign investment and trade, while apparently a dramatic policy change, was in practice more gradual. The 1979 equity joint venture law permitted foreign investment for the first time since 1949, but foreign investment in China was very small before 1984 (Table 3), and most of the inflow was concentrated in the Shenzhen special economic zone adjacent to Hong Kong. In 1984–5, as wages and land prices rose sharply in the crown colony, entrepreneurs from Hong Kong led a foreign investment boom in China, shifting their labor-intensive manufacturing operations into China. In most cases the domestic partner was a TVE, which were more flexible than state enterprises. The ability of Hong Kong entrepreneurs to transfer appropriate technology and export-marketing skills was especially crucial to the development of neighboring Guangdong province, a previous backwater which led Chinese economic growth during the 1980s (Table 4).[8]

Restrictions on foreign firms' activities and ability to repatriate profits were relaxed gradually during the second half of the 1980s. The pattern of direct foreign investment has been cyclical as each boom ran up against obstacles which were subsequently removed, and only in the 1990s has foreign investment in China really taken off (Table 3).[9] Restrictions on imports and exports have also been relaxed substantially since 1979, but remain severe enough to impede China's application to join the General Agreement on Tariffs and Trade (GATT).

Reform of the industrial sector has been even more closely controlled.[10] Tentative attempts to introduce greater enterprise autonomy had little impact on the state sector in the early and mid 1980s. After 1988 a contract responsibility system was generally adopted, by which taxes were separated from profits. This had far less impact than the ostensibly similar agricultural reform of a decade earlier, in part because the government recontracted its tax demands if the enterprise became ore profitable, but mainly because the ownership structure provided no strong incentive to earn profits. The government began to encourage the creation of conglomerates, which would issue shares (predominantly to their employees) - a strategy which could provide a basis for future privatization (see next section), but which had little immediate impact on enterprise behavior. A bankruptcy law was drafted and some state enterprises were

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8 Taiwanese and South Korean investors played a similar role later in the 1980s and especially in the 1990s. The critical contribution of investors from the East Asian "Tigers" was not so much the capital, which often came in the form of used equipment, but rather in the skills of the entrepreneurs at organizing the production and marketing of labor-intensive goods; both the physical and the human capital had lost economic value as wages increased in the entrepreneurs' homelands, but were valuable in China with its huge reserves of unskilled labour.

9 The government's basic dilemma is between creating an environment attractive to capitalist investors while not diluting its own control over the economy. The authorities have tried to maintain control over the capital account of the balance of payments and have placed strict emphasis on macroeconomic stability, but it is difficult to isolate economic policies. Some relaxation of exchange controls proved necessary to support the trade reforms and the opening up of the country to foreign investment. Also, as the economy has become more developed foreign and domestic firms require financial services which could not be provided under the old system, but financial reform is undermining the former method of direct credit control.

10 W.A. Byrd, *Chinese Industrial Firms Under Reform*, Oxford University Press, 1992, pp. 1–32. The author surveys industrial reform and performance up to 1989; this volume contains seven case studies of Chinese industrial performance.

closed down amidst great publicity, but the numbers were small (39 by the end of October 1991).[11]

Prices have been substantially liberalized since the late 1970s. Agricultural prices to producers were first raised to encourage output, and then consumer prices were gradually increased to eliminate the subsidies. The prices of most manufactured consumer goods were freed during the second half of the 1980s. For producer goods, however, a dual pricing system still exists, as a means of preserving a role for planned allocations and softening the disruption of immediate price liberalization.[12]

Despite frequent published "reforms" the state enterprises continue to face a soft budget constraint. The problem is more fundamental, insofar as with distorted prices profitability would not be a good guide to social desirability. The result has been lack of incentive and of entrepreneurial behavior, which combined to make the state enterprises a drag on overall growth.[13] There is a strong correlation between total factor productivity in industry and the share of the non-state sector in industrial activity,[14] with the most dynamic provinces being those in which the township and village enterprises have flourished best (Guangdong, Fujian, Jiangsu and Zhejiang). These five east-coast provinces enjoyed the most rapid growth during the 1980s (Table 4).

China's agriculture-first plus gradualism strategy led to a "natural" growth process reminiscent of that in eighteenth century England or mid-nineteenth century Canada. Increased demand, generation of savings and release of labor from a more efficient agricultural sector, all stimulated the growth of consumer good industries and services. (Figure 2) The open door policy helped because the small-scale manufacturing enterprises set up to meet domestic demand could expand by exporting labor-intensive goods. Rapid growth of manufactured exports benefitted from the proximity of Hong Kong, but most important was China's large labor force and low wage which meant that there were huge potential gains from specialization and trade. Other countries can follow this development pattern, but the benefits are likely to be less dramatic.

2. *Shortcomings in Chinese Economic Reforms*

The apparent smoothness and success of China's gradual and partial reform process hides significant shortcomings. Even advocates of the Chinese model such as Chen, Jefferson and Singh list four shortcomings: weak labor markets; excessive interven-

[11] By contrast about three million township and village enterprises went bankrupt or were taken over during the economic austerity year of 1989 (Y. Qian and Ch. Xu, "The M-reform Hierarchy and China's Economic Reform." *European Economic Review*, April, 1993, p. 547).

[12] K. Chen, G. Jefferson and I. Singh, "Lessons from China's Economic Reform." *Journal of Comparative Economics*. 1992. p. 208. This is made possible by the incomplete liberalization of international trade. Nicholas Lardy describes the Chinese system as one of creating an "airlock" between domestic and world prices. (N. Lardy, *Foreign Trade and Economic Reform in China 1978–1990*. Cambridge University Press, 1992.

[13] G. Jefferson, T. Rawski and Y.X. Zheng, "Growth, Efficiency and Convergence in China's State and Collective Industry." *Economic Development and Cultural Change*, January, 1992, pp. 239–66. provide evidence that the industrial enterprise reforms since the mid-1980s have had some impact on efficiency, but there is no doubt that the state enterprises are the poorest performers in the Chinese economy.

[14] *China: Reform .Op.cit.ff* 1992. Figure 1. p. 58.

tion in enterprises by officials; persistent soft budget constraints; and inhibiting of competition and interregional trade.

One would add to this list the absence of real financial reform before the 1990s, which prevented resolution of the fundamental central planning problem of efficient mobilization and allocation of capital. It is unsurprising that enterprise reform, labor market reform, government reform and financial reform feature so prominently; they are the difficult areas to tackle in the transition from central planning to a more market-oriented economy. Indeed, the word "shortcoming" may be inappropriate in that a gradual transition inevitably involves sequencing issues, with some reforms progressing faster than others. The practical question is whether gradual reforms will become bogged down when they enter the difficult areas.

Despite the difficulties of reform in these areas, there are two strong pressures for keeping the reform process moving in China. First and most important, there is pressure from below as people become more and more accustomed to growing material wealth. This could be offset by concerns about job security and about growing income inequality, but at present the demand for higher consumption levels appears dominant. Second, the bureaucracy is also a force for reform insofar as all levels below the center now have more influence, and associated with that the opportunities for corruption have mushroomed. The latter is not a good omen for future economic efficiency, but so far the forces of corruption and rent-seeking have been stimulating rather than inhibiting the reform process.[15]

The next steps will, however, be difficult. Financial reform is progressing in the 1990s with the arrival of foreign bank branches and the growth of the two stock exchanges, but the most fundamental reform, i.e. changing the domestic banks into entrepreneurial financial intermediaries, is still in the future.[16] Allowing inefficient state banks to fail is even more costly than with other state enterprises, so the banks face the softest of all budget constraints.

Labor market reform will also be difficult, because like banking reform it is not simply a matter of scrapping existing restrictions but rather involves replacing one set of rules by another. Not just the work relationship between employee and enterprise must be reformed, but also the social welfare role of the employer. Under Chinese communism the work unit covered every aspect of its members' lives. Mobile labor needs portable social security and the means of obtaining entitlement to housing, education and so forth for family members. Providing such services will be difficult for a government facing budget crises as existing revenue sources dry up and a new tax system has not yet been put in place.

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[15] The felicitous outcome seems to be because the opportunities for rent-seeking are greatest in China when a project is operational and officials can command a share of the gross profits through their control over allocation of goods at plan prices. This is in contrast to India, where the opportunities for corruption are mainly in the approval process, which in consequence is dragged out with harmful economic results. Further price and enterprise reform in China may be opposed by officials fearful of losing their influence or if they go through may shift the outcome from benevolent to malignant corruption.

[16] China made an early decision to create a two-tier banking system in 1983, but it proved difficult to change the behaviour of the specialized banks which still dominate commercial banking. The central bank also plays an allocative role because, when credit is being restricted, its almost three thousand branch managers decide who gets the scarce funds.

Within industry, the state sector remains essentially unreformed.[17] The dominant current approach to enterprise reform is to create joint stock companies whose shares will be traded on the two stock markets. There is, however, some confusion about the purpose of these flotations which are seen as methods of attracting domestic and foreign capital for restructuring technologically outdated enterprises, but not as a method of transferring control to shareholders.[18] All of the listed companies on the stock exchanges (including those in which foreigners are allowed to hold shares) have majority state ownership, so it is unlikely that individual shareholders could vote to change the management of an under-performing company.[19]

The manufacturing sector in China has been dynamic only because of the huge scale of new enterprise formation. The township and village enterprises are the most important part of this non-state sector, but there is also a growing private sector. Recent official figures refer to over 150,000 private enterprises in China, employing over ten million workers with over RMB 13 billion in capital and accounting for some 6% of industrial production. Also, there are over fourteen million private household businesses.[20] These are positive developments which to some extent have been a substitute for enterprise reform, but they cannot avoid the long-run need to address the inefficiency of the old industrial enterprises.[21]

3. *Assessment of Chinese Economic Performance*

When measured by conventional growth criteria, the Chinese economic reforms have been a phenomenal success. During the 1980s China enjoyed one of the highest rates of economic growth in the world; GDP grew by 9.5% per annum, slightly less than South Korea, but ahead of all other Asian countries. The abundance of consumer goods in Chinese cities by the late 1980s was in stark contrast to the pre-1979 situa-

[17] This is related to the previous point because the major existing source of government revenue is the financial profits of state enterprises. These profits are declining, but the government is unwilling to take steps which would encourage greater efficiency in the state enterprises at the expense of losing government revenue.

[18] There is also a tax incentive. An enterprise switching to a joint stock company will see its tax rate fall from the standard 55% to as low as 27%.

[19] There are three types of shares, owned by the state, by institutions and by individuals, and in principle the markets for each type are segmented. By 1993 there was considerable pressure for loosening this restriction in order to create a larger market in shares of each company, and some institutions had sold shares to individuals who offered a higher price than institutional buyers. The proportion of state-owned share varies from 51% to 80% (*China Daily, Business Weekly*, May 2, 1993, p. 3), so even if the institutional and individual markets were merged takeovers would remain impossible.

[20] The difference is that a household business employs less than eight workers. Figures are from the *Shanghai Star*, October 23, 1992, p. 10), reporting a survey by the State Council's Development and Research Centre.

[21] Qian and Xu *(Op.cit.* 1993) argue that the rapid entry and expansion experienced by the non-state sector is the secret of China's economic success, and they ascribe this to the more decentralized nature of the Chinese communist economy (the M-form hierarchy as distinguished from the U-form, or unitary system, of the USSR). In my view there is not such a huge difference in pre-reform organizations, and the non-state sector has grown quickly in post-1989 Poland and post-1991 Russia; it is more pronounced in China because the phenomenon started a decade earlier.

tion and to the situation in the USSR and Central and Eastern Europe. After a brief slowdown in 1988-90, the economy achieved new growth records in the early 1990s.

Despite the obvious success in increasing the availability of consumer goods for ordinary people, China's economic performance has not been without problems. In particular, as government control over the economy has loosened, it has proven increasingly difficult to restrain inflation without arbitrary credit restrictions. Each episode of booming demand and increasing inflation (1984–5, 1988–9 and 1993–) has raised more serious problems – including a threat to political stability in June 1989. The need is for reform of the financial system to permit more subtle monetary policy.[22]

It is already apparent that financial reform will top the agenda during the 1990s. Maintaining "Chinese walls" between financial areas is difficult, and creating a bond market will also involve reform of capital markets in general, with market-determined interest rates and a variety of instruments to allow for differences in risk.[23] Such reforms will inevitably be associated with significant changes in ownership patterns, which are desirable in their own right because the state-enterprise sector is a serious drain on resources and drag on economic growth, but privatizing these "commanding heights" would weaken government control over resource allocation, so this is an area in which China's political leaders have been very cautious. Nevertheless, the situation was serious enough for the leadership to take the dramatic step of summarily dismissing the central bank governor in July 1993 and putting Vice-Premier Zhu Rongji in temporary control of the bank.

In sum, the shortcomings listed in the previous section pose a serious threat to the long-term success of the Chinese model. If they are not addressed economic growth will falter, but if they are addressed they could undermine the political stability characteristic of the model.

4. Adoption of the Chinese Model by Other Transition Economies

Income growth since 1979 in China has been spectacular, but – except a similar characteristic of the early Hungarian reforms in the 1960s – few former centrally planned economies have adopted the Chinese model. Only Vietnam since the mid-1980s has followed a strategy of agriculture-first plus open door policy, gradually implemented and without political change.[24] There too the Chinese model has enjoyed success.

[22] Although bonds have been issued since the early 1980s, the market is too small to be a suitable arena for monetary policy. Initially bonds were forced on unwilling recipients as part of their pay, but even when voluntarism was accepted the government was unwilling to pay market-clearing interest rates. hen a 1993 Treasury Bond issue was undersubscribed the Ministry of Finance raised the interest rate (eg. from 10% to 12.5% on three-year bonds), but even the higher rates are unattractive if potential buyers think inflation is higher than official projections.

[23] See: R. Pomfret, "Financial Reform in China." *Seoul Journal of Economics*, Winter, 1992.

[24] The description fits Hungary's pre-1989 reform strategy, which was the most successful in Central and Eastern Europe. The response to this strategy was less dramatic in Hungary than in China, primarily because Hungary was more economically developed; the agricultural supply response was smaller than in China, and the potential gains from international trade were more limited. Despite its earlier succes, the strategy came to be seen as a dead-end in Hungary after the 1989 political changes had opened up the possibility of more radical economic reform.

measured by economic growth, despite the inhibiting factor of the US embargo. Some of the Central Asian successor states to the USSR have expressed interest in the Chinese model, but it has been ignored in post-1989 Central and Eastern Europe.

A major reason why so few transition economies have followed the Chinese path is that they started from different positions. China faced economic stagnation after the cultural revolution, but the USSR, Mongolia, and many of the Central and Eastern European countries faced economic chaos (in addition to civil war, secession and other political problems) which was exacerbated by the breakdown of international trade relations and payment mechanisms which had existed under Comecon. The scale of disruption in 1989–90 in the former Comecon members led to extreme reactions: either adoption of a "Big Bang" approach or conservatism. The middle way proved impractical, except perhaps in Hungary which had progressed furthest along the reform path before 1989.

Most of the Central and Eastern European transition economies are now following Poland's lead in trying to introduce a rational pricing system quickly by adopting fairly free trade policies and macroeconomic stabilization measures (i.e. adopting world prices as the appropriate relative prices for a small economy, and not allowing changes in these to be obscured by a rising price level). Czechoslovakia, Bulgaria and Romania adopted Polish-style programs in early 1991, Slovenia in October 1991, and Estonia and Latvia left the ruble area in 1992 in preparation for introducing a similar package.

Poorly implemented rapid change can, of course, be traumatic, and this threatens to be the scenario in Russia as hyperinflation gains a hold. Conservatives in Russia and elsewhere have highlighted this danger and used it as a reason not to implement serious reforms. This appears to have been the outcome in Ukraine and some other transition economies, but the conservative or non-reform approach seems essentially unstable, assuming that the unreformed centrally-planned economies were in secular economic decline during the 1980s. Thus, although the verdict on the Big Bang approach is not yet in, it does appear to be the only alternative to the Chinese model.

5. *Assessment of the Chinese Model*

Given the rate of economic growth in China since 1978, it is difficult to deny the success of the Chinese model in its own country. There are, however, reasons why it may be less applicable elsewhere. China in 1979 was far less economically developed than the USSR or Central and Eastern Europe, measured both by living standards and by industrialization. Even after a decade and a half of rapid growth in China, while it is difficult to compare living standards, China probably lags almost all of the other transition economies; some major items are of better quality and more plentiful in Central Eastern Europe and the former USSR (housing and cars), while cheaper consumer goods are more abundantly available in China.[25]

[25] Even a more important problem than the differing consumption bundles is the artificialness of exchange rates, which grossly overvalued the domestic currency during the central-planning era but are now undervalued to differing degrees. In China, using official rates from 1979 and swap-centre rates from 1993 gives negative growth rates in per capita income in US dollars over the fifteen year period!

Relative to China in 1979 the Central and Eastern European transition economies in 1989 had some advantages and disadvantages in embarking on economic reforms. The main disadvantage was that, even if the Central and Eastern European countries were to embark on an agriculture-first strategy, the potential gains are much smaller than in China, where agriculture was far more important (Table 2) and in many areas had been particularly ill-suited to collectivization (because of the technology of rice production).[26] The main advantage was the high level of human capital; even though many of the specific skills learned under communism became redundant, an educated population should be more readily adaptable to change. A second advantage was the higher living standard, which will make short-term income losses relatively easier to bear; of course nobody enjoys falling incomes and they have threatened the sustainability of radical reform programs in Central and Eastern Europe, but the majority of the Chinese population after the disaster of the cultural revolution had no margin for short-term losses during the early part of the reform process. The short-term economic costs associated with a Big Bang approach to economic reform would have been disastrous in China in the late 1970s; it was simply not a feasible option.

There is also an important political difference between the starting points. Communism has been discredited in Central and Eastern Europe, and there is an official commitment to changing ownership patterns. This presents an opportunity to leapfrog the problems which Chinese reformers are now experiencing. It also has serious implications for the "gradualism" argument.

Gradualism in privatization-led reforms is dangerous, because it creates many opportunities for people to exploit artificial profit opportunities in the semi-controlled economy. From an economic efficiency perspective there is a very strong argument for rapid establishment of property rights, accompanied by rapid price reform.[27] There will be some unfairness in the distribution of state property, and there will be short-run unemployment as the economy's output-mix adjusts to a new set of relative prices. Nevertheless, these costs are likely to be much smaller than the cumulative costs of continuing inefficiencies and inequities of a partially reformed system.

The drawbacks of gradualism are already visible in the former Soviet republics pursuing a conservative strategy. The partially reformed economies with ruble and dollar tracks and free and regulated prices offer tremendous scope for arbitrage, often requiring connections to make the most of the opportunities. Slow progress in privatization has led to various forms of alienation of state property or appropriating its use for private gain, which is often inefficient and is generating huge income inequalities.

These costs of gradualism are also apparent in China. There is widespread discontent with the way in which the children of the senior leadership have become rich. Corruption is also rife at all levels of the bureaucracy. Outright theft of state property has been limited because of the tight control exerted by the government and the public

[26] Some Central and Eastern European countries, notably Hungary, have given priority to agricultural reform, but with much less impact on the economy as a whole than in China.

[27] The argument that the allocation of property rights is immaterial for efficient resource allocation (as long as there are well-defined property rights) is associated with Ronald Coase, and it seems appropriate that he received the Nobel Prize for economics just as the practical relevance of his work to a major issue was being recognized.

security forces, and draconian punishments – appropriating state property of even small value is subject to the death penalty. Such enforcement mechanisms are hopefully not on the agenda of Central and Eastern European leaders who advocate gradualism.

In sum, although the Chinese model has been successful so far, it is running up against serious problems in the 1990s, which can only really be addressed by moving towards more thorough-going economic reforms. Moreover, the Chinese model may yield far smaller short-term benefits in European transition economies. Faced by the choice between radical and gradual reform, policy-makers in the Central and Eastern European countries are thus tending to favor the former. Despite the short-term dislocation, this enforced choice may be a long-term blessing if it enables them to avoid the systemic difficulties which China is facing in the 1990s.

Table 1: Main indicators of the Chinese economy

Item	*Unit*	*1980*	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*
Total population	Million	987	1001	1017	1030	1044	1059	1075	1093	1110	1127	1143
Gross national product	Billion Yuan	447.00	477.30	519.30	580.90	696.20	855.80	969.60	1130.10	1401.82	1591.63	1768.61
Real GNP per capita (1978=100)		116	121	132	145	167	188	203	226	251	261	274
Exports	$US billion	18.1	22.0	22.3	22.2	26.1	27.4	30.9	39.4	47.5	52.5	62.1
Imports	$US billion	20.0	22.0	19.3	21.4	27.4	42.3	42.9	43.2	55.3	59.1	53.4
Overall retail price index (previous yr=100)		106.0	102.4	101.9	101.5	102.8	108.8	106.0	107.3	118.5	117.8	102.1

Source: *China Statistical Yearbook 1991*, State Statistical Bureau of the People's Republic of China.

Table 2:
Share of the Economically Active Population Working in Agriculture, 1988.

	Economically Active Population (A) Total (million)	(B) Working in Agriculture (million)	(A)/(B) (percent)
Bulgaria	4.5	0.6	13.3%
Czechoslovakia	8.2	0.8	9.8%
GDR	9.5	0.8	8.4%
Hungary	5.2	0.7	13.5%
Poland	19.3	4.3	22.3%
Romania	11.6	2.6	22.4%
USSR	143.6	20.4	14.2%
Vietnam	30.5	18.9	62.0%
China (1975)	481.8	367.5	76.3%
China (1988)	655.0	451.2	68.9%

Source: FAO Production Yearbook 1988 (Rome, 1989), p. 70–6.

Table 3: Direct foreign investment in China

DIRECT FOREIGN INVESTMENT IN CHINA, 1979–90 (Millions of U.S. Dollars)

	1979	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
Equity joint ventures:												
Ventures approved	6	20	28	29	107	741	1,412	892	1,399	3,909	3,659	4,091
Foreign investment pledged	$8	$63	$28	$29	$188	$1,060	$2,030	$1,375	$1,920	$3,134	$2,659	$2,704
Actual foreign investment	...	...	...	$100	$74	$255	$580	$804	$1,480	$1,975	$2,037	$1,836
Cooperative ventures:												
Ventures approved	N.A.	320	70	402	331	1,089	1,500	582	786	1,621	1,179	1,317
Foreign investment pledged[1]	...	$500	$1,300	$926	$504	$1,480	$2,189	$1,358	$1,286	$1,624	$1,083	$1,254
Actual foreign investment[1]	...	...	...	$531*	$227	$460	$580	$790	$620	$780	$752	$674
Wholly foreign-owned ventures:												
Ventures approved	None	4	14	12	18	26	46	18	45	410	931	1,861
Foreign investment pledged[1]	None	$14	$262	$55	$44	$79	$32	$20	$470	$481	$1,654	$2,444
Actual foreign investment[1]	...	...	...	$40*	$43	$15	$13	$16	$25	$226	$371	$683
Joint oil development projects:												
Ventures approved	8	4	None	1	18	None	4	6	3	5	10	5
Foreign investment pledged	$110	$1,112	None	$170	$1,031	None	$360	$80	$4	$59	$204	$194
Actual foreign investment	...	...	...	$497*	$292	$520	$480	$260	$180	$212	$232	$244
Total:												
Ventures approved	...	348	112	444	474	1,856	2,962	1,498	2,233	5,945	5,579	7,274
Foreign investment pledged[1]	...	$1,689	$1,590	$1,180	$1,767	$2,619	$4,611	$2,833	$3,680	$5,298	$5,600	$6,596
Actual foreign investment[1]	...	...	...	$1,168*	$636	$1,250	$1,653	$1,870	$2,305	$3,193	$3,392	$3,437

SOURCES.—For the years 1979–87, Richard Pomfret, *Equity Joint Ventures in Jiangsu Province* (Hong Kong: Longman, 1989), and *Investing in China: Ten Years of the Open Door Policy* (Ames: Iowa State University Press, 1991), based on *China Investment Guide*, *China Business Review* (May 1988, p. 57); *Almanac of China's Foreign Economic Relations and Trade* (1986, pp. 1212–15, and '87, p. 1385); *Far Eastern Economic Review* (March 2, 1989, pp. 59–60); *Business China* (January 30, 1989, p. 12). The last three columns are from *Beijing Review* (March 6, 1989, pp. 17–18; June 25, 1990, p. 43; February 4, 1991), and *Business China* (June 25, 1990, p. 92, and May 27, 1991, p. 76), reporting Ministry of Foreign Economic Relations and Trade data.

* Total for 1978–82.

Table 4: Value of Gross Industrial and Agricultural Output and Investment in Capital Construction by Region

Region	Output		Investment	
	1990 (Billion Yuan)	Average annual real growth rate (1981-90) (per cent)	1990 (Billion Yuan)	Average annual real growth rate (1981-90) (per cent)
Guangdong	169.1	16.9	12.8	15.7
Fujian	49.1	13.9	2.3	10.5
Zhejiang	114.4	13.8	2.6	12.1
Shandong	164.2	13.6	5.6	12.9
Jiangsu	216.2	13.0	4.4	10.7
Xinjiang	23.6	12.7	2.9	10.9
Hebei	95.7	11.8	3.7	7.1
Ningxia	5.9	11.7	0.6	12.4
Yunnan	36.0	11.3	1.6	6.7
Guizhou	23.5	11.3	1.3	3.9
Anhui	67.3	11.2	2.3	8.3
Henan	99.5	11.0	3.1	5.7
Neimenggu	26.9	10.8	2.0	9.3
Jiangxi	44.0	10.7	1.6	10.8
Qinghai	5.2	10.6	0.8	3.1
Sichuan	120.2	10.5	5.4	11.8
Shaanxi	39.6	10.4	2.4	7.3
Guangxi	39.2	10.4	1.3	6.7
Hubei	91.1	10.3	3.2	4.8
Jilin	49.0	10.2	1.7	7.5
Shanxi	42.9	10.1	3.5	12.2
Gansu	24.6	9.8	1.7	10.3
Hunan	71.5	9.4	2.3	7.6
Liaoning	121.6	9.1	6.3	10.1
Beijing	52.0	8.8	5.1	9.0
Tianjin	47.5	8.7	2.4	4.7
Heilongjiang	71.7	8.3	4.0	5.5
Tibet	1.3	6.8	0.4	16.1
Shanghai	110.0	6.0	6.5	8.5
Non-classified			9.1	17.1
Total	2041.5	11.1	101.5	9.9

Source: State Statistical Bureau of China, Statistical Yearbook of China, China Statistics Press, Beijing, various years.

Figure 1: Total Factor Productivity and the Share of the Non-state Sector in Industrial Output

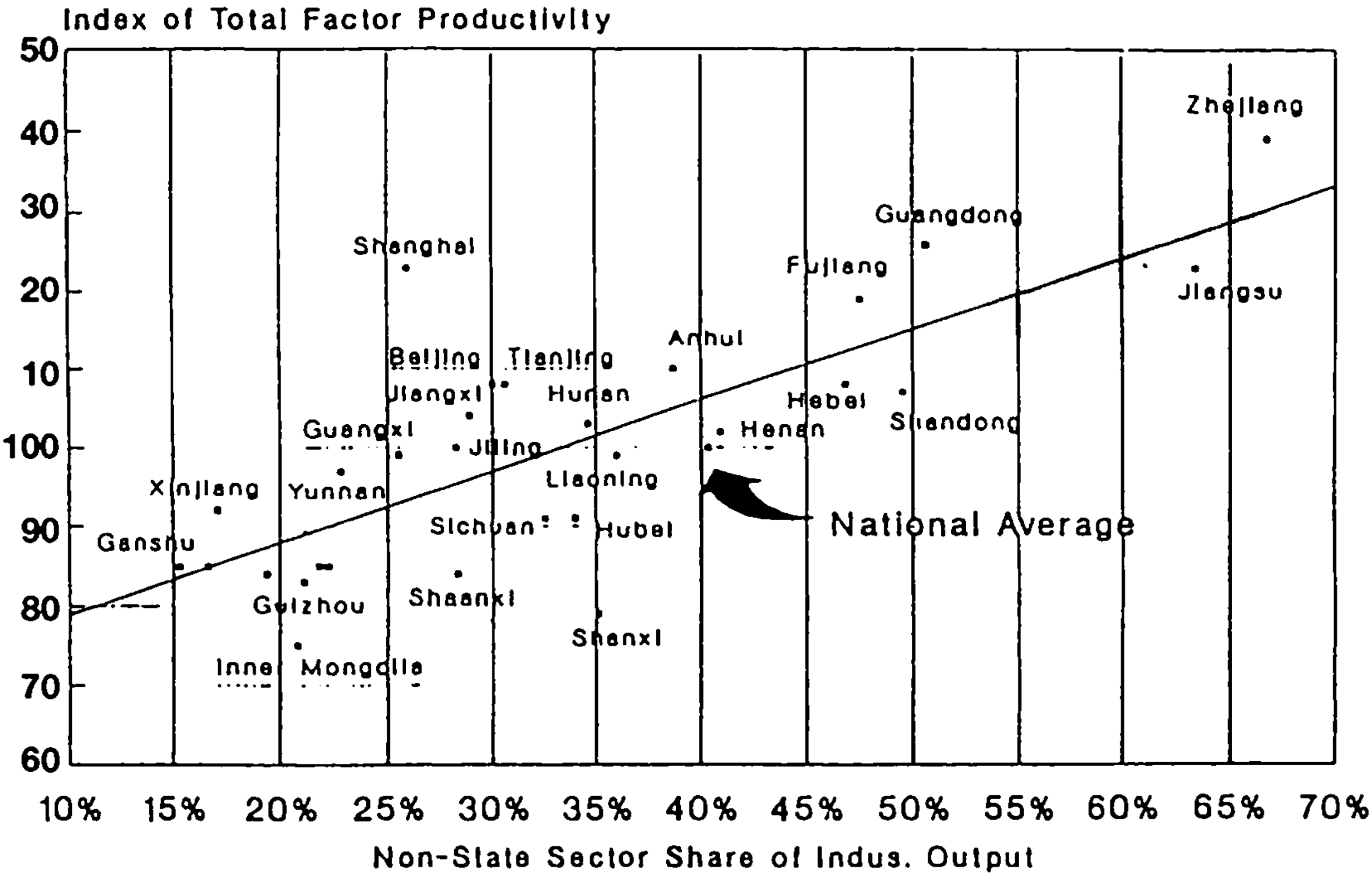
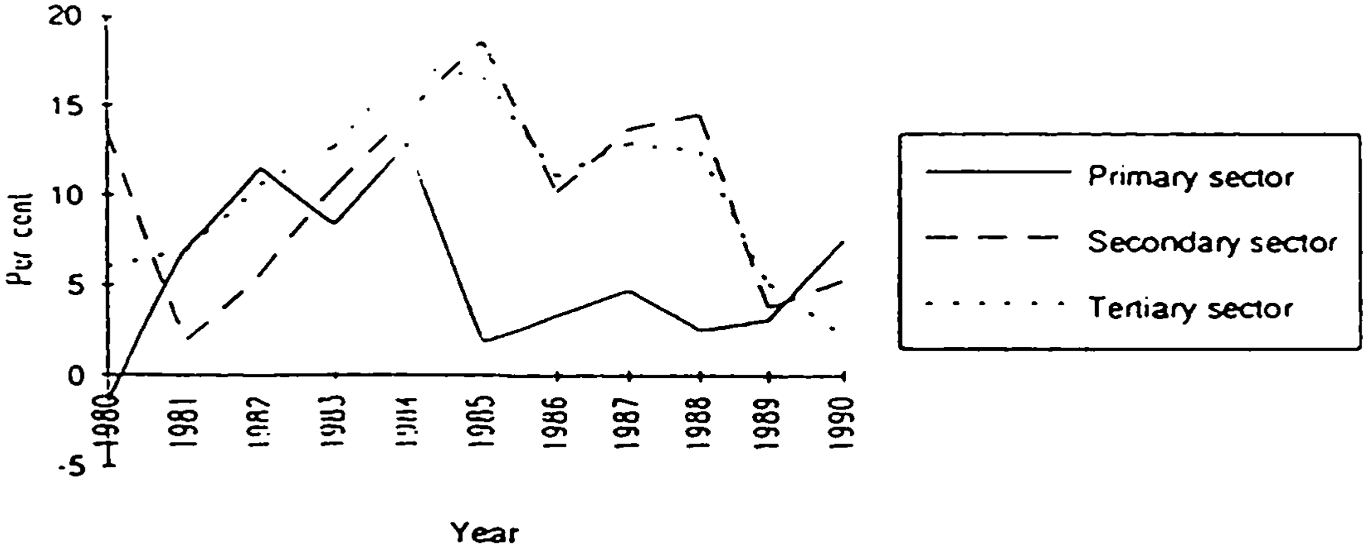


Figure 2: Real Annual Growth Rates of GDP by Sector (per cent)



Source: State Statistical Bureau, *Statistical Yearbook of China*, China Statistics Press, Beijing, various years

Barbara Geddes

How Politicians decide who bears the Costs of Liberalization

– Latin American, South European, and African Experiences –

Introduction[1]

As large numbers of developing countries have made efforts to liberalize their economies, two results not predicted by observers ex ante have occurred. First, the urban formal sector working class, which had been expected to be one of the main political obstacles to liberalization, has proved less able to defend its interests than expected. And second, privatization, which would seem less problematic than policies that reduce wages, since it affects only a part of the working class and can provide immediate benefits in the form of budget and debt relief, has proved difficult to carry out in a number of countries.

This study explains these results as consequences of the pursuit of political survival by policy makers in countries facing intense international pressures to liberalize. It argues that because of limited information and the lack of transparency in the policy process, workers have difficulty monitoring their political representatives and thus difficulty making credible threats to punish those who fail to represent their interests. In consequence, political leaders can, when confronted with strong international pressure, ignore working-class interests. The costs of privatization, in contrast, often fall on a more politically central group. When loyalists of incumbent political leaders staff the state bureaucracy, privatization and other measures aimed at slimming the state threaten the maintenance of incumbents' political support organizations, and are thus perceived as costly to incumbents themselves. Privatization thus tends to occur slowly when incumbents have many supporters in the state enterprise sector, but rapidly when staffing is dominated by opponents of the current incumbent.

Since the initiation of the debt crisis in 1982, changes in the international economy have exerted tremendous pressure on less industrialized countries to change traditional economic policies and adjust to the post-debt crisis reality. Prior to 1982, financial flows into developing countries, mostly in the form of loans, made it possible to sustain overvalued exchange rates and finance enormous and often inefficient public sectors. All that has now changed.[2] Without the continuing inflow of capital, earlier

[1] I am grateful to David Collier, Ruth Collier, Jeff Frieden, Stephan Haggard, Steve Levitsky, John Zaller, and the members of the Liberalization Workshop at UC, Berkeley, for useful comments on earlier drafts of this article; to Nancy Bermeo, Jeffrey Herbst, Bob Kaufman, Kevin Middlebrook, Nick van der Walle, and Steven Webb for sharing their expertise with me; and to Glen Biglaiser and Kimberly Niles for research assistance. Financial support for this research was provided by the World Bank, IRIS, the Hoover Institution, and the Institute for International Studies and Overseas Programs at UCLA. I alone am responsible for the interpretations and conclusions reported here.

[2] Except, as of this writing, in Argentina where, despite extensive liberalization in other domains, the foreign capital inflow associated with privatization has permitted the maintenance of an overvalued exchange rate.

policies can no longer be maintained, and international organizations such as the IMF, the World Bank, and the EC, through their control of loans, aid, and other forms of economic cooperation, reinforce the pressures for change coming from the international economy itself.

A remarkable consensus has developed within the community of international experts and aid givers about the appropriateness of policy changes aimed at liberalizing trade, reducing state involvement in the economy, and, in general, extending the domain of competitive markets. It seems likely that within a few years this orthodoxy, like any other, will have been challenged, but at the moment it stands firm. Economists in countries with long statist traditions, responding to international pressure and to the current hegemony of free market ideology, now advocate privatization of state-owned enterprises, reduced government spending, and liberalization of trade and finance.

Despite the real need to adapt to changed international circumstances, the predominance of free-market rhetoric, and the enormous financial incentives deployed by international agencies to influence their policy choices, however, governments in many countries have found it difficult to implement some of the prescribed policies. Trade liberalization subjects previously protected domestic industries to foreign competition, which can lead to bankruptcies and lay-offs. Exchange rate reform raises the prices of imported products, which often include urban consumption staples, inputs for manufacturing, and fuel. Reductions in state spending lead to reductions in essential services, declines in state investment, and ecreased employment and wages in the public sector, which in many developing countries is a substantial part of non-agricultural employment.[3] These may be only transitional costs of the move from a distorted to a more efficient economy, but for the years during which they are being borne, they make many liberalization policies unpopular, and thus, it would seem, difficult for governments to impose.

Some governments have gone further than others in carrying out these policies, and some policies have been easier to carry out than others. This study seeks to identify the political factors that affect the probability that governments under strong international pressure to do so will choose and carry out the various policies expected to contribute to economic liberalization. The existence of a large number of countries facing similar economic constraints and a consensus about appropriate policies provides an opportunity to examine efforts to implement these policies in several countries, and thus to draw out some generalizations.

This study examines the ability of different groups to defend their interests during political struggles over who will shoulder the costs of economic adjustment, and it identifies some of the political and institutional characteristics that affect the political feasibility of different elements of the typical reform package. It focuses in particular on the effects of liberalization on two partly overlapping groups: the urban formal

[3] Public employment is an especially large part of formal sector employment in Africa. In Senegal, 45.6% of those employed outside of agriculture were employed by the public sector in 1976; in Zambia, the figure was 81% in 1980; in Argentina, fairly typical for Latin America, 22.7% in 1981 (P.S. Heller and A.A. Tait, *Government Employment and Pay: Some International Comparisons*, IMF Occasional Paper, No. 24. Washington, DC: IMF, 1983. p. 42;

sector working class; and state employees. Two policies frequently included in liberalization packages, explicit wage restraint and exchange rate reform, tend to affect urban real wages adversely. Wage restraint aims at holding wage increases below inflation rates and thus depresses real wages over time. Exchange rate reform, in countries that have previously kept exchange rates overvalued, increases the cost of imported consumption goods, which in most developing countries include a number of working-class staples, and thus reduces the purchasing power of wages. Trade liberalization, another element of the standard package, tends to increase unemployment, at least in the short run, as previously protected industries are hurt by foreign competition. State employees face the same threats to real wages during liberalization episodes as do workers in the private sector. In addition, privatization of state-owned enterprises, which is usually preceded or followed by widespread lay-offs, and the wholesale dismissal of public employees, which is sometimes undertaken during liberalization as a budget cutting measure, threaten them with unemployment. Both of these groups are large, vocal, and well-organized, and thus one would expect that politicians would find their demands difficult to ignore. Evidence from the cases discussed below, however, shows that the urban working class has been relatively ineffective at defending its interests during liberalization episodes, while public sector employees have been quite effective in some political circumstances, but completely ineffective in others.

Case material for this study comes primarily from eleven countries: Argentina, Brazil, Greece, Mexico, Nigeria, Senegal, Spain, Turkey, Uruguay, Venezuela, and Zambia. Table 1 summarizes liberalization episodes in these cases, which were selected to provide regional variation, developmental variation, and variance in the degree of success in implementing proposed policies. In all these countries, elections and popular support play a role in the political system, though not all are democratic.

An examination of the case material reveals two puzzles: first, the working class has apparently been unable to defend its interests during these episodes, even when well-organized and allied with the ruling party; and second, politicians have shown greater reluctance to squeeze the public sector than the working class.

Liberalization efforts in all countries included wage restraint and/or other policies that reduced the growth of real wages in the urban working class (see Table 2). In all but Spain, real wages actually fell, in several cases by close to 20% in the worst year. Where wages had been falling before the policy change, they fell faster afterward. In many, unemployment has also risen during liberalization (see Table 3). In some, losses were much greater than in others, but these differences, as shown below, fail to correlate with ruling party ideology, degree of democracy, or other factors that might be expected to affect working class political efficacy.

Two of the most severe reductions in working-class income in these countries occurred in Mexico and Argentina, both governed by parties that have traditionally relied on working-class support. Real wages in Mexico fell by 50% between 1982 and 1988. Manufacturing wages in Argentina were 24% lower in 1992 than in 1980, in other words, lower than during the second Argentine bureaucratic-authoritarian regime, which is usually considered to have pursued draconian anti-labor policies.

Mexico is governed by the Partido Revolucionario Institucional (PRI), a dominant centrist party that has always included labor as a materially rewarded though coopted part of its coalition. The Mexican political system is nominally democratic, with universal electoral participation but limited competition among parties that is often further constrained by electoral fraud. The Peronist Party (Partido Justicialista), Argentina's traditional labor party, governs Argentina. Argentina has universal suffrage, open party competition, a free press, and fair elections. The Socialist Party of Spain (Partido Socialista Obrero Español, PSOE), governing in a system of open competition, fair elections, and universal suffrage, also imposed heavy costs on the working class – wage constraint and unemployment in the vicinity of 20% for five years in a row during the eighties.[4]

The first puzzle, then, is: why has the working class apparently been unable to defend its interests, even where political circumstances seem ideal? The second puzzle involves the contrast between policies that squeeze the working class and policies that squeeze the public sector. Privatization and cutting public employment have been proposed in all the cases, but, in contrast to wage declines, these policies have not always been carried out. Why, if politicians are interested in maximizing support, are they more willing to damage the interests of a large well-organized interest group – the urban working class – than of a smaller well-organized interest group – public employees?

A frequent interpretation of the dramatic liberalizations carried out by labor-backed parties is that these parties are more capable of persuading labor leaders to moderate working-class demands and mobilization, and more likely to distribute effective side payments to politically crucial losers, than parties identified with labor's opponents. This argument helps to explain the relative quiescence and ineffectiveness of labor protest in Mexico, Argentina, and Spain. Labor leadership has cooperated extensively with the government in Mexico, restraining the expression of rank-and-file protest. In Spain, very generous unemployment benefits and other increases in social welfare reduced the costs of liberalization and facilitated cooperation between unions and the ruling party,[5] though the unions eventually found the price too high and broke their hundred year alliance with the PSOE.[6] In Argentina, the government has been supported by leaders of one faction of the Peronist union movement, which has received benefits to offset the costs of liberalization, but opposed by other factions.

In this group of cases, three of the most successful liberalization efforts were carried out by ruling parties long allied with labor, but three of the governments that abandoned liberalization policies also enjoyed longstanding close relationships with labor: the governments of Acción Democrática (AD) in Venezuela, the Panhellenic Socialist Movement (PASOK) in Greece, and the Parti Socialiste (PS) in Senegal. Moreover, labor mobilization was at least as low during successful adjustment episodes in Thai-

[4] It is estimated that about a quarter of those officially listed as unemployed in Spain, and hence receiving unemployment benefits, are actually employed in the informal economy. Even with this number subtracted, the unemployment rate in Spain was extremely high (near 15%) for a very long time. SEE: *Yaerbook of Labor Statistics 1990*, International Labor Organization.

[5] J.M. Maravall, "Politics and Policy: Economic Reforms in Southern Europe." In: L.C. Bresser Pereira, J.M. Maravall, and A. Przeworski (eds.), *Economic Reforms in New Democracies*, Cambridge: Cambridge University Press, 1993.

[6] R. Gillespie, "The Break-up of the 'Socialist Family': Party-Union Relations in Spain, 1982-89." *West European Politics*, No. 13, 1990, pp. 47–62.

land and Turkey, both governed by parties considered opponents of labor interests. It thus seems that the "Nixon goes to China" analogy is at best an incomplete explanation for the pattern observed. The China analogy would also seem to imply that parties with the closest ties to state employees would be most effective at carrying out privatization, but just the opposite is true. Leaders of parties or party factions with the weakest links to the public sector have proposed the most radical reforms.

1. Theoretical Perspective

A large literature on stabilization, structural adjustment, liberalization, and economic policy making more generally already exists. The aims of this study, however, differ from those of most of the existing literature. I seek not to explain particular policy-making episodes in particular countries or groups of countries, but rather to identify the political and institutional characteristics that can be expected to have the same effects on the likelihood of implementing particular policies in any context in which they occur. In other words, I will not attempt to provide a thorough explanation for any specific outcome, but instead will argue that certain institutions and circumstances increase the probability of certain kinds of outcomes in any setting.

The approach taken here emphasizes, as do most others, individual material interests as the basis of support or opposition to economic policies. It differs from most other approaches, however, in that it explicitly recognizes the role-specific interests of the politicians and officials who make and carry out economic policies. Such recognition is essential because the interest of politicians and bureaucrats in political survival affects their policy choices and their decisions about which of the many proposals made by advisors they will actually implement.[7]

The solution to the puzzles noted above begins with a stylized depiction of a political system in which public office depends at least partly on popular support, from which one can make some inferences about the costs and benefits to politicians of various liberalization strategies. We are accustomed to thinking of the cost of economic liberalization to politicians in terms of the private interests hurt by them and the punishment these interests can inflict on political incumbents. The dilemma posed by such policy changes is that they reduce the welfare, at least in the short run, of many of the individuals whose support determines whether the officials who have initiated the policies remain in power. We routinely think of tariff reduction, for example, as hurting the producers of import substitutes – both owners and workers – and thus leading to their opposition to the government that imposed it.

When assessing the costs of liberalization to politicians, however, we must *also* consider the costs to their ability to maintain successful political machines as well as the costs imposed by interest groups. That is, we must include the cost of a reduced ability to distribute political resources in exchange for support in any assessment of the cost to politicians of initiating economic reform.

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[7] See: B. Ames, *Political Survival: Politicians and Public Policy in Latin America*, Berkeley: University of California Press, 1987.; D. Mayhew, *Congress: The Electoral Connection*, New Haven: Yale University Press, 1975.

In order to deal with policy outcomes in a wide range of countries, it is necessary to develop and keep in mind some general ideas about how political systems operate. A standard view of the generic political system includes citizens who vote – if allowed to – and lobby, strike, demonstrate, and rebel in order to influence policy in their favor; and political leaders whose best survival strategy is to please their constituents (including "special interests"). To the extent that this view captures the essence of real political systems, there is no need to pay attention to the particular interests of politicians; the interests of citizens determine the policy choices of politicians interested in remaining in office. Some modification of the standard view is required, however, to take into account the costs to citizens of monitoring political leaders and expressing demands.

The standard view assumes either democracy or some other system that makes leaders partially accountable to citizens. It may thus substantially underestimate the costs of lobbying, demonstrating, and striking in some political systems. For the sake of argument, however, let me set this issue aside and concentrate on the case in which citizens would be expected to see their preferences acted upon by politicians: democracy.

In the real world of scarce and expensive information, even in democracies citizens have limited ability to monitor the performance of their representatives. Citizens, in other words, face an agency problem. The citizenry, through its vote for parties and leaders that advocate particular policies, chooses a set of policies. To implement citizens' choices, politicians must enact necessary laws and allocate adequate resources.

Principal-agent problems are caused by an interaction of information asymmetries and conflict of interest between principal and agent.[8] In the kind of situation under contemplation here, the information asymmetry between citizens and politicians looms especially large. Most citizens, especially in developing countries where levels of education are low and few read newspapers, have little ability to monitor the policy-relevant activities of politicians. This generalized inability to monitor is exacerbated when the decision process is not fully public, as is the case for many executive decisions affecting trade and exchange rate reform, and when the relationship between policies and their effects lacks transparency. The unionized part of the urban working class may receive reasonably good information about the implications of particular policies – as shown by its participation in strikes and demonstrations. But most of the urban and rural workforce does not.

As recent elections in Mexico and Argentina demonstrate, most people judge politicians on the basis of the availability of particular benefits and assessments of the overall performance of the economy, such as aggregate growth rates. These indicators are seriously flawed, since politicians can often provide particular benefits without carrying out the policies preferred by voters, and because overall economic performance reflects many factors over which politicians have no control.

In short, citizens often lack the necessary information to judge whether politicians are carrying out their promises and therefore cannot make credible threats to use

[8] T. Moe, "The New Economics of Organization." *American Journal of political Science*, 1984, 28. pp. 739–77.

votes, demonstrations, or other means to punish those who do not. This information asymmetry has the expected effect of reducing the citizenry's ability to select the candidates most likely to provide – as opposed to simply promising – the public policies they prefer. Citizens' limited ability to monitor permits politicians considerable autonomy when it comes to deciding which policies to support.[9] And the further the actual regime diverges from democratic ideals, the greater this agency problem becomes.

In theory, democracy eliminates the conflict of interest between citizen principals and their politician agents. The best way for politicians to pursue their own interest in political survival should theoretically be to give constituents the policies they want. In practice, however, politicians face multiple constituencies and therefore cannot be expected to represent completely the interests of any one of them. Of special salience for the issues involving costs to public employees is what Harold Demsetz[10] calls the internal constituency, that is, party activists, to distinguish it from the external constituency made up of voters. These two constituencies differ from each other with regard to both interests and resources.

Party activists may have policy preferences different from those of the average voter. But, for the purpose of the argument being made here, it is the resources needed to pay party workers for their efforts that are important. Because citizens cannot adequately monitor politicians' policy performance and thus vote decisions depend heavily on the availability of particularistic benefits, electoral machines become essential to the successful mobilization of the vote. They distribute the individual benefits and favors that affect many people's electoral decisions.[11] Individual benefits include things like coupons that entitle pregnant women to free milk or school children to free lunches, places in better schools, help getting pensions, loans, and all kinds of other government services to which the client has a legal claim.

To reach large numbers of voters with individual benefits, politicians need extensive political machines staffed by party activists and workers. Politicians' ability to deliver individual benefits depends on the extent to which members of their parties occupy positions in the bureaucracy, the importance of partisan loyalty to bureaucratic recruitment and promotion, and the size of the state bureaucracy. Parties that have held power for substantial periods of time, whether fully democratic or not, can thus be expected to have distributed many public sector jobs and other benefits to their partisans.[12] Consequently, such politicians often resist reforms, such as merit-based

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[9] J.P. Kalt and M.A. Zupan, "Capture and Ideology in the Economic Theory of Politics." *American Economic Review*, 1984, 74. pp. 279–300.; and "The Apparent Ideological Behavior of Legislators: Testing for Principal-Agent Slack in Political Institutions." *Journal of Law and Economics*, 1990, 33. pp. 103–31.

[10] H. Demsetz, "Amenity Potential, Indivisibilities, and Political Competition." In: J. Alt and K. Shepsle (eds.), *Perspectives on Positive Political Economy*, Cambridge: Cambridge University Press, 1990.

[11] K. Shepsle and B. Weingast, "Political Preferences for the Pork Barrel: A Generalization." *American Journal of Political Science*, 1981, 25. pp. 96–111.; B. Cain, J. Ferejohn, and M. Fiorina, *The Personal Vote Constituency Service and Electoral Independence*, Cambridge: Harvard University Press, 1987.

[12] J. Herbst, "The Structural Adjustment of Politics in Africa." *World Development*, 1990, 18. pp. 945–58.

hiring and promotion, that reduce their control over the bureaucracy and reforms aimed at reducing public employment, selling off public enterprises, or otherwise reducing the size of the state.

In order to maintain their electoral machines, politicians need to be able to "pay" their local party leaders, ward heelers, precinct workers, and campaign contributors with jobs, contracts, licenses, and other favors. What kinds of payments are common or even possible depends on political traditions, legal contraints, and the amount of state intervention in the economy, among other things. Where state intervention has customarily been high, politicians depend heavily on the distribution of state largesse to cement party loyalties.

Because of the need to "pay" party workers, politicians may fail to reflect voters' interests, even if politicians and party activists themselves have no independent policy preferences at all and care only about reelection. They may have good reason to spend the resources they control in the distribution of individual benefits to important supporters rather than the pursuit of external constituents' policy goals. Because of the difficulty of assessing day-to-day policy implementation as compared with the ease of determining whether one has received particular benefits, politicians' interest in reelection gives them an interest in responding to the demands of the clientele that forms the indispensable link between themselves and voters, even when this means undermining the goals of the aggregate principal, the constituency.

In other words, although a democratic political system should ideally provide politicians with good reasons for carrying out the policy choices of citizens whose votes they need to stay in office, in reality the combination of information asymmetry between citizens and officials and the influence asymmetry between members of internal and external constituencies gives politicians an incentive to respond to the particular interests of some politically useful citizens rather than to the general interest of the public expressed in their votes. The principal-agent problem is of course much more severe in incompletely democratic polities.[13]

The principal-agent problem has consequences relevant to the implementation of policies aimed at reducing state spending and state intervention because most market-extending policy changes reduce officials' discretion over the distribution of individual benefits and thus cost officials political resources. These costs affect politicians' willingness to initiate such reforms.

The political feasibility of efforts to extend markets depends on an interaction between the particular policies proposed, the underlying distribution of interests in the country, the political rules and institutions that determine the political weight of different economic interests, and the interests of incumbent politicians in their own continuing political success. The rest of this study focuses on identifying characteristics that make such policy changes more or less costly to politicians in different

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[13] See: J. Herbst, *Op.cit.* 1990, for a more extended discussion of these issues in Africa, where most regimes have been authoritarian or single-party dominant.

institutional settings and therefore influence the likelihood that they will occur, but this focus does not indicate a belief that interests are unimportant.[14]

I turn now to a more systematic treatment of the interaction between the economic interests of voters, the political interests of officials, and political institutions.

2. The Costs of Adjustment to Politicians: External vs. Internal Constituencies

It might seem that no government staffed by politicians interested in remaining in office and dependent on citizens concerned about their own material interests for doing so could afford to impose welfare losses on one of the largest and best organized segments of the population, the working class.[15] And it might seem especially unlikely that a socialist or labor party elected through explicit appeals to working-class interests would do so – though if it did initiate such policies, as noted above, a labor government might be better able to control or finesse the expression of opposition than a conservative government, and thus better able to sustain them.

The principal-agent logic sketched above, however, suggests that, although governments would be reluctant to hurt the interests of any large, well-organized group of voters, they would be even more reluctant to damage their internal constituencies. An examination of the evidence from the cases surveyed here supports this view. Governments in all eleven countries, regardless of party ideology or extent of meaningful democracy, did impose policies injurious to the working class. (This is not to say that governments could in all cases prevent declines in working-class consumption if liberalization policies were abandoned. In many cases, declines caused by unsustainable prior policies have been one of the pressures leading governments to initiate liberalization.)

The conclusion to be drawn from an examination of policies affecting the working class during this time of international economic distress and forced adjustment is that virtually all governments subject to intense pressures to liberalize their economies have been politically capable of squeezing the working class. The sample examined here includes countries with strong, well-organized unions (Argentina, Uruguay), countries in

[14] Though I focus on the effects of political institutions on the incentives facing politicians, the underlying distribution of interests in the country is equally important – especially in interaction with features of the political system. Political institutions that can be expected to contribute to successful liberalization in a country with a particular distribution of interests would not be expected to have the same effects in a country with a different distribution of interests. In a country with a relatively small urban sector and a peasant-based agricultural export sector, for example, the highest probability of sustaining trade liberalization might be achieved in a political system characterized by universal suffrage and a highly competitive party system. Large numbers of peasant exporters would benefit from the reform, while the small urban sector would be hurt. Peasant participation in a democratic system could sustain the reform. The same kind of political system might impede trade liberalization, however, in a country with a predominantly urban population, an export sector owned by a small number of large land owners, and a long history of heavily protected import substitution industrialization. In such a country, much of the population would be hurt, at least in the short run, by liberalization and could be expected to try to unseat the political leaders who initiated it.

[15] Indeed, exactly this argument is made with force and persuasiveness by G. O'Donnell, *Modernization and Bueraucratic-Authoritarianism*, Berkeley: UC Berkeley, Institute of International Studies, 1973, and a number of others.

which the working class was an important constituency of the party that governed during liberalization episodes (Argentina, Greece, Mexico, Venezuela, Senegal, and Spain), and countries in which the ruling party had an effective opposition further to the left that could capitalize on working-class discontent (Brazil, Greece, Uruguay). Liberalization was slowed or stalled by widespread public opposition in several of the countries examined (Brazil, Greece, Nigeria, Senegal, Uruguay, Venezuela, and Zambia), but in none was the working class fully able to protect itself while it was going on. None of the factors that might have been expected to limit the ruling party's willingness to hurt working-class interests was sufficient to safeguard them.

Governments that have imposed such heavy costs on the working class have of course paid an electoral price for it. The PRI in Mexico very nearly lost the presidential election in 1988,[16] for the first time in its history. PASOK in Greece lost the 1989 election (though the loss was due as much to scandals involving party leader Andreas Papandreou as to PASOK's economic performance.[17] Senegal's Parti Socialiste ended austerity measures after a near defeat in the 1988 election. The Motherland Party in Turkey eased up on wage restraint after its poor showing in the 1989 local elections, but nevertheless lost the 1991 general election (as in Greece, as much because of scandals involving party leader Turgut Özal and his family as because of economic performance).

These costs, however, have not been as heavy as many would have predicted. The party that initiated cuts in working-class income has been defeated in the first election after the policy change in only two of the cases examined, Venezuela and Zambia. In contrast, in Senegal, Spain under PSOE, Argentina, and Turkey in 1987, initiating governments have won at least one election after the imposition of cuts. The PRI in Mexico has bounced back from its near defeat in 1988 with an impressive victory in the 1991 congressional elections – a victory attributed not to easing liberal policies, but to a high aggregate growth rate for the first half of 1991, announced a few days before the election, and the distribution of individual benefits on a massive scale.[18]

I draw four conclusions from the willingness of many governments to damage working-class interests and the failure of voters routinely to oust these governments. First, a principal-agent problem such as that described above is not simply a figment of the academic imagination; it exists in reality.[19] Second, politicians recognize that

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[16] Some observers believe that an honest vote count would have resulted in a PRI loss, and that the PRI only held onto power by fraud. It is impossible to know for sure.

[17] K. Featherstone, "The 'Party-State' in Greece and the Fall of Papandreou." *West European Politics*, 1990, 13. pp. 101–15.

[18] *Economist*, August 24, 1991, p. 38.

[19] An alternative interpretation sometimes advanced to explain support for governments following liberal policies, especially in Chile and Spain, is that most of the population has "learned" that their long-run interests will be best served by these policies. This possibility cannot be ruled out, though such learning – to judge by strikes, demonstrations, and public statements by opposition leaders – has not occurred in most countries currently being pressed to liberalize. Nor is it supported by Chilean survey data showing low levels of support for central elements of the economic package or Spanish strike activity.

(G. Arriagada and C. Graham, "Chile: The Maintenance of Adjustment and Macroeconomic Stability During Democratic Transition." In: S. Haggard and S. Webb (eds.), *Voting for Reform: Economic Adjustment in New Democracies*, Washington, DC: World Bank, Forthcoming.

they can fool some of the people all of the time and all of the people some of the time. That is, politicians recognize that they have some autonomy from constituency interests. Third, although politicians would prefer to respond to their constituents' demands – it is certainly a safer strategy – when external pressures force hard choices, politicians will abandon their external constituencies before their internal constituencies. And finally, arguments that claim that authoritarian regimes are better able to maintain stability while reducing working-class consumption are wrong. It seems that virtually any government that wants to can squeeze the working class.

3. Privatization

Although governments have initiated policies that hurt working-class interests in all the countries in the sample, not all have been willing to carry out policies such as privatization that would damage and disorganize their internal constituencies. When considering privatization or reductions in public employment, politicians have to assess not only its expected effect on groups in society that may withdraw support, but also its direct effect on their own ability to maintain their political machines. Jobs in the bureaucracy are the most important currency for paying party workers in many countries. The ability to deliver the individual constituency services that are the meat and potatoes of successful party maintenance depends on having party loyalists in relevant bureaucratic agencies. The more the state intervenes in the economy, the more benefits are potentially available to parties to distribute. More state enterprises make possible the distribution of more jobs and contracts.

This reliance on state resources to maintain political support characterizes authoritarian governments as well as democracies. The military government in Argentina (1976-83), despite its free market rhetoric, could not bring itself to sell off any significant number of public enterprises, many of which were controlled as virtual fiefdoms by the armed forces. Many of the failed adjustment attempts in Africa seem directly linked to the unwillingness of political leaders in single party regimes to reduce public employment and sell off state enterprises. Consequently, these reforms are often the most difficult to initiate or maintain in both democratic and authoritarian settings.

Leaders in single party systems do, however, have some advantages over those in competitive party systems when it comes to carrying out privatization *if* they really commit themselves to doing it. Those hurt by changes find it much harder to remove single parties from office than competitive parties, and disgruntled party activists have no easy alternative to which to transfer their loyalties. Politicians in single parties can, however, usually be expected to be especially reluctant to initiate such reforms because government jobs and other state benefits are the main resources used to cement the loyalties of party supporters.[20] The single party's monopoly of these resources is often one of the most important barriers to the entry of other parties into serious competition.

[20] Mexico, the obvious counter example, is discussed below.

In short, privatization and reductions in state employment potentially threaten the internal constituencies of rulers in both democratic and authoritarian regimes. Whether these policies are carried out should then depend on who has decision-making power and whether his or her supporters are concentrated in particular agencies. This is a very simple idea. It does not take into account many factors everyone recognizes as important, such as societal economic interests and public attitudes toward privatization. But this very simple idea goes a surprisingly long way toward explaining the differences in the experiences of the eleven countries examined here.

One can infer the costs of privatization or large-scale dismissals of state employees to incumbents if one knows the party affiliation of the executive, which party's loyalists predominate in staffing state agencies, and what incentives executives can deploy to affect the behavior of other political actors, especially legislators, who must acquiesce in decisions. The probability of successful privatization falls as these costs rise, and thus depends on political and institutional characteristics that affect party affiliations and the relationship between the executive and the legislature, such as: the frequency of regime change; constitutional provisions that grant power to the executive relative to the legislature; the relationship of the president to his or her party; and the permeability of the party system to political outsiders. Let me sketch the logic underlying the politics of privatization.

Policies leading to privatization and the dismissal of personnel are initiated by executives and often require legislative cooperation. Executives face intense pressures from the external economic environment to privatize. It is a relatively quick and attractive way to cut budget deficits, reduce outstanding debt, secure revenue, and make international agencies happy. These are the benefits of privatization. Executives, however, must also consider the costs to their own future political viability and that of their parties.

It might seem that presidents in fully democratic systems would not share the concerns of legislators and prime ministers in maintaining party and personal political machines since in many countries presidents cannot legally be elected to consecutive terms. Nevertheless, presidents' interest in political survival does not differ greatly from that of legislators. They want to maintain their party base while in office in order to govern effectively. Many face midterm legislative, gubernatorial, and/or municipal elections that can be interpreted as plebiscites on presidential performance. And finally, even though they may not be able to run for office again immediately, most wish to continue their political careers as party leaders, and many hope to win the presidency again after a term or two have elapsed. The hope of achieving the pinnacle of power again is very widespread and not as unrealistic as one might at first suspect. Carlos André Pérez and Rafael Caldera of Venezuela, Fernando Belaúnde of Peru, Juan Perón of Argentina, Carlos Ibáñez of Chile, and Getúlio Vargas of Brazil were all elected to a second term as president after being out of office for at least one. And many others have hoped and campaigned for a second term but failed to achieve it. At the moment, speculation abounds in Latin America about the visible maneuvering for advantage in future elections by recent presidents Raúl Alfonsín of Argentina, José Sarney of Brazil, and Alan García of Peru.

To the extent that presidents' interests differ from legislators', it is mainly because of two situational differences. First, they represent the national constituency rather than a smaller and less encompassing one. Second, in most cases they need to build a base of support while in office that will survive anywhere from four to twenty years out of office. Both of these differences give them a greater interest than legislators in aggregate economic performance. Presidents also frequently have longer time horizons than legislators; on average, the next election they face will be further in the future than the legislator's. The interests of prime ministers fall somewhere between those of presidents and those of legislators. They have a national constituency, but usually a shorter time horizon than presidents.

Their interest in aggregate economic performance makes both presidents and prime ministers more likely to favor liberalization than legislators in some, but certainly not all, circumstances. Presidents' longer time horizon makes such policies more politically feasible for them, since they can hope that the largest welfare losses will have receded into the past and the benefits will have become apparent before they face another election. Even when presidents' own political interests would be best served by carrying out reforms, however, their behavior may be constrained by pressures from other political actors, especially members of their own party or coalition – as discussed below.

4. Executives' Decision to Privatize

Whether executives will favor privatization or extensive layoffs of public employees depends on whether their own party or faction occupies a disproportionate number of positions in the bureaucracy or state enterprise sector. Executives opposed by other factions or parties that rely heavily on political resources dependent on their control of state positions will be especially likely to favor privatization. In this group of countries, the executives who proposed the most extensive privatizations were Carlos Salinas of Mexico, Carlos Menem of Argentina, Fernando Collor of Brazil, and Felipe González of Spain. Collor and González lead or led parties with few jobs in the state sector. Salinas, discussed in more detail below, leads a party faction opposed by the faction within his party more closely linked to state employment. Menem leads a party in which the rank-and-file is heavily represented in the state sector, but which, because of purges during the military regimes between 1966 and 1983, had few higher status partisans in the bureaucracy at the time he took office. He was supported for the presidential nomination and during the campaign by only one of the four main factions of the Peronist union movement.[21] The recent democratization of nominating procedures in several well-established Latin American parties has resulted in a greater probability that a candidate not supported by the party establishment could be nominated and elected to the presidency. Menem, Carlos Andrés Pérez of Venezuela, and César Gaviria of Colombia were all nominated despite the opposition of established party leaders, and all have attempted very substantial economic liberalization.

Privatization has been most extensive in Argentina and Mexico. In Mexico, between eight and nine hundred out of a 1982 total of 1,172 public firms had been

[21] J. McGuire, "Union Political Tactics and Democratic Consolidation in Alfonsin's Argentina, 1983-1989." *Latin American Research Review*, 1992, 27, pp. 37–74.

disincorporated, liquidated, or sold off by the end of 1993. Two hundred sixty-nine, including some of the largest (for example, Petroleos Mexicanos [PEMEX], the state-owned oil industry, and Comisión Federal de Electricidad, which supplies electricity), are slated to remain under state control. The majority of the previously state-owned firms were liquidated or disincorporated rather than privatized in the strict sense of being sold off to private buyers.[22]

By the end of 1992, the Argentine government had earned $ 17.6 billion from privatizations since 1990.[23] As of mid-1993, the most important privatizations included: 15 year concessions for the operation of two of the main television stations; 10,000 km of federal highways, transformed into privately operated toll roads; the state interest in five petrochemical enterprises; the telecommunications monopoly; 57% of the state airline; the Tandanor state shipyards; 30 year concessions for the operation of water and sewerage facilities in greater Buenos Aires; controlling shares in the natural gas pipelines and distribution system; controlling interest in electric power services in greater Buenos Aires; concessions for private operation of grain elevators in ports; a ten-year contract for the operation of the state stockyards in Buenos Aires; most freight and passenger railroads;[24] and 58.5% of the state oil industry, Yacimientos Petrolíferos Fiscales (YPF).[25] These sales, along with many smaller ones, accounted for 90% of what the Menem government proposed to sell.

Privatization in Mexico was initiated by President Miguel de la Madrid, but only affected large numbers of firms after the accession to power of President Salinas.[26] It was opposed by the much larger traditional PRI machine. During most of the de la Madrid presidency (1982–88), government efforts focused on stabilization, which included a harsh assault on real wages (as shown in Table 2) and the liquidation of a number of small money-losing state firms. Large state firms employing large numbers of workers organized in unions affiliated with the PRI were not affected. Beginning in 1987, a new round of much more intense liberalization was initiated, under the guiding hand of soon-to-be next president Carlos Salinas.

Salinas, like de la Madrid before him, came from the technocratic wing of the PRI, but he faced a different political environment. If he won the presidency at all, it was by the barest majority. The old party machine, that had delivered the vote so regularly for nearly fifty years, had been seriously undermined by the previous six years of austerity. It could no longer deliver the carrots to voters, and it could no longer deliver the vote for PRI candidates. Furthermore, it had fought against Salinas's nomination,

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[22] *Latin American Special Report*, April 1991, p. 4–5. All figures relating to the number of state-owned enterprises are controversial because of differences among sources about what should be counted. The 1982 figure reported here is from a 1990 study by the Centro de Estudios Económicos de Sector Privado, and is, in my judgment, more accurate than the much smaller figure often cited.

[23] *Chronical of Latin American Economic Affairs*, January 7, 1993, p.2.

[24] *Ibid.* June 17, 1993, pp. 2-6.

[25] *Ibid.* June 4, 1993, p. 4, July 22, 1993, pp. 3–5, and July 29, 1993, pp. 5–6.

[26] B.R. Schneider, "Partly for Sale: Privatization and State Strength in Brazil and Mexico." *Journal of Interamerican Studies and World Affairs*, 1989, 30: 89-116; B.R. Schneider, 1990. "The Politics of Privatization in Brazil and Mexico: Variations on a Statist Theme." In: John Waterbury and Ezra Suleiman (eds.), *The Political Economy of Public Sector Reform and Privatization*, Boulder: Westview, 1990; *Latin American Special Report*, April 1991, pp. 4–5.

opposed his economic reforms, and hindered at every turn his efforts to transform the party and the Mexican economy. Salinas actively attacked the political resource base of the traditional PRI, not only through extensive privatizations, but also through well-publicized assaults on some of the most powerful unions in Mexico. The vast numbers of lay-offs in the state-owned oil industry, mining, and railroads were made more palatable to the rank-and-file by generous severance pay,[27] but the old union elite, cogs and wheels of the PRI machine, were forced out in several unions.[28] I do not doubt Salinas's sincere commitment to liberal economic ideology, but his political interest in reducing the size and resource base of the tranditional wing of the party seems equally obvious. He has tried to use some of the revenues generated by privatization to build a new form of political organization, in which the distribution of patronage is unroutinized and occurs through individuals linked directly to the president, the organizational unit is the neighborhood rather than the workplace, and intermediate elites such as union leaders have been cut out of the loop. By all accounts, these efforts have been quite effective, both in the delivery of real benefits to needy voters and in the creation of support for Salinas.

In Argentina, President Carlos Menem, from the backward provincial wing of the Peronist Party, and supported for the presidential nomination by only one relatively small labor faction,[29] has led the drive for privatization. No one has accused Menem of having a sincere commitment to anything. Because of the dominance of Peronists in the union movement, most rank-and-file state employees have been Peronists. But higher status bureaucratic jobs do not play the role in party maintenance they once did because many Peronists in government were purged by military rulers. When Menem came to power, the Peronists had not had an opportunity to control appointments for nearly 15 years.

Because of the importance of public sector jobs to union members, and of public sector unions to the union movement, however, the extensive privatizations in Argentina have been carried out in the face of widespread and severe opposition from much of the president's party. Menem has waged a largely successful campaign to consolidate his own control of the party and reduce the power of potential rivals, especially those with power bases in the unions. Early in his administration, he managed to unseat long-time union leader Saúl Ubaldini and replace him with a close relative of his own. The union faction supporting Menem has been rewarded with generous side payments, while the rest of the union movement has borne the costs. Privatization for Menem, as for Salinas, has many benefits: it reduces the budget deficit, reduces the debt, and reduces the political resources of the part of the Peronist party over which his control is the most tenuous.

Brazil's president Fernando Collor, much more of an outsider than Salinas or Menem, proposed one of the most radical reductions in the public sector in the region.

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27 Three months salary is legally required as severance pay by the 1917 Mexican Constitution. In addition, many state employees received 20 days pay for each year of seniority (K. Middlebrook, *Organized Labor and the State in Mexico*, Baltimore: Johns Hopkins University Press, 1994).

28 Middlebrock, *Op.cit.*

29 J. McGuire, "Union Political Tactics and Democratic Consolidation in Alfonsin's Argentina, 1983–1989." *Latin American Research Review*, 27: 37–74.

Collor came from a small, backward state outside the mainstream of Brazilian national politics and led a small, fly-by-night, regionally based party put together to support his presidential campaign. The bureaucracy and state enterprise sector are honeycombed with supporters of the older, more established parties. When he first came to power, Collor announced that 22% of public employees, or 360,000 people would be sacked,[30] that 24 state agencies would be closed,[31] and that largescale privatizations would be carried out in the steel, petrochemical, and fertilizer industries.[32] Changes have in reality been much more limited, for reasons discussed below.

Regime change and even government change in some cases can increase the likelihood of privatization, since the new executive often belongs to a party different from the one that previously dominated bureaucratic staffing. For the new government, privatization may be a means of eliminating resources controlled by supporters of the old regime or government, and thus a means to consolidating the new government's power. The public enterprise sector in Spain dates from the Franco regime. The state holding company, Instituto Nacional de Indústria, owned about 12 firms, had a controlling interest in 37, and a minority interest in another 12. By current comparative standards, this is a small state sector, but it included the state airline, telephone service, and direct involvement in the production of steel, hydroelectric power, ships, chemicals, aluminum, fertilizers, textiles, and cars. Because of its links to the Franco regime, the PSOE had no stake in its perpetuation.[33] PSOE strategists seem to have believed that it would be easier to privatize than to oust old Franco appointees from their strongholds in the state enterprise bureaucracy. Between 1984 and 1986, the PSOE government dissolved or sold its interest in more than 30 state firms.[34]

In other countries, government or regime change has also contributed to privatization or reductions in state employment. In Nigeria, the Buhari military government (1983–85) dismissed 250,000 state employees hired by past governments when it first came to power.[35] The Babangida military government (1985–93) conducted a moderately successful privatization campaign. By the end of 1991, 78 enterprises had been sold, earning the government $ 89 million, though privatization of the largest state enterprises had not occurred.[36] Among the least controversial privatizations in Argen-

[30] *Latin American Economic Report*, June 30, 1990, p. 3.
[31] Sá, Xico, "Estatais resistem a liquidação." *Estado de Sao Paulo*, 1991, May 23, p. 6.
[32] B.R. Schneider, "Privatization in the Collor Government: Triumph of Liberalism or Collapse of the Developmental State?" In D. Chalmers, M.do Carmo Campello de Souza, and A. Borón (eds.), *The Right and Democracy in Latin America*, New York: Praeger, 1992; *Latin American Economic Report*, August 31, 1991, p. 3; *Latin Finance*, 28, 1991, p. 44.
[33] In contrast, the Unión de Centro Democrático (UCD), the first post-democratization ruling party, which included in its ranks many former Franco supporters, did not carry out any privatization, though it carried out other moderately liberal policies. On the contrary, employment in state enterprises increased by 11 percent between 1975 and 1980, and budgetary transfers to public enterprises increased 500% between 1977 and 1982 (N. Bermeo, "The Politics of Public Enterprise in Portugal, Spain, and Greece." In E. Suleiman and J. Waterbury (eds.), *The Political Economy of Public Sector Reform and Privatization*, Boulder: Westview, 1990, 140).
[34] *Ibid.* pp. 140–41.
[35] T. Callaghy, "Lost Between State and Market: The Politics of Economic Adjustment in Ghana, Zambia, and Nigeria." In J.M. Nelson (ed.), *Economic Crisis and Policy Choice*, Princeton: Princeton University Press, 1990.
[36] Economist Intelligence Unit. *Country Report: Nigeria*, No. 2, 1992, p. 18.

tina have been those of assets controlled by the military.[37] Since their disastrous performance when last in power, the military in Argentina has been singularly bereft of civilian support. The military controlled large parts of the state enterprise sector and employs a large number of people, but has virtually no political allies now, so it is a tempting target for deficit reduction efforts. In addition to privatization, more than 20,000 military employees have lost their jobs, military pay has fallen, and real estate owned by the military, including the Campo de Mayo base 'near Buenos Aires, is being sold.[38] When the New Democracy Party took power in Greece in 1990, it immediately began pressing for privatization of state-owned enterprises, most of which had been created and staffed by its rival PASOK.

Not all regime and government changes, however, result in privatization or the wholesale firing of public employees because not all regime changes result in an executive unsupported by those who staff the public sector. The Greek change in government was unusual in that most of the public sector jobs that New Democracy wanted to eliminate were staffed by one particular party, New Democracy's main rival, PASOK. Regime changes in Brazil (1985), Uruguay (1985), and Turkey (1983) failed to lead to widespread privatization since parties that won transitional elections were well-represented in the bureaucracy.

In Brazil, the continuity of personnel between the outgoing military regime and the first democratic government led by José Sarney was very high. Sarney had, until shortly before presidential selection by the electoral college, been a member of the party that supported the military, as had most of his closest political allies. Their supporters were well entrenched in the bureaucracy during military rule, and the pact between the opposition parties and the military that facilitated the return to civilian rule included a provision for the protection of military appointees. Supporters of the largest opposition party had also had the opportunity to secure substantial numbers of jobs during the long transition process. The convergent interests with regard to public sector jobs of the main parties at the time of the transition to democracy found formal reflection in the provisions of the 1988 Constitution protecting all public employees with five years tenure from dismissal and in the various provisions that limit the possibilities for privatization. The initiation of significant privatization had to await the election of a president supported by a party that had not existed at the time of transition, and has proceeded slowly because of opposition from many powerful political groups still well represented in the legislature, judiciary, and state governments.

The Uruguayan public sector was traditionally staffed by Colorado and Blanco party loyalists, with Colorados predominating most of the time. The Colorados controlled the first government after redemocratization and made no progress on privatization. The current Blanco government proposed extensive privatization along with a number of other liberalizing reforms, but has lacked sufficient support in Congress and among the public to carry it out.

In contrast to the executives discussed above who tried to initiate privatization, though they did not always succeed, executives who had founded their parties and led them through the achievement and consolidation of power are especially unlikely

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37 *Latin American Special Report*. April 1991, p. 3.
38 *Latin American Regional Report: Southern Cone*. July 4, 1991, p. 2.

to support privatization or firing public employees, who are likely to be their own supporters. Among the cases in this study in which little or no privatization has occurred are: Zambia, governed from independence until recently by Kenneth Kaunda and his United National Independence Party (UNIP);[39] Greece, while governed by Andreas Papandreou and his PASOK;[40] and Turkey, governed by Turgut Özal and his Motherland Party.[41] In all, the founder of the ruling party was still in power at the time of the effort at liberalization.

The public sector in Zambia during UNIP rule included: the copper industry, Zambia's most important export; an oil pipeline, refinery, and hydroelectric plants; railways, road and bus services, and the national airline; two banks and the insurance industry; and an important part of the manufacturing sector.[42] Privatization was neither proposed nor carried out during the liberalization episode in the late eighties. There were 111 public enterprises at the beginning of the period, and 123 at the end.[43] Since its victory over UNIP in the October 1991 elections, the government of Frederick Chiluba has sold six out of 19 firms offered for sale, and announced the sale of a second group. Those sold so far have been small, but the sales, along with lay-offs in the public sector and reduced lending to state enterprises, indicate a change in government.[44]

Much of the state enterprise sector in Greece was created by the first PASOK government led by Andreas Papandreou, which ended in 1989. No privatization occurred during PASOK rule. The New Democracy party carried out a number of privatizations, despite widespread opposition, between 1990 and 1993. After his return to power in October 1993, Papandreou promised to reverse much of the privatization accomplished by New Democracy, including the act providing for the sale of 35% of the Greek telecommunications industry, the privatization of Athens Urban Transport, and the sale of AGET-Heracles, a cement producer. He has also promised to rehire 20,000 PASOK loyalists "unfairly dismissed" by the previous government.[45]

During the 1980s, the Turkish public sector accounted for more than 50% of total fixed capital formation and about 40% of valued added in manufacturing.[46] More

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[39] K. Good, "Debt and the One-Party State in Zambia," *Journal of Modern African Studies*, 1989, 27: 297–313; J. Wulf, "Floating Exchange Rates in Developing Countries: The Case of Zambia." *Journal of Modern African Studies*, 1989, 27: 509–13; J. Kydd, "Coffee after Copper? Structural Adjustment, Liberalization, and Agriculture in Zambia." *Journal of Modern African Studies*, 1988, 26: 227–51; F. Meijer, "Structural Adjustment and Diversification in Zambia." *Development and Change*, 1990, 21: 657–92.

[40] N. Bermeo, 1990a. "Greek Public Enterprise: Some Historical and Comparative Perspectives." *Modern Greek Studies Yearbook, 1990, 6: 1-22.; N.* Bermeo, "The Politics of Public Enterprise in Portugal, Spain, and Greece." In E. Suleiman and J. Waterbury (eds.), *The Political Economy of Public Sector Reform and Privatization*, Boulder: Westview, 1990.

[41] Z. Önis, "The Evolution of Privatization in Turkey: The Institutional Context of Public-Enterprise Reform." *International Journal of Middle East Studies*, 1991, 23: 163–76.

[42] R.H. Bates, and P. Collier, "The Politics and Economics of Policy Reform in Zambia." In R.H. Bates and A.O. Krueger (eds.), *Political and Economic Interactions in Economic Policy Reform*. Oxford: Blackwell, 1993, p. 400.

[43] *African Economic and Financial Data*, World Bank, 1989, p. 163.

[44] Economist Intelligence Unit. *Country Report: Zambia and Zaire*, No. 4, 1993.

[45] Economist Intelligence Unit. *Country Report: Greece*, No. 4, 1993.

[46] Önis, *Op.*cit. p.164.

privatization was accomplished during the Ö¿zal government than during the Kaunda or Papandreou governments discussed above, but privatization was surprisingly slow and affected few firms, given the context of extensive and quite successful liberalization in other areas.[47] By 1989 when the Motherland party's political strength had waned and the coherence of its economic policies had deteriorated, 45 fully or partially owned firms had been identified for sale, but only three substantial privatizations had occurred: 22% of Teletas, the telecommunications company; 90% of Çitosan, a cement producer; and 70% of Usas, the state airline. The proceeds of these sales totaled about $120 million.[48]

In contrast, privatizations carried out in 1993, by a coalition of the True Path party and the Social Democratic Populist party, both of which opposed privatization in 1989, yielded receipts of $ 400 million. The current government (in early 1994) has also proposed the privatization of telephone services, expected to yield $ 10–15 million, and the Turkish Petroleum Refining Corporation, worth up to a billion dollars.[49] It remains to be seen if they will be able to carry them out, since opposition to these privatizations is high among other important political actors. Nevertheless, these proposals indicate that this government's attitude toward privatization is more positive than that of the previous one, even though its general economic policy stance has emphasized heavy state spending, high growth, and low unemployment rather than liberalization.

To summarize the argument about executives' preferences, they have strong reasons to privatize and reduce the public payroll. Such policies reduce the budget deficit, please international financial agencies, reduce the debt, and, in some countries, respond to private interests and public opinion. But these reasons are not strong enough to cause the executive to press for such policies if his own political machine depends heavily on state employment and other benefits derived from party control of the state apparatus.

5. Legislators' Decisions to Acquiesce in Privatization

Legislatures have gone along with executives' proposals to privatize where the president's party has had a working majority in the legislature, as would be expected, and where electoral rules (for example, list proportional representation) or characteristics of internal party structure insure party discipline in the president's party.

In Argentina, Mexico, and Spain, the ruling party has had a working majority (that is, either an absolute majority or a plurality that can be turned into a majority by the addition of a very small number of votes, usually from a small marginal party) in the legislature and strong party discipline. Especially in Mexico and Argentina, opposition to privatization from within the ruling party was quite strong, but party discipline

[47] T. Aricanli, and D. Rodrik, "An Overview of Turkey's Experience with Economic Liberalization and Structural Adjustment." *World Development*, 1990, 18: 1343–50; A.O. Krueger, and I. Turan, "The Politics and Economics of Turkish Policy Reforms in the 1980s." In: R. Bates and A.O. Krueger (eds.), *Op.cit.*

[48] Önis, *Op.cit.* p. 172.

[49] Economist Intelligence Unit. *Country Report: Turkey*, No. 1, 1994.

in the legislature held firm. All three also have strong executives relative to the legislature,[50] though, as Brazilian experience shows, even an executive with extensive decree powers needs some legislative support.

Venezuela is an interesting case to contrast with Argentina and Spain. President Pérez proclaimed his support for privatization along with a number of other important economic reforms. His party, Acción Democrática (AD), fell only slightly short of a majority in the legislature and could easily have achieved a majority by allying with one of the small parties. Party discipline in Venezuela is unusually strong and normally assures the passage of proposals important to the president. Pérez initiated a number of significant liberal reforms, including a major trade liberalization and reductions of subsidies to urban consumption. Progress in carrying out privatization, however, was slowed by political opposition.

In 1990, Venezuela had about 430 state enterprises employing about 20% of the workforce. The Pérez government announced a modest privatization affecting 60 firms and expected to yield $ 100 million in 1990.[51] The first privatizations were carried out in 1991, 80% of the national airline (20% to employees) and 30% of CANTV, the telecommunications industry. Political turmoil and cumbersome legal requirements impeded privatization during 1992. Only nine small firms valued at $ 27 million were sold. Pérez asked the legislature to pass reforms that would ease privatization, but these reforms failed because of opposition from unions and in legislators, including some in his own party.[52] Pérez proposed further privatizations expected to yield $ 2 billion in early 1993, but the increasingly violent opposition to the president that led up to his impeachment in mid-1993 effectively blocked further privatization.

Because of its historic position as the most important party in Venezuela, AD party loyalists permeate the state enterprise sector, which gives party leaders a major stake in its continuation, and party opposition to privatization has been vehement. After gaining his party's presidential nomination despite opposition from virtually all established party leaders except labor, Pérez attempted to consolidate his own position within AD and replace existing leadership with allies of his own, as Menem did in the Peronist Party. But he failed. AD is a much more fully institutionalized party than the Peronist, and established party leaders were able to defend their positions against the president. The impeachment of Pérez on corruption charges in 1993 is an indication of the lengths many in the party were willing to go to halt liberalization and privatization.[53] As of this writing (February 1994) both seem effectively stalled in Venezuela.

The privatizations and reductions of state employment proposed by Brazilian President Collor and Uruguayan President Lacalle were also largely blocked by the legislature and other political actors. Both presidents relied on coalitions in the legis-

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[50] P. Heywood, 991. "Governing a New Democracy: The Power of the Prime Minister in Spain." *West European Politics*, 1991, 14: 97–115.

[51] *Latin American Special Report*, April 1991, p. 6.

[52] *Chronical of Latin American Economic Affairs*, January 28, 1993, pp. 7–8.

[53] This is not to say that the corruption charges against Pérez were false, but only that there is no indication that corruption was any worse than usual. The impeachment could not have taken place without the support of some members of his own party.

lature on which they could not impose party discipline, and both failed to gain support for privatization.

In Uruguay, when President LaCalle took office in early1990, he formed a coalition that included his own faction of the Blanco Party and the two largest opposition factions to support stabilization measures including large tax increases, cuts in subsidies, and privatization. The tax increases and cuts in subsidies passed in the legislature despite widespread public opposition,[54] but the coalition broke up over the issue of privatization. In late May 1991, the Foro Batllista faction of the Colorado Party led by former president Sanguinetti withdrew from the coalition over a bill proposing the sale of the telephone company, the airline, and the ports, and the end to state monopolies in insurance, electricity, gas, and alcohol.[55] The Colorado Party, like AD in Venezuela, has been the strongest party in Uruguay for most of its democratic history. Its party workers and members stand to lose heavily if state enterprises are sold. Many members of the Blanco Party also oppose privatization. The Blancos have held power less frequently than the Colorados, and therefore have had fewer opportunities to pass out jobs, but Uruguay's various experiments with pacts and collegial executives have assured the Blancos a minority share of patronage for most of the twentieth century. Many Blanco party workers have also found berths in Uruguay's public sector.

In Brazil, President Collor's efforts to reduce public employment were limited by opposition forces. Only a small number of the 80,000 people he proposed dismissing during his first 100 days in office were actually laid off.[56] On less controversial issues, the president could count on support from a coalition of parties, but not on this issue. He attempted to end-run Congress by using the same decree provision he used to freeze bank accounts early in 1990, but he was blocked by the Supreme Court. The 1988 Constitution, written by the legislature sitting as a constituent assembly and dominated by the Party of the Brazilian Democratic Movement (Partido do Movimento Democrático Brasileiro), granted to all public employees with five or more years of service permanent tenure. The Supreme Court ruled Collor's efforts to get around this provision unconstitutional.

Of the 24 government agencies announced disbanded in early 1990, 21 still existed more than a year later and had cost the government Cr$ 53 billion during that year. In some cases, the agencies had ceased performing any functions, but employees were still being paid.[57]

Privatization also went slowly under Collor, and stirred up wide opposition. Collor initially promised one privatization a month, claiming that privatization would raise $ 18 billion in five years.[58] The first privatization was delayed for more than a year by violent opposition from unions and regional political leaders in states where the enterprises were located, and a series of suits seeking injunctions against the sale.[59]

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[54] *Latin American Economic Report*, April 30, 1990, p. 17.
[55] *Latin American Regional Report: Southern Cone*, July 4, 1991, p. 6.
[56] *Latin American Economic Report*, June 30, 1990, p. 3.
[57] Sá, *Op.cit.*
[58] *Latin Finance*, 28, 1991, p. 44.
[59] T. Kamm, "Brazil's Privatization Program Faces Obstacles That Threaten Its First Sale." *Wall Street Journal*, September 24, 1991, p. A13; "Usiminas: E o Martelo Ficou no Ar," *Visao*, October 2, 1991, pp. 20–23.

Nineteen state firms worth $ 4 billion were eventually sold prior to Collor's impeachment for corruption in late 1992, a modest amount of privatization, given the "immense size of the Brazilian economy and the weight of the public sector in it.[60] At the same time, the wage bill for the state enterprise sector and state banks increased "by 40%, fro $ 18 to $ 25 billion between 1991 and 1993.[61] Although Collor did advance "corruption to new heights in Brazil,[62] it is possible that the political class would have turned its usual blind eye to his depredations on the public till had they not also been threatened by his liberalization efforts.

At this writing, the issue of privatization in Brazil remains unresolved. Impediments continue to be substantial. The 1988 constitution prevents privatization of the telephone company and the oil industry, limits foreign ownership of other firms to 49%, and requires legislative approval for sales of more than 40% of a company's shares. Constitutional reform is now under consideration, but changes in these provisions are by no means assured. Other regulations also limit the appeal of Brazilian state enterprises to potential private buyers. Brazil has very strict profit remittance laws and the highest corporate taxes in the world.[63] Changing these regulations would also require legislative consent.

Political outsiders such as Collor, not backed by or beholden to large established parties, are quite likely to propose state-reducing reforms – though they may not be able to carry them out. They can reap political benefits from cutting state employment and privatizing public enterprises since, in doing so, they undermine the resource base of other parties without hurting their own base of support. Thus they differ from other presidents in that their own political interests are served by privatization rather than having to be subordinated to economic needs.

Furthermore, as Collor's campaign against "maharajas" (bureaucrats claimed to be getting rich at public expense) has shown, attacks on the bureuacracy can be quite popular with the general public. This popularity gives presidents an additional reason to propose reductions in the state bureaucracy. Besides Collor, I would put Alberto Fujimori of Peru and Oswaldo Hurtado of Ecuador, both of whom tried to initiate liberalizing reforms but ran into severe opposition within the rest of the political class, in this outsider category. The efforts of such outsiders to liberalize are likely to be unsuccessful. The very fact of being an outsider means that they have no solid base of disciplined party support in the legislature or the rest of government.

Conclusion

This study has reached two general conclusions. First, that politicians find it less politically costly to harm their external constituents, ordinary voters, than to harm their internal constituents, party activists. In consequence, when under severe exter-

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[60] *Chronical of Latin American Economic Affairs*, February 4, 1993, pp. 2–4.

[61] *Latin American Monitor: Brazil*, 11, February 1994, pp. 2–4.

[62] See B. Geddes and A. Ribeiro "Institutional Sources of Corruption in Brazil." *Third World Quarterly*, 1992, 13. for details of events leading to Collor's impeachment.

[63] "Brasil é campeão mundial de tributação," *Folha de São Paulo*, October 21, 1993; F.J.P. Lascelles Pallin, "Privatization under Collor." In: Price Waterhouse, *Privatization in Latin America*, 1991.

nal pressure to liberalize, all governments regardless of ideology, interest group base, or degree of real democracy seem able to introduce measures that cut real wages or increase unemployment.

In contrast to their readiness to damage working-class interests, politicians seem very reluctant to alienate their internal constituency of party workers and loyalists by eliminating the jobs they have earned in return for their services to the party. Consequently, although privatization and cuts in public employment have been proposed in all the economically stressed countries surveyed for this study, their implementation has been problematic in some cases.

Whether these particular measures can be pursued depends, in the most crass formulation, on who has the power to make decisions and whose supporters will be hurt. Generally, because of their longer time horizons and greater concern about overall economic performance, executives have more interest in deficit reduction than do legislators. Executives are most likely to propose privatization and cuts in state employment when, for one reason or another, their own supporters will not be affected by cuts. Their own supporters are less likely to be among those who lose their jobs when the executive is an outsider to traditional parties, when a regime change has occurred, or when the executive comes from a party faction traditionally underrepresented in the state bureaucracy. Executives are least likely to implement privatization when they have been the founders and leaders of a party that has achieved and consolidated political power because, in that case, most of those whose jobs will be eliminated will be their own party loyalists.

Legislators are most likely to acquiesce in privatization when the ruling party has a working majority in Congress and party discipline is strong. In most cases, privatization hurts the electoral chances of members of majority parties, and they can be expected to oppose the executive's proposals. But, where discipline is strong, they will support him in the legislature despite reservations.

Regime change often makes privatization easier because the incumbent government is willing to eliminate the jobs of its predecessor's supporters, though it would not have been willing to eliminate its own supporters' jobs.

Table 1: Liberalization Episodes*

Country	Ruling Partv	Policies
Argentina 1989-	Peronist (labor)	Wage restraint, austerity, extensive privatization, trade liberalization, tax reform
Brazil 1990-92	PRN (center-right)	Trade liberalization, bank accounts frozen, some privatization
Greece 1985-87	PASOK (social dem)	Deindexation, wage restraint, no privatization
Mexico 1982-90	PRI (center)	Austerity, wage controls, trade liberalization, extensive privatization
Nigeria 1984-87	Military	Exchange rate reform, reduced subsidies, wage reductions, moderate privatization
Senegal 1981 -87	PS (nominally socialist)	Trade liberalization, wage restraint, few privatizations
Spain 1977-82	UCD (center)	Wage restraint, modest trade liberalization
1982-90	PSOE (social dem)	Wage restraint, trade liberalization, substantial privatization
Turkey 1980-83	Military	Austerity, modest trade liberalization
1984-88	ANAP (center)	Trade liberalization, exchange reform, wage restraint, little privatization
Uruguay 1990-	Blanco (center)	Trade liberalization, wage restraint, increased taxes, little privatization
Venezuela 1989-93	AD (center-left)	Trade liberalization, reduced subsidies, austerity, limited privatization
Zambia 1985-87	UNIP (single party)	Exchange rate reform, reduced subsidies, no privatization

*"Episodes" begin when a government initiates a set of policies aimed at increasing the market orientation of the domestic economy. They "end" when very substantial liberalization has been achieved (Spain and Mexico in this sample); when elements of the initial policy package that affect wages are abandoned by the initiating government in response to popular opposition, even if other elements of the package are maintained (in Nigeria as the military began the process of democratization, in Greece, Senegal, and Turkey in response to electoral pressures, in Zambia after massive demonstrations); or when the initiating government loses office, even though the successor government sometimes continues or deepens policies (in Brazil and Venezuela when the initiating president was impeached, in Spain when the UCD lost the 1982 election, and in Turkey when the military regime ended in 1983).

Table 2: The Effect of Liberalization on Urban Real Wages[1]

Country	Ave. Change in Real Wages before Liberalizn Episode	Ave. Change in Real Wage during First Liberalizn Episode[2]	Ave. Change in Real Wage during Second Episode	Change in Real Wage during Worst Year	Ave. Change inReal Wage after Abandonment of Program
Argentina 1990-	3.1 (83-89)	-5.0 (90-92)		-5.0 (90,91,92)	
Brazil, 1990-92	11.8 (85-89)	-3.3 (90-92)		-14.0 (90)	
Greece 1985-87	4.9 (77-84)	-4.6 (85-87)		-8.4 (86)	3.1 (88-90)
Mexico 1983-90	-2 (77-82)	-3.0 (83-90)		-23.0 (83)	7.0 (91-92)
Nigeria 1984-87	NA	NA		Est. 22-42% decline 10/85-3/87	
Senegal[3] 1981-87	-2.5 (71-80)	-6.4 (81-84)	0.1 (85-87)	-9.9 (82)	5.9 (88-89)
Spain 1978-90	7.8 (70-77)	5.0 (78-82)	1.5 (83-90)	0.4 (84)	
Turkey 1980-88	7.6 (76-79)	-3.8 (80-83)	-3.7 (84-88)	-16.2 (80)	32.8 (89-91)
Uruguay 1990-	1.2 (85-89)	-5.7 (90-92)		-19.2 (90)	
Venezuela 1989-	-6.8 (83-88)	-15.0 (89-91)		-19.0 (89,90)	
Zambia 1985-88	Ave. formal sector wage = $ 1633/yr (84)	Ave. formal sector wage = $ 346/yr (87)			

Sources: Argentina and Brazil, Mexico (1983-92), *Latin American SDecial Report* SR-93-04 (August 1993), pp. 3-12, (manufacturing wages); Greece, Spain (1978-90) OECD, *Economic Outlook: Historical Statistics*, 1992 (real average hourly wage in manufacturing); Mexico (1977-82), Kaufman, Bazdresch, and Heredia, forthcoming (percent average change in manufacturing wage); Nigeria, Herbst and Olukoshi, forthcoming (urban); Senegal, Ka and van de Walle, forthcoming (public sector, see note); Spain (1970-77) Bermeo with Garcia Durán, forthcoming (real average hourly wage in manufacturing); Turkey (1976-88) Onis and Webb, forthcoming (real wages in manufacturing, deflated by the CPI); 1989-91, OECD, *Economic Survey: Turkey*, 1991-92, p. 25 (real wages in unionized private sector); Uruguay, 1985-89, UN, ECLAC, *Economic Survey of Latin America*, 1991; 1990-92, *Latin American Monitor: Southern Cone* 10:3 (March 1993), p.1129; Venezuela, *Latin American Special Report* (August 1993), p.9 (minimum wage); Zambia, Economist Intelligence Unit, *Country Report: Zambia*, 1991-92

[1] Data on real wages vary quite a lot from one source to another, especially for Latin America, but the general direction of change during structural adjustment episodes is not open to question.

[2] Adjustment was defined as "over" when either crucial parts of the policy package had been abandoned or when liberalization was judged to be more or less complete. The only completed adjustments in this sample are Mexico and Spain. In both cases, I judged the transition to have been complete by the end of 1990.

[3] Real wage data are not available for most African countries. The figures shown for Senegal are for civil servants' salaries. Public sector employment was 45% of formal sector employment in Senegal in 1980, so public sector wages have an important effect on the level of formal sector wages more generally. The long-term decline in civil servants' wages in Senegal reflects not only long-term economic problems, but also the very high wage rates of civil servants (equal to those in France) at the time of independence.

Table 3: The Effect of Economic Liberalization on UnemDlovment

Country	Average Unemployment before Liberalizn	Average Unemployment during First Episode	Average Unemployment during Second Episode	Unemployment during Worst Year	Average Unemployment after Abandonment of Program
Argentina 1990-	5.9 % (84-89)	7.7% (90-93)		9.9% (5/93)	
Brazil 1990-92	3.9 (85-89)	12.4 (90-92)		15.2 (92)	
Greece 1985-87	5.7 (80-84)	7.5 (85-87)		7.8 (85)	8.2 (88-93)
Mexico 1983-	4.3 (80-82)	4.7 (83-88)		6.6 (83)	
Nigeria 1984-87	NA	11.1 (86-87)		12.2 (87)	7.4 (88-90)
Senegal 1981-87	NA	estimated 5-10,000 formal sector jobs lost		NA	24.4 (91)
Spain 1978-	2.9 (70-77)	11.6 (78-82)	19.3 (83-90)	21.5 (85)	19.1 (91-93)
Turkey 1980-88	8.2 (72-79)	7.5 (80-83)	7.9 (84-88)	8.4 (88)	8.1 (89-93)
Uruguay 1990-	10.2 (85-89)	8.7 (90-92)		13.1 (85)	
Venezuela 1989-93	11.1 (82-88)	10.3 (89-91)		14.3 (84-85)	
Zambia 1985-88	NA	20.1 1986		NA	NA

Sources: Argentina (1984-91), Brazil (1985-89), Mexico, Uruguay (1985-91), and Venezuela UN, ECLAC, *Economic Survey of Latin America and the Caribbean.* 1990, 1991 (urban); Brazil (1990-92), *Brazil File* 2:8 (November 2, 1993), p. 3; Argentina (1992-93) and Uruguay (1992), *Latin American Monitor: Southern Cone* 10:10 (October 1993), pp.1206, 1213, see also *Latin American Economv & Business* (September 1993), p. 6; Spain (1970-77) and Turkey (1972-79), UN, Economic Commission for Europe, *Economic Survey of Europe,* 1992; Greece, Spain (1978-93), and Turkey (1980-93), OECD, *Economic Outlook* 54, December 1993, p. 143; Nigeria, Economist Intelligence Unit, *Country Report: Nigeria* 1990-91, 1991-92, 1992-93 (urban, official estimates); Senegal, Economist Intelligence Unit, *Country Report: Senegal* 1992-93 (Dakar); Zambia, Republic of Zambia, Central Statistical Office, *Selected Socio-Economic Indicators,* 1992, p.6 (males with one to seven years education; the figures for males with no education, or with between eight and 12 years of education were between 3.4 and 5.8 percent)

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From Self-Sufficiency and Planning Towards A Market Economy in Angola

– A Case Study on Africa –

1. Introduction: Self-sufficiency and Market in Pre-Colonial and Colonial Times

Until the first half of the first millennium AD., the population of the future territory of Angola was formed by a maximum of 100,000 Pygmies (in the North) and Bushmen (in the South), all with a predatory way of life.

Between the first half of the first millennium AD. and the 15th century, the bulk of the territory was occupied by Bantu peoples who practiced a spade agriculture and animal raising, and mastered the iron work technique. The population gradually increased to around 1.5 million inhabitants. The overwhelming majority of these inhabitants were Bantu living in the equatorial forest, savanna, and steppe regions of the north and the center of the country, while a few thousand Bushmen survived in the semi-desert and desert zones of the South, and Pygmies disappeared altogether. During this period, some Bantu peoples began to develop long range trade routes. However, as these routes were still rather incipient, it is possible to say that self-sufficiency remained the dominant economic system until the beginning of the colonial era.

The first colonial period began with the Portuguese exploration of what is today the coast of Angola during the 1470's. This period was characterized by the development of market relations with the Euro-Atlantic world-economy mainly geared towards the slave trade: European merchants sold textiles and metal works in exchange for African slaves and ivory. Another important change was the replacement of sorghum by manioc and maize as the main crops, allowing an increase of population, in spite of the ravages of the slave trade.

During this period, direct European rule extended only to the coastal plain of the Low Zaire and Low Cuanza (around 100,000 sq.km), with its main center at the fortress of São Paulo de Luanda, built during the 1570s. This region remained under Portuguese control, except for a short Dutch occupation between 1641 and 1648. The political situation of the rest of the future territory of Angola was not affected by Europeans.

The legal (1835), and especially the actual abolition of slave trade (1850s) and of slavery itself (1876) reduced the relations of the future territory of Angola with the world economy during the second half of the 19th century. Anyway, as other powers tried to acquire colonies in the region during the last quarter of the 19th century, Portuguese authorities made efforts to maintain and enlarge the territory under their control. This led to the diplomatic definition and military occupation of the territory of Angola, during the last decade of the 19th century and the beginning of the 20th century.

Once the process was over, Portugal controlled around 1,247,000 sq.km, including the small territory of Cabinda on the right bank of the Zaire (around 8,000 sq.km), and the main territory on the left bank of the Zaire (around 1,239,000 sq.km) – see map 1. These territories had around 3 million inhabitants. The bulk of the population were Bantu belonging to more than a dozen tribes, the main ones being the Ovimbundo, the Quimbundo, and the Bacongo – see map 2. Only around ten thousand people were of European origin and the figure for Bushmen was even lower.

There followed nearly half a century of stable colonial rule. The population of Angola was legally divided into two groups: the civilized, that is to say the inhabitants of European origin and the so-called assimilated natives (actually literate people with permanent jobs in the modern sector), to whom full citizenship was given; and the indigenous, that is to say the non-assimilated natives, to whom only limited civil rights were awarded. In spite of the existence of a local parliament (and of representatives of Angola in the Portuguese parliament), the central government had tight control over the legislative and administrative life of the colony through a overnor-general or high-commissioner. In 1951, the colonial status was formally abolished, and Angola became a Portuguese overseas province, but no real changes occurred

In what concerns the economic regime, Angola had particular economic laws, a particular monetary system, and a particular tariff system, though schemes of imperial preference and barriers to the development of several industries to prevent competition with Portuguese economic activities prevailed.

Between World War I and the 1950s, Angola developed mainly as a plantation and mining economy, though traditional activities still maintained a significant share of economic life, and some transit trade also existed – see maps 3 and 4. Coffee, sisal, cotton, and sugar were the main crops and exports of the modern agricultural sector. Diamonds and iron ore were the main products and exports of the mining sector. Corn was the only significant crop and export coming from the traditional agricultural sector. Three important railroads, with a total extension of more than 3,000 km, were built: one in the north, to link the port of Luanda with the Malange plateau, which became the main coffee producing region; one in the center, to link the port of Benguela with the plateaux of Huambo and Bie, which were the most densely populated areas of Angola, and with the plateau of Lunda and the province of Katanga (today Shaba) in the Belgian colony of Congo (today Zaire), which became diamond producing regions; one in the south to link the port of Mocamedes with the plateau of Huila, another densely populated zone, which became the main iron ore producing region. Three ports – Luanda, Lobito (that gradually superseded Benguela) and Mocamedes (today Namibe) – and several interior towns – such as Malange, Nova Lisboa (today Huambo), Silva Porto (today Cuito), and Sa da Bandeira (today Lubango) – became the main urban centers of the country.

Open revolt against Portuguese rule broke in 1961 led by the People's Movement for the Liberation of Angola [MPLA – Movimento Popular de Libertacão de Angola], mainly based among the urban population and the Quimbundo and supported by the Soviet Union, and by the National Front for the Liberation of Angola [FNLA – Frente Nacional de Libertacão de Angola], mainly based among the Bacongo, which received American support, joined in 1965 by the National Union for the Total Independence of Angola [UNITA – União Nacional para a Independencia Total de Angola], mainly based among the Ovimbundo and supported by China.

The Portuguese government reacted by sending massive military expeditions (attaining roughly 100,000 troops, to which a similar local levy was added), and by abolishing discrimination against non-assimilated natives (still more than 95% of the population), every inhabitant of Angola becoming entitled to full citizenship in 1961. The war soon became a stalemate, as the Portuguese authorities managed to control the urban centers and the main communication lines, but were unable to destroy the bases of the independent movements in the rural areas and in the neighboring countries.

In what concerns the economic regime, there were two important changes. First, there was an attempt to create a free trade zone and a monetary union in 1962, partly to allow the maintenance of the privileged economic relations between Portugal and its colonies after Portugal became a member of the European Free Trade Association (1959) and a subscriber of the General Agreement on Tariffs and Trade (1962). All quotas and tariffs should disappear until 1972, and a clearing system and a monetary fund were organized to ensure the fixed (usually one-to-one) parities among the currencies of the various territories under Portuguese administration. Second, most of the legal barriers to the development of competitive economic activities were dropped in 1966, to allow the start of the industrialization of the colonies, which was supposed to complement the industrialization of Portugal.

The free trade zone and the monetary union were a failure, mainly because Angola (as other Portuguese overseas provinces) had structural balance of payments problems. As a matter of fact, Angola had a balanced foreign trade, but other current payments to Portugal, not compensated by investment inflows, soon dried out the monetary fund of the escudo zone. The possibility of developing new economic activities, however, together with the stimulating effect of the local expenditure made by the central government to sustain the war effort, led to the start of an economic boom – see table 1. and figure 1. The annual growth of real GDP, which had been around 4% during the 1950s, attained nearly 7% during the 1960s, while population growth remained stable around 1.5%. Thus, the annual growth of per capita real GDP increased from 2.5% to nearly 5.5%. At the same time, a modern banking system began to develop.

In 1971, the need to overcome structural balance of payments problems, and the pressing demands of the emerging of an Angolan entrepreneurial class generated import-substitution policy in order to stimulate industrialization and to reduce dependence on imports. Consumption goods industries directed to the domestic market, such as textiles, food, beverages, tobacco and cement, were protected, and plans to extend protection to capital goods industries and to increase infrastructure building in the late 1970s were made. At the same time, exchange controls with a list of priorities for foreign payments that amounted to multiple exchange rates were implemented. Imports of investment goods were given top priority and increased in the short run. Balance of payments problems, however, were avoided by the decrease in imports of consumer goods, and by the rise of a new staple export – oil (produced mainly in the territory of Cabinda). After a slowdown in growth by 1971, the 7% annual growth of GDP was coming back by the mid-1970s. As population growth accelerated, attaining a 3% annual rate, the growth of per capita real GDP slowed down to roughly 4% – see table 1. and figure 1.In 1972, there were also political changes: Angola became an autonomous region within the Portuguese state. As the role of Portugal as an important trade partner was decreasing as a consequence of the 1971 measures, it may be said that slowly but steadily Angola was drifting away from Portugal.

To sum up, the second colonial period was characterized by the gradual development of market which superseded, but did not eliminate self-sufficiency. On the eve of independence, the institutional background of a national economy had been built, and there was a rather prosperous period, though Angola was still clearly underdeveloped in structural terms. The total population had increased to around 6 million inhabitants, of which around half a million were of European origin, and per capita GDP had increased to a level slightly above $ 1,000 at 1980 prices, which was quite a good performance in African terms, in spite of huge inequalities in income distribution.

2. The Attempts to Build a Centrally Planned Economy After Gaining Independence

On April 25, 1974, the authoritarian regime that had ruled Portugal since the 1920s was overthrown by a military coup. The new Portuguese government soon set up as one of its main priorities the decolonization of the Portuguese overseas provinces. In the case of Angola, negotiations with the movement of independence led to an agreement signed at Alvor (Portugal) in January 1975. According to it, elections should be held before the granting of independence, and Angola should become independent on November 11, 1975.

It was impossible to fulfil the terms of the agreement, because a civil war between the MPLA and an FNLA-UNITA alliance began during the first half of 1975. After some unsuccessful attempts to restore peace, Portuguese authorities left the territory on November 11, 1975, as previously agreed. For a while there were two rival governments in Angola, the MPLA government in Luanda, which controlled the north of the country, and the FNLA-UNITA government in Huambo, which controlled the south and the east of the country. However, during the following months, the MPLA government was able to impose itself in the battlefield, with the help of a Cuban expeditionary force. One year after the day of independence, it controlled all the main urban centers and communication lines. As a consequence, the MPLA government was recognized by the United Nations as the only government of Angola.

However, this was not the end of the civil war. The UNITA forces did not give in, and they were supported by South Africa and by the United States of America as an instrument to fight the Soviet influence in the region. At the same time, the support of the MPLA government to the SWAPO guerrilla against the South African occupation of Namibia, brought South African forces to intervene in Angola. As a consequence, the south of the country became the theater of a conventional war between the Cuban expeditionary force and the MPLA army on one side and the South African expeditionary force and the UNITA army on the other, and most of the country became the theater of a guerrilla war led by the UNITA army against the MPLA administration.

The economic situation the MPLA government found when it became internationally accepted as the government of Angola was a very difficult one. As a matter of fact, besides the structural underdevelopment, the economic boom that preceded independence had been replaced by a deep crisis, caused by three main factors. First, the international economic problems of the mid-1970s reduced the demand for traditional exports (a trend partially compensated by the boom in oil exports and prices). Second, the civil war disturbed normal economic life and destroyed human and material resources. Third, the great majority of the population of European origin, which formed the human backbone of modern economic activities, left the country, mainly for Portugal and South Africa. This movement was partly a consequence of independence itself, but certainly accelerated because of the outbreak of the civil war.

In such a context, the MPLA government had to define as immediate goals of its economic policy the redressing of the short term stabilization and the long term development of the economy. A centrally planned economy appeared to be the adequate economic system to achieve them. This choice, which was at that time epoch quite common among ex-colonies, may be explained by two main reasons. Dependence upon the former colonial power and upon the capitalist world economy was perceived as the main cause of economic underdevelopment. Thus, a break with that past appeared as the only way to achieve economic development. The Soviet Union and the communist Cuba, which seemed to have the experience of a successful development based on a centrally planned economic system, had been the main allies during the war against the Portuguese and remained the main allies during the civil war. Thus, to copy their model appeared as the best way to ensure prosperity.

Actually, to win the civil war soon became the main goal of the government. This disturbed the priorities of the economic policy, but did not change the choice of central planning as the main economic system. Such a situation is not surprising, because, as it is well known, state intervention in the economy is usually reinforced in war times.

It may be said that the key elements of the central planning framework in the case of Angola were the control of output, the banking system and foreign economic relations.

Almost all industry and services firms were nationalized. The significant exceptions were some foreign firms in key sectors, such as oil extraction, to ensure the support of qualified manpower. In the case of agriculture, the government created state farms on land abandoned by previous owners and tried to foster the organization of cooperative firms by means of the association of small enterprise. However, independent small business were allowed to exist as before. As a consequence, the state came to control roughly 60% of the existing firms, corresponding to nearly 75% of employment. Moreover, transportation, wholesale trade and retail networks also became state controlled.

In the banking system, there was a thorough reform, which reduced the number of banks to two: an issuing bank – the National Bank of Angola [Banco Nacional de Angola] – which also provided loans for investment projects, and a savings bank - the People's Bank of Angola [Banco Popular de Angola] – which accepted deposits and channelled them to the Banco Nacional de Angola. Thus, the main investment decisions were controlled through the Banco Nacional de Angola.

The framework of administrative allocation of foreign exchange already existing in colonial times was maintained and reinforced as the basis of state control of foreign trade. As the exchange rate was kept stable (roughly $1 = 30 kwanzas), political priorities had to be set up as a device to limit imports and to allocate scarce resources to make foreign payments.

The main consequence of the economic policies of the MPLA government and of the civil war was the collapse of the national economy. The network of long distance land transportation (roads and railroads) was seriously damaged and ceased to work in most cases (the most important one, because it stopped all transit trade to Zaire and Zambia, was the closure of the railroad from Benguela to Lubumbashi). This implied the use of the more expensive and less efficient air transportation for long distance contacts and severely reduced internal trade.

Black market began to flourish in many sectors, while several regions affected by military operations reverted to self-sufficiency. Thus, central Government soon lost control of a significant part of the economy. As black marketeers and autarkic producers do not pay taxes, such a development deeply reduced state revenues. Moreover, corruption and inefficiency became endemic in both legal and illegal economic activities. An outstanding example is the case of the rather perverse functioning of the system of administrative authorization for foreign payments. Defense was given top priority, followed by the working of vital export sectors, above all the oil sector. Intermediate supplies for other sectors, basic private consumption, and foreign debt service received lower priority. Actually, the system had a bias towards consumption, often towards luxury or at least non-basic consumption to ensure the political fidelity of privileged strata, totally inverting the import-substitution policy of the late colonial period. The result was the destruction of several productive sectors and the rise of an illegal economy.

Last but not least, the civil war in Angola was certainly fostered by geo-strategical interests totally alien to the country, but it also had its roots in traditional rivalries and conflicts among its tribal groups. As a matter of fact, the various tribes of Angola were melted into the unified political framework of the Portuguese colony only one century ago. Thus, nation building and loyalty to the nation was still in the making at the moment of gaining independence and may have deteriorated since then.

Government expenditures increased, mainly because of the civil war, while traditional sources of revenue dried up, mainly because of the end of significant legal market activities. As a consequence, the state became more and more dependent on oil export duties – representing more than one half of the state revenue – and the deficits of state accounts significantly increased to roughly 20% of legal GDP. This situation led to huge monetary issues and inflation. The inflationary process in Angola was the peculiar type characteristic for centrally planned economies, that is to say, official prices did not change very much, but a severe shortage and the soaring of black market prices reflected an undeniable repressed inflation.

Until the mid-1980s, foreign payments remained roughly balanced and foreign debt was kept at a low level thanks to the growth of oil exports and high oil prices (such a statement leaves aside possible secret military debts to the Soviet Union and Cuba). Since the mid-1980s the situation changed, because of the fall of oil prices. Deficits in foreign payments and the consequent increase of foreign debt led Angola to become a debtor country. The ratio of total foreign debt to GDP is now around 70%, higher than the 50% average of less developed countries. Taking into account illegal economic activities the ratio might be a more comfortable 35%.

The lack of adequate statistical data – a serious handicap for a centrally planned economy – makes it difficult to measure economic development since independence. However, it is certain that "legal" (that is to say centrally planned) output fell sharply. As a consequence, legal GDP attained in the late 1980s around 40% of the 1973 level. At the same time, it is possible to suggest that illegal (i.e. market) and non-marketed production attained a level roughly of the same size as "legal" production. This means that the total GDP fell to 80% of the 1973 level. As the population grew, during the same period, from around 6 to more than 9 million inhabitants, the average standard of living fell to about 50% of the 1973 level, that is to say from slightly above $ 1,000 to nearly $ 500 at 1980 prices – see table 1. and figure 1.

The collapse of the national economy, the macroeconomic disequilibria and the economic slump set up an unfavorable background to further economic development. In spite of this, according to United Nations figures, the indicators of human development showed some improvement during the late 1970s and the 1980s: life expectancy increased from 39 to 45 years, infant mortality dropped from 20% to 17%, and adult literacy improved from less than 15% to 40%.

These improvements may seem somewhat surprising (and may even be put in doubt as statistical follies). However, they may be at least partly explained by the easier access to health and education services that resulted from the increase in the urban population. As a matter of fact, the flight to towns generated by the civil war brought the urban population from roughly 15% of the population in 1973 (roughly 500,000 inhabitants in Luanda and a similar total in other urban centers) to more than 30% of total population in the early 1990s (more than 1.5 million inhabitants in Luanda and a slightly lower total in other urban centers).

Such an explanation, however, uncovers the very fact of inequality, either resulting from the place of residence, or from someone's position in social stratification, which remains a key factor in the living standards of the population.

The commodity composition of foreign trade changed dramatically, as most of the regions in which traditional exports were produced became ravaged by the civil war and the above mentioned priorities in foreign payments were implemented. Exports came to consist almost exclusively of oil, coffee and diamonds – see table 2 and figure 2. All other traditional exports disappeared, and Angola even became a net importer of some commodities traditionally exported, such as sugar and maize. At the same time, the weight of military and civil consumption goods in imports increased at the cost of investment goods and raw materials.

Changes in the regional structure of foreign trade were less conspicuous. Angola became an observer member of Comecon, but the Soviet Bloc was unable to replace the United States (the main buyer of Angolan oil and an important supplier of imports) and Western Europe, as leading foreign trade partners of Angola. As a matter of fact, traditional links with Portugal were further reduced, continuing the trend of the early 1970s.

The situation of the economy of Angola during the late 1970s and the 1980s made it impossible for the MPLA government to claim to have attained the original goals of its economic policy. The civil war, however, was an easy scapegoat for all troubles. Thus, no need for radical change of economic policy arose before the late 1980s. Then, short term problems, mainly in the wake of foreign payments difficulties, forced the government to consider plans for partial economic reform. A common characteristic of these plans, however, was the lack of change in the basic principles of the one-party system and central planning.

In the mid-1980s, changes consisted mainly in a fiscal and tariff reform that might reduce the monetary issues needed to finance public deficits and in a rescheduling of foreign public debt service. Moreover, acceptance of the prevailing structure of foreign economic relations led to the signing of the Lome convention (in 1984 – thus, Angola became for a while the only country associated both to Comecon and the European Community). The fiscal and tariff reforms are little more than a dream, but the rescheduling of foreign public debt service brought some relief to foreign payments, and the aid from the European Community helped to give a new breath to the MPLA government.

In the late 1980s, in the context of the beginning of the crumbling of the centrally planned economies, further measures were considered. They included the usual plans for fiscal and tariff reforms, establishing relations with the International Monetary Fund and the World Bank, a sharp devaluation of the kwanza (50% – the official exchange rate increased to $ 1 = 60 kwanzas), partial liberalization of prices, and a larger place for private initiative. Practical results were, nevertheless, rather deceiving. This was partly the consequence of the civil war and of structural features such as the large amount of illegal economic activities. The lack of a comprehensive plan for the transition to a market economy and the piecemeal implementing of often inadequate half-measures were enough to ensure poor results. The example of the attempt made in September 1990 to reduce the money supply by the compulsory freezing of 95% of bank deposits, leading to mistrust in the banking system and increased obstacles to non-inflationary financing of state deficits, is a paradigmatic one.

3. Transition to a Market Economy in the 1990s

The late 1980s brought significant changes to the political background of Angola. These were mainly the consequence of two foreign events: the collapse of communist rule in Central and Eastern Europe and later even in Soviet Union, and the decision of South Africa to give up its control over the territory of Namibia. The first of these events greatly reduced foreign support to the MPLA government and made American efforts to counter Soviet influence in the region less pressing. The second of these events reduced South African concern about the future of Angola and greatly complicated the logistics of foreign support to the UNITA rebels.

As a consequence, for a while both the MPLA government and the UNITA rebels had to look for peace. The first step was the withdrawal of the Cuban and South African expeditionary forces in 1989 and 1990. An agreement followed, reached under Portuguese mediation and signed at Bicesse (Portugal) in 1991. A cease fire was granted in June 1991, the MPLA government was accepted as the government of Angola, other (opposition) parties were recognized in the country, and multi-party elections were held in late September 1992. However, the standing armies of the MPLA government and of the UNITA rebels were only partially demobilized, and remained outside the control of their formal common high command for all practical matters.

The official results of the 1992 elections gave the MPLA a clear majority in parliament (129 seats out of 220). However, the UNITA minority (with 70 seats) obtained veto power on constitutional matters, even without the support of the other minority parties (with 21 seats). In the presidential election, the MPLA candidate, Jose Eduardo dos Santos, received almost 50% of the votes, while the UNITA candidate, Jonas Savimbi, received only roughly 40%, and other candidates about 10%. Thus, a second turn should be held according to the previously agreed rules. These results were recognized by the United Nations.

However, the second turn of the presidential election and the free meeting of the new parliament are likely to become impossible. As a matter of fact, the MPLA government tried to get complete military control of the country in late 1992 and early 1993 (claiming to respond to an attempted UNITA coup). It failed (at least in the short run), and by mid-1993 the country was divided again between two rival governments along the same lines that had existed in 1975.

These political development halted all plans for immediate economic stabilization and reforms. The government of Angola took short term measures (such as sharp devaluations of the kwanza to put an end to the exchange black market), and even took some steps towards liberalization and privatization (such as the opening of the banking sector to private, mainly foreign, initiative) but none have produced significant results.

Whatever the political development may be, the end of the support from the Soviet Union and the loss of confidence in central planning as an adequate instrument to foster economic modernization leave Angola no alternative to marketization.

As is generally acknowledged, the process of transition to a market economy is unprecedented and painful. Some degree of political stability, resulting from a consensus about the legitimacy of the government and a strong will to fight vested interests of the privileged strata, are certainly needed to allow an efficient government action in such a process. At the same time, the widespread destruction caused by civil war makes an emergency plan to fight famine and poverty and to reintegrate the civilians dislocated by the war and the demobilized troops into productive life a pre-requisite to any further measures. From an economic point of view, the macro-economic stabilization and a radical change of the economic regime appear to be the most pressing tasks.

To devise policy of macro-economic stabilization might seem easier since African countries have some experience of short term stabilization programs. However, these programs mainly followed the orthodox line of the International Monetary Fund, and their results clearly show that such programs are condemned to failure, at least in the African context. As a matter of fact, there is a need to change traditional instruments in countries structurally different from the industrialized nations. An interesting example of this requirement already illustrated by a frustrated experiment of interest rate increases to curb inflation in Angola in 1990, is the irrelevance of the interest rate for monetary developments in the context of huge budget deficits financed by monetary issues coupled with quantitative control of credit by the central bank. Moreover, structural imbalances between the basic needs of urban populations and the absence of adequate incentives and transportation devices to allow the rural areas to supply them put the inflationary process out of the reach of purely short term monetarist remedies.

Several theoretical perspectives, not only the so-called structuralist school, but also those of international organizations linked to multilateral aid to Africa, such as the World Bank and the United Nations, underline the fact that to concentrate on short term equilibria and to ignore the key factors of the long term development cannot lead to lasting results. Thus, an efficient short term stabilization program must consider the following aspects: Partial, inconsistent measures are unable to realize the goal of short term stabilization. There is a need for a comprehensive and coherent program, in which individual measures must be linked to one another.A shock treatment, in which all measures are taken in a short period of time, has given way to disastrous experiments. A gradualist approach is clearly preferable, provided its full scope and timing are well stated and correction of the most important distortions is not delayed.Short-term intervention must interact with long-term improvements, that is to say, in the case of Angola, with the rebuilding of the framework of a national economy and the promotion of economic development.

The first steps to be taken concern prices, trade, especially foreign trade, and credit liberalization, to restore the economic function of prices, exchange rates and interest rates. This must be accompanied by a management of the money supply able to find the balance between the increases needed to respond to the higher monetization of the economy and the restraints needed to avoid inflationary pressures. The control of the deficit of public accounts is perhaps the key factor to attain this goal, since financing the budget deficit by means of monetary issues has recently been the main cause of unwarranted changes in money supply.

At the same time, the reform of the economic system must overcome the main distortions produced by central planning and the civil war. The definition of the scope and basic measures of the reform is only a preliminary step, because some reforms take longer than others, most measures are complementary, and tensions are inevitable. Thus, although we may draw a broad line of sequencing, timing and magnitude of the measures, only the specific evolution of the country can determine the exact pattern of the reform.

Liberalization of markets and of the prices for goods and services, distribution networks, banking system and financial markets, foreign investment and labor market must be one of the first measures, because it creates the basis for legal market activities. However, the pace of liberalization must depend on the success of enterprise reform, which is a condition for an efficient resource allocation and stability. As a matter of fact, in the context of rigidity of supply and of lack of adequate institutional and material infrastructure, liberalization may stimulate black markets, increase the dependence on imports, and lead to a dangerous degree of monetization of the economy stimulating inflation and recession.

The enterprise reform, however, must be linked to the change of management procedures and privatization, that is to say, the change of property status of existing state firms.

The change of management procedures is a priority, because it must be linked to the first steps of the reforms. Such a change may face the problem of the lack of adequate human resources. It is possible to call for the aid of foreign managers, but to prepare competent Angolan managers is certainly crucial for the success of the entire process.

Privatization faces the problem of a lack of capital accumulation and domestic buyers. It is possible to call for foreign investors, but the question of foreign control of the national economy must be taken into account. The economic inefficiency of the majority of the enterprises, specially in the case of large-scale monopolistic enterprises, also hinders the transfer of property to private owners and causes deep social problems that may compromise the whole reform.

Moreover, experience has revealed that the full transformation of centrally planned economies needs the support of measures directed to a sustained economic growth that encompass market supporting institutions (through legal, fiscal and monetary reforms and an efficient banking system), the building of basic material infrastructures, an active and broad economic policy (including the promotion of savings and investment, the support to small and medium scale enterprises, rural markets and trading networks, the promotion and possible temporary protection of strategic sectors, the encouragement of greater participation of the population in decision making and implementation, the protection of the environment and the promotion of adequate resource exploitation), and a policy for social security in order to prevent sharp social-political de-stabilization.

It may be expected that, given the undeniable potential of the economy of Angola, short term stabilization and the beginning of economic reforms through liberalization and privatization are sufficient conditions for a burst of economic growth and improvement in the average standard of living. However, sustained economic growth also depends on the reinforcement of regional integration and economic cooperation, the possibilities open by foreign cooperation, the evolution of the world economy and on further efforts of the people and authorities of Angola.

It is important to stress the key role of cultural factors in all those processes of economic change. A cultural outlook seeking the fruits of development and accepting the temporary sacrifices needed to attain it is a necessary condition for a sustained development process. No single economic policy measure is a sufficient condition for the process to go on, but the qualitative improvement of human resources is perhaps the most vital one.

All this leads to the question of the role of the state. Of course, private initiative should be the leading force of the economy, but there is certainly need for significant intervention to allow domestic human and financial resources to take over current management and property of most of the main firms. Besides, the state has to provide goods and services the market is unable to deliver, at least temporarily for some of them, and basically has a decisive role in promoting the sustained economic growth. Finally, the state should promote a satisfactory pattern of income distribution, compensating some of the worst social consequences of transformation, mainly in the first years, and whenever measures become a source of social discontentment.

Neither short term recovery, nor long term development are possible without the rebuilding of the physical, institutional and social framework of the national economy.

To rebuild the physical framework of the national economy implies the restoration of the long range land communications network, especially roads and railroads. The end of the civil war would make the task feasible, but it needs a huge investment effort that may imply some foreign assistance.

To rebuild the institutional framework of the national economy implies the recovery of more or less isolated regions from self-sufficiency and black market activities to a legal framework. Both processes depend on the economic reform, on physical reconstruction, and on incentives and support for the development of market, especially in rural areas. These processes may be rather slow, depending on the short term benefits that it is possible to offer to isolated regions, and to persons occupied in illegal activities.

The rebuilding of the social framework of the national economy implies the need to overcome the internal conflicts that still persist in the society of Angola. The rising of particularism all over the world provides a disheartening background to the badly needed effort to root a national consciousness among the people of Angola that may overcome tribal differences and rivalries. There is no choice: the alternative to peaceful cooperation among all ethnic groups of Angola is certainly detrimental to long term improvement for everybody.

To these problems must be added the claims for independence of Cabinda. As a matter of fact, this demand emerged in the 1970s. From a legal point of view, they are based on the fact that local tribes accepted in the 1880's the protectorate of Portugal, irrespective of the definition of the border of Angola, which prevents the use of the doctrine of unchanging colonial borders. However, the relevant fact is that Cabinda is the main oil producing region of the country. Let alone to enjoy their oil income, the inhabitants of Cabinda might attain one of the highest per capita GDP of Africa (a statistical effect reduced in the case of Angola as a whole by the higher population). Deprived of the oil income of Cabinda, Angola may face very difficult problems in foreign payments. Sheer force more than peaceful acceptation has been the basis for the control of Cabinda by the MPLA government since the independence, and the partial boycott of the 1992 elections in the territory shows that the government of Angola may find it difficult to appease the independence claims with the offer of larger autonomy.

Foreign cooperation deserves some further discussion, because of its possible role in the economic recovery and in the definition of trade partners. There are three main directions of possible foreign cooperation: Portuguese speaking countries; the main economic powers of the world; and neighbors in Southern Africa.

Regarding Portuguese speaking countries three cases must be distinguished: African countries, Brazil and Portugal. Portuguese speaking African countries have developed schemes for political and economic cooperation among them, but it is unlikely they may be of great help to one another as economic partners. As a matter of fact, none of them is significantly developed, and they are either too small (as in the case of Cabo Verde, Guine-Bissau and São Tome e Principe), or are facing problems of recovery from civil war and economic slump similar or even worse than Angola (as in the case of Mozambique).

Brazil has a much more developed economy, facing difficult short term problems, but with a large economic potential. It may provide useful investments and human resources, given its cultural similarity with Angola, but it may also be a dangerous rival in many aspects of international competition.

Portugal does not have the long-run potential of Brazil because of its small size and limited resources, but may be the ideal immediate partner among the European Community members, because of the higher cultural affinities with Angola.

Besides, the European Community is undoubtedly one of the main economic powers of the world, to which Angola has been linked since 1984. Angola has already benefitted from the aid of the European Development Fund for investment in agriculture, fishing, transportation, and small-scale and medium-size industrial firms, of the Industrial Development Center for stimulating joint-ventures between European and ACP [African, Carabean and Pacific] countries firms, and of special relief program. From the point of view of Angola, expansion of these programs would, of course, be welcome, but it is likely that the higher concern of the European Community with the problems of neighboring Central and Eastern Europe will put a brake on such expansion.

The United States of America and eventually Japan might be alternative partners among the main economic powers of the world, but these countries are not highly interested in cooperation with Africa, because they have much better alternatives, and no cultural similarities exist to improve the situation.

Economic cooperation among the Southern African countries has been organized in the framework of the SADCC [South African Development and Cooperation Conference] formed today by Angola, Botswana, Lesotho, Malawi, Mozambique, Namibia, Swaziland, Tanzania, Zambia and Zimbabwe. Until now it has been little more than the economic aspect of the front line countries' alliance against the apartheid regime in South Africa. It achieved some results, but did not help much countries plagued by civil war, such as Angola or Mozambique.

The future of the organization and its usefulness for Angola depend on the development of South Africa. A quick and peaceful transition to a stable post-apartheid regime would make South African the true locomotive of Southern Africa development (with the side effect of some dependence of its neighbors upon it), and the SADCC might become a potentially fruitful common market for all countries of the region. Other scenarios for South Africa are certainly less attractive for other Southern Africa countries. This is only one more unknown factor in making the future of Angola.

Table 1: Economic Development of Angola 1953–1989

year	gross domestic product current prices (10^9 kwanza)	price index 1980 basis	gross domestic product (10^9 kwanza)	population 1980 prices (10^3 people)	per capita gross domestic product 1980 prices (10^3 kwanza)
1953	9	17.0	53	4 340	12
1954	9	17.0	55	4 406	13
1955	10	17.1	57	4 474	13
1956	10	17.2	59	4 543	13
1957	10	17.3	60	4 613	13
1958	11	17.1	63	4 684	14
1959	11	17.6	65	4 757	14
1960	12	17.3	67	4 830	14
1961	13	16.6	76	4 908	16
1962	13	17.8	75	4 988	IS
1963	15	18.2	81	5 069	16
1964	19	19.3	97	5 151	19
1965	19	20.4	94	5 235	18
1966	22	21.1	105	5 319	20
1967	25	22.7	109	5 406	20
1968	28	23.6	120	5 493	22
1969	34	25.6	132	5 582	24
1970	39	26.6	148	5 673	26
1971	42	28.2	149	5 851	25
1972	46	30.5	151	6 034	25
1973	59	36.4	161	6 223	26
1974	?	?	?	6 418	?
1975	?	?	?	6 619	?
1976-,	?	?	?	6 826	?
1977	?	?	?	7 040	?
1978	?	?	?	7 260	?
1979	?	?	?	7 488	?
1980	168	100.0	168	7 722	22
1981	167	113.6	147	7 918	19
1982	182	128.9	141	8 119	17
1983	205	146.4	140	8 386	17
1984	235	166.3	141	8 537	17
1985	260	188.8	138	8 754	16
1986	259	187.5	138	8 990	15
1987	338	238.3	142	9 233	15
1988	349	223.9	156	9 483	16
1989	410	273.3	150	9 739	15

Sources and methodology – Figures are of ficial estunates from World Bank, 1989 and Roque, 1991, except for the linkage of the 1973 price index to the 1980 price index, which may be described as an educated guess of the authors. The guess is rather conservative, assuming a trend of economic stagnation, which may be explained by the situation of civil war only compensated by the increase of oil production and expons.

Table 2: Exports of Angola

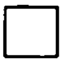
year	coffee	diamonds	oil	others
1969	35	20	5	40
1974	20	8	51	21
1979	14	13	72	1
1984	4	3	91	2
1989	+0	5	94	1

Figures in percentages
Sources – United Nations – International trade statistics.

Table 3: Economic Reform-Scope, Sequencing and Magnitude

Based on Gelb, Gray, 1991 and Rogue, 1993

Conventions:

 intensive effort  moderate effort

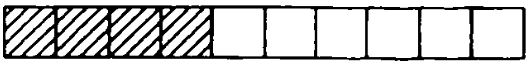
Rebuilding plan

years 1 2

- Combat to famine and poverty
- Reconstruction of physical and social infrastructures
- Reintegration of dislocated population and demobilised troops.
- Activation of rural markets and trading networks

Macroeconomic stabilization

years 1 2 3 4 5 6 7 8 9 10

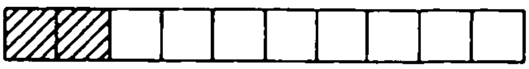


- Rigorous budgetary policy
- Appropriate fiscal regime.
- Sound targets for money supply and domestic credit expansion.
- Realistic price, wage, interest rate and exchange rate levels.

Liberalization

- Price reform

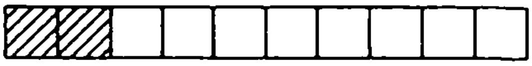
years 1 2 3 4 5 6 7 8 9 10



most goods | some basic goods and housing

- Trade reform

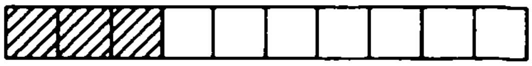
years 1 2 3 4 5 6 7 8 9 10



remotion of quantitative restrictions | tariff adjustments to moderate levels

- Distribution system and banking and financial sector.

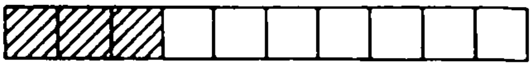
years 1 2 3 4 5 6 7 8 9 10



privatization and demonopolization | implementation of an autonomous banking and financial sector

- Foreign investment.

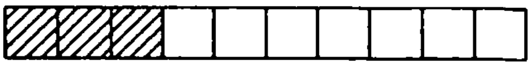
years 1 2 3 4 5 6 7 8 9 10



revision of regulation and promotion

- Labour market

years 1 2 3 4 5 6 7 8 9 10



deregulation liberalization of foreign bargain

Privatization

- State enterprises

years 1 2 3 4 5 6 7 8 9 10

small and medium scale | large scale

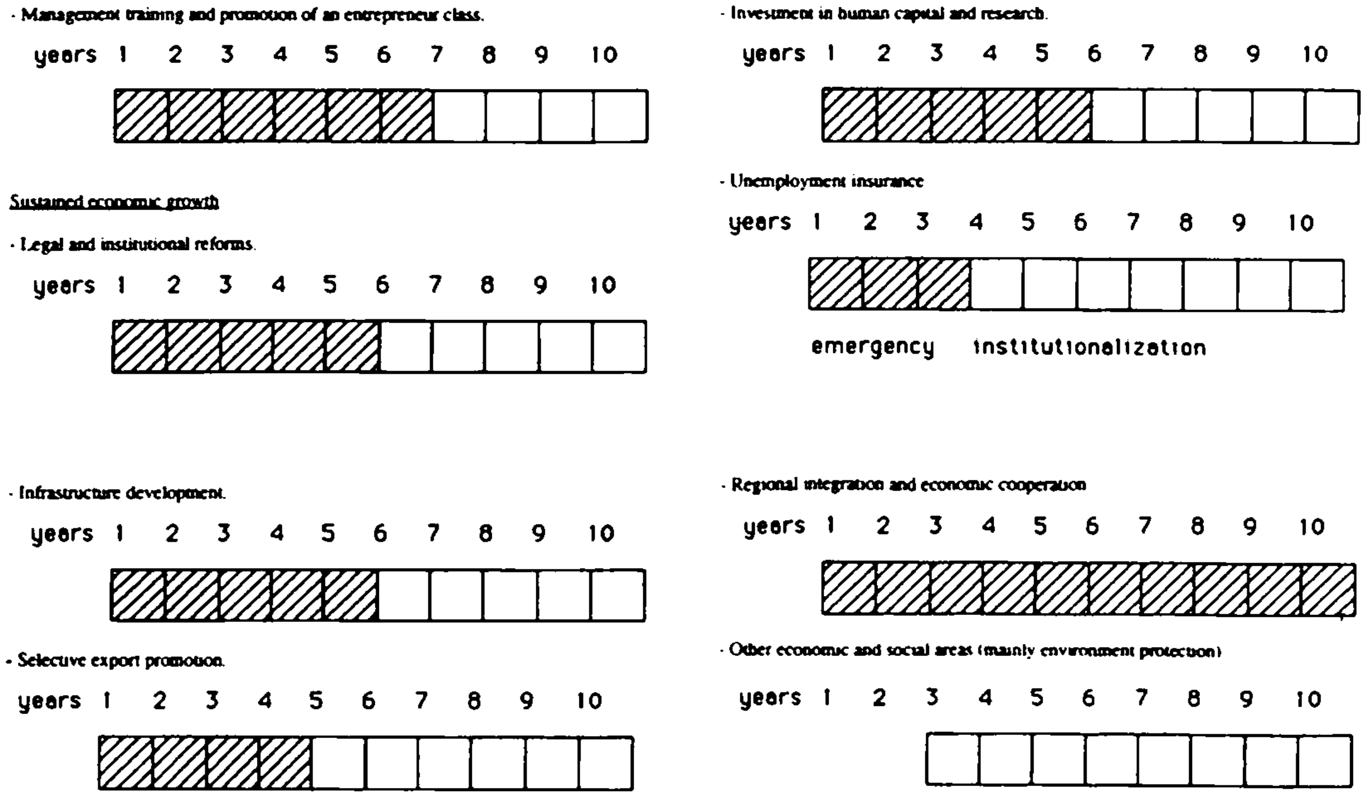


Figure 1: The Economic Evolution of Angola 1953–1989

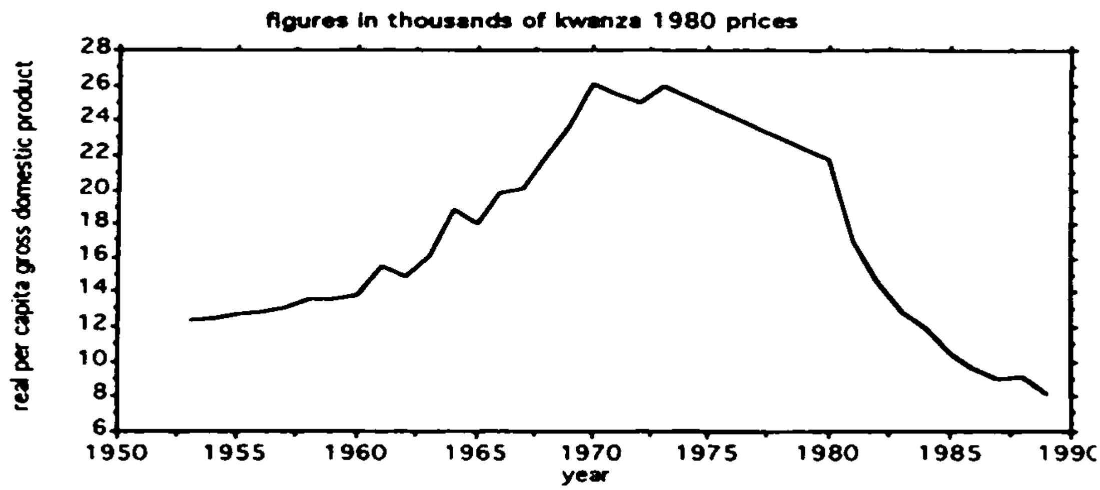
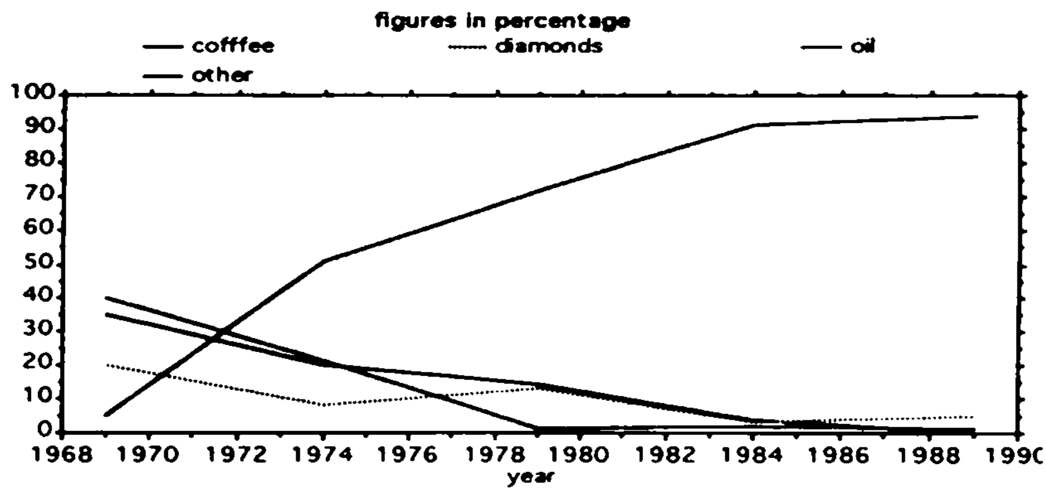
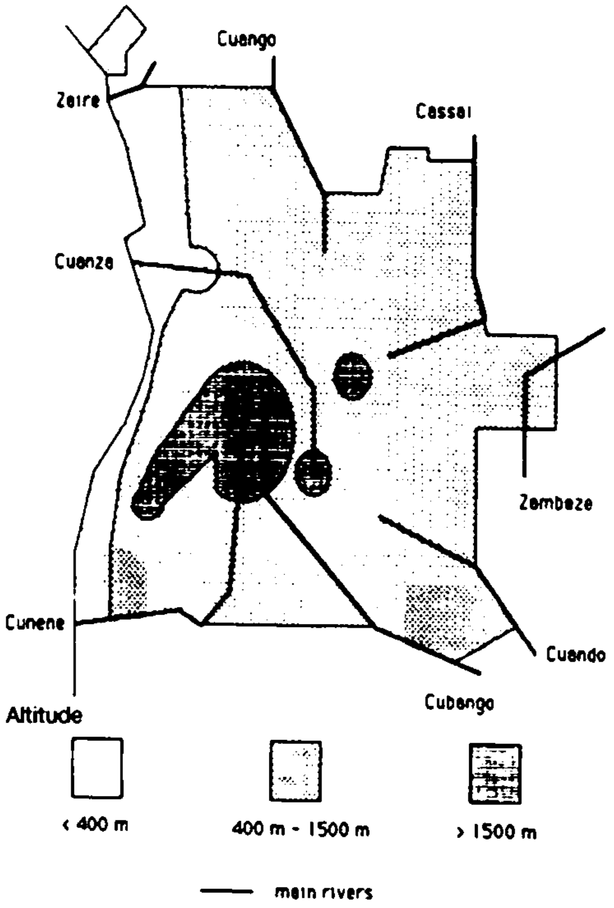


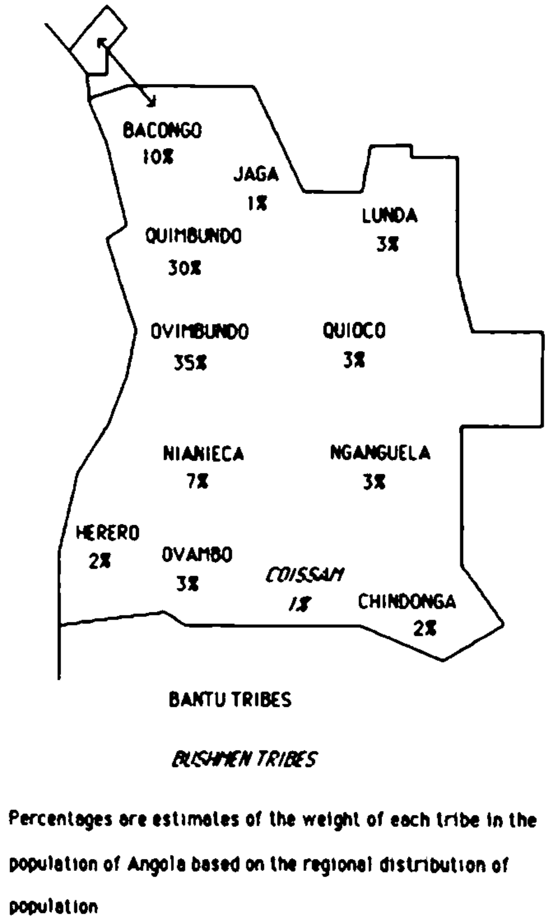
Figure 2: Exports of Angola



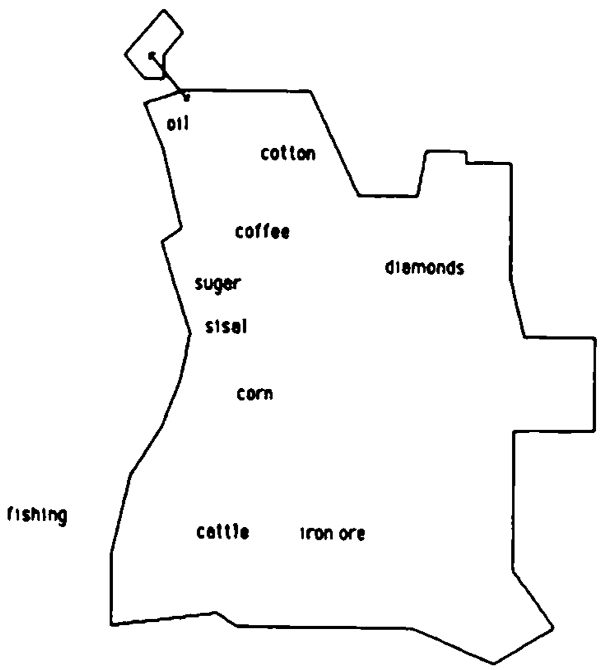
Map 1: Orography and Hydrography of Angola



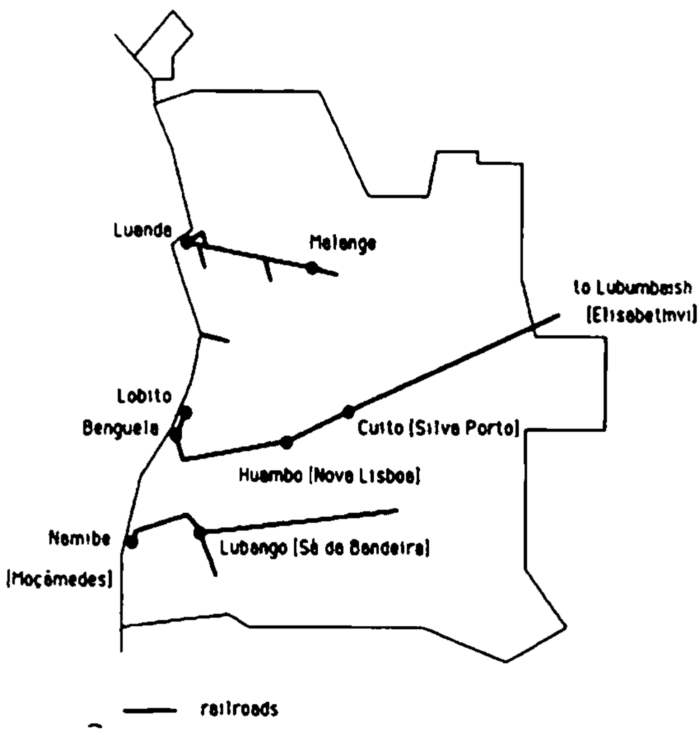
Map 2: Tribes of Angola

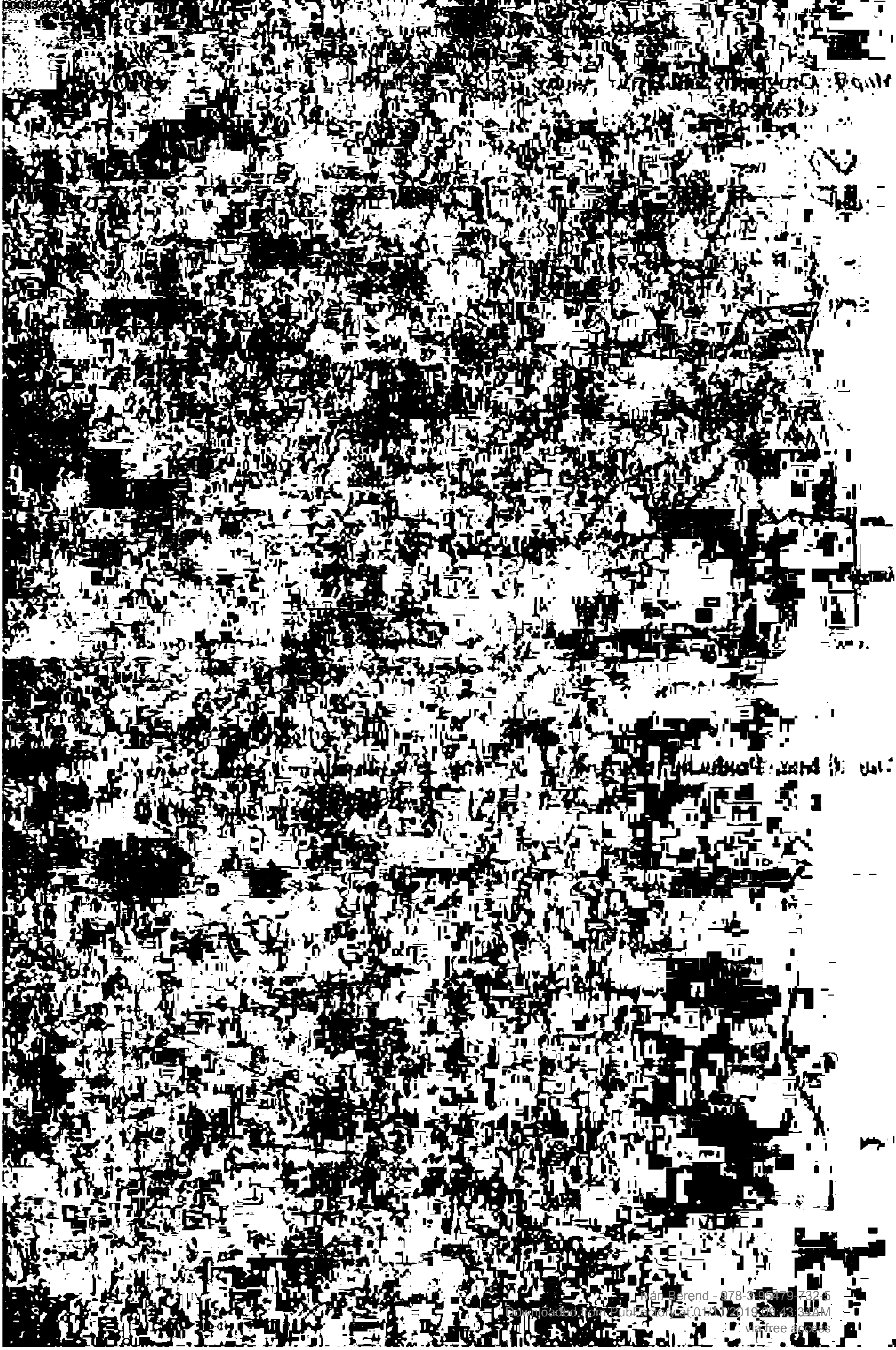


Map 3: Main Productions of Angola



Map 4: Railroads and Main Towns of Angola





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