Macalester International

Volume 2 *Transition and Globalization in Central and Eastern Europe* Article 20

Fall 12-31-1995

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I. Introduction

In the formerly centrally planned economies it is accepted that the market economy is a more desirable method of allocating resources than the alternative allocation, via command or directive. Most observers and participants in this process also assume that the transition to a market economy will be long and difficult. Finally, there is an implicit assumption that all of the difficulties associated with the transition will be worthwhile because the additional benefits of a market economy will offset the short- and medium-term pain of the transition. Under this set of assumptions the end is viewed as the market economy, *per se*, while one need only quibble as to the means of arriving there. Much as one might dispute which is the best mode of transport to cross the ocean, the only point of debate concerning the transition need concern the rate of transition, i.e., big bang, or shock therapy versus some nebulously defined "gradualism."[1]

This paper explores the implications of accepting the first and third assumptions, while rejecting the second: namely that the transition to a market economy will be lengthy and difficult. Of course, it is ludicrous to argue that the current situation in Central and Eastern Europe is not difficult. Rather, this paper will argue that the transition to market has already happened and that the difficult part of the transition is not related to the economic transformation, but to the creation of a society founded on the principles of rule by law and the sovereignty of the individual over the state. From this perspective, many transition societies have lost sight of the "end," which is the creation of a civil society based on some agreed upon rules of behavior ideally codified in law.

As we will see, failure to move toward this end has had disastrous consequences for many transition economies, especially Russia. It is important to note that in effecting this transformation to a civil society, markets and *laissez-faire* economic policies may not necessarily play a significant role. However, given the experiences these societies have had with central planning, one expects an outcome closer to *laissez-faire* than to a *dirigiste* alternative. Failure to recognize the fundamental fact that the market is only a "tool for moving things around," or allocating resources, and not a means to an end has left many of these societies socially and politically directionless. This lack of direction has contributed to rampant crime, corruption, and an overall sense of anarchy in many transition societies.[2]

This paper will examine the transformation process in Central and Eastern Europe beginning from the perspective of an economist who has been fortunate to observe the transition in Russia since 1992. Some social and political implications of the economic process will then be considered. A hypothesis maintained throughout this paper is that the economics of the transition are relatively straightforward. The far more difficult task is eliciting a political mandate resulting in agreed upon principles governing dispute resolution, contract enforcement, and related aspects of economic and social behavior. In the democracies of the West these principles are easily taken for granted and have become almost invisible.[3] Before we begin, it is important to understand why these principles were initially absent in most transition economies, and in doing so we need to ask what central planning was and how it worked.

II. A Short Primer on the Economics of Central Planning

For many reasons, socialist principles led leaders to prefer an administrative/command as opposed to a market system of allocation. An economic rationale favoring a command economy over a market economy was that the market was "anarchic," i.e., prone to excessive volatility and often choosing an inappropriate mix of output and technology. Also, it was generally accepted that command economies, through mobilizing resources on a large scale, could create industrial enterprises capable of exploiting economies of scale. Implicitly and explicitly it was also assumed that decision-making is best left up to those at the top levels of the hierarchy. Simply put, the socialist planned economy was predicated upon paternalism, where the center knew best as to the optimal allocation of resources.

In practice, centrally planned economies constructed enterprises that were huge by any standard and concentrated decision-making authority for entire industries in just a few hands. Legal authority for allocating resources rarely extended far down the hierarchy. With relatively few people involved in resource allocation, the rules and regulations governing such activity need not necessarily be codified or very complex. Unlike Western companies, the value of legal, as opposed to technological, knowledge in a centrally planned enterprise was very low. Consequently, the preferred career path for management was engineering.

Even though planners needed to communicate with few enterprises in an industry, problems of coordination, i.e., ensuring that the same number of nuts and bolts are produced at the same time, plagued the economy. These coordination problems are intrinsic to the very nature of planned economies. Grossman (1963) has shown that the commands that govern resource allocation must necessarily contain some level of aggregation, that is, they must be stated more or less broadly and they must be stated using some unit of measure. The level of aggregation may be over products—for example, superiors (planners) may give a directive to an enterprise to produce "shoes," rather than "Nike Air Jordans size 11.5, white with black stripes"—or the aggregation may be over time, as in "Produce these products by the end of the year."

The consequence of aggregation is that subordinates in any hierarchical organization always have some autonomy or discretion in decision-making. Informal mechanisms for allocating resources emerged to fill the voids where central preferences and directives were unspecific, unclear, or contradictory. The result was that a significant fraction of economic activity was allocated on an "informal" basis where managerial discretion played an important role in the final outcome.

A significant determinant of economic performance, and an eventual contributor to the collapse of central planning, was how managers used their discretion. In an effort to induce managers to perform as planners, desired managerial performance was monitored and rewards (bonuses) paid out accordingly. In the Soviet Union, and elsewhere with slight variations, planners issued plans typically directing enterprises to produce five to seven different products, for which prices remained fixed, then rewarded managers and workers on the basis of plan fulfillment. With roughly 45,000 enterprises in the Soviet Union and so few products produced per enterprise, variety, style, and quality were typically absent in centrally planned economies.[4] The mix of output of a planned economy was the economic equivalent of the tundra, a few large species and very little else.

Because planners were forced to ensure that certain technical relationships were maintained—for example, four tires were produced for each automobile—plans were issued in physical (not monetary) units, i.e., tons or units. Planning in a "physical" economy was more convenient if prices remained fixed, which they did for decades at a time. Because so much depended upon fulfillment of the plan, managers sought ways to ensure that they would always fulfill their plans.[5] If plans were in tons, manufacturers of tires sought to make tires only for large trucks; if plans were in units, better to make lots of tires for motorcycles. Because the informational burdens of coordinating economic activity were so great, tire manufacturers were able to undertake these decisions independently of other manufacturers. Similar problems occurred throughout all levels of the economy, resulting in ubiquitous shortages and also tremendous waste of materials, time, and energy. Planners wishing to address the problem of tire assortment would have had to "spend" more of their scarce planning resources on the tire industry and less elsewhere — for example, the chemical industry — giving more discretion to managers of chemical plants. The tendency was for planners to devote most of their energy to "putting out fires" and relatively little to longer-term strategic planning.

Cheating on the assortment of production was not the only method through which enterprising managers sought to ensure plan fulfillment. Because materials were in shortage, managers would reduce the quantity of materials in many products, reducing quality but allowing for the production of larger quantities of output.[6] Also as a consequence of shortages, managers sought to hoard whatever was available, labor for "storming" at the end of the month, or capital and materials for producing more output or for barter with other enterprises. Significant entrepreneurial activity was directed at obtaining materials with specialists known as *Tolkachi* ("pushers"), who wined and dined and otherwise bribed potential suppliers, much as salespeople in market economies do for potential customers. Managers also bargained for as much materials as they could obtain, while simultaneously seeking the lowest possible plan target, effectively providing "disinformation" about their true capacity to superiors. As managers overordered materials, shortages became more intense, hoarding and its consequent deceit, more necessary.

Consumers as well as managers would make purchases, not because the product was what they wanted, but because they could probably barter it with someone who could use it.[7] Informal connections and semilegal and illegal markets dominated allocation of consumer goods. In addition, material supplies and other consumer goods became stores of wealth, as money correspondingly was devalued, effectively demonetizing the economy and all of the industries associated with money and finance. One of the most serious problems of transition economies has been overcoming the legacy of a "demonetized" economy. This legacy includes not just an absence of physical capital associated with the finance industry, but, more important, a shortage of people schooled in accounting, finance, insurance, and all related activities.

Reforms begun in the 1960s and continuing until the abandonment of central planning were mostly designed to "monetize" the economy, especially the enterprise production plan. Plan targets were altered from output in physical units to "sales." However, with fixed prices, "sales" began to mean "quantity delivered" to the (usually) unhappy customer. Also, with fixed prices, financial targets such as "profits" had little economic content, especially when supervising ministries tended to skim surplus profits from one enterprise to cover losses at another, a process known as "leveling." With the exceptions of Hungary in the late 1960s and China in the late

1970s, where central planning was abandoned first in agriculture and later in consumer services and small industry, reform attempts probably did more harm than good.

In Hungary, China, and, later, Poland, flexible prices eliminated most shortages for most products, although large state enterprises continued to receive subsidies, draining other sectors of the economy of scarce resources. Reforms in the Soviet Union were far more timid, usually amounting to little more than changing plan targets for bonus determination or changing the organizational structure in order to better supervise enterprise directors. For the next twenty-five years the Soviet economy was on a "treadmill of reforms," seemingly making changes, only to find they contradicted essential aspects of the system, which could not be altered without abandoning socialism. A consequence of the more aggressive reform strategy in Hungary and Poland was that activity in gray and black markets was less significant than in the Soviet Union, resulting in a greater amount of activity conducted on a "legitimate" basis.

By the mid-1980s it had become obvious to citizens and leaders alike that central planning was a failure. The incentives of the system had led managers to produce an energy-hungry, outdated mix of goods using excessive quantities of raw materials, satisfying few customers. Because managers were reluctant to engage in major innovations that might threaten short-term plan fulfillment, factor productivity (how much output a unit of capital or labor produces) began to decline. Were it not for ever greater extraction of raw materials and ever higher levels of investment, growth in output would have also declined. Geology and demographics (i.e., a declining birth rate) dictated that continued existence of central planning was untenable.

The legacy of central planning had left an environmental disaster, an economy and populace lacking any basic understanding of the role and use of markets, with huge, often antiquated industrial enterprises. It had also left a legacy of "an informal" *po svyazom* (through connections) system of allocation where the prevailing attitude was "rules are to be gotten around" not observed.[8] Finally, attitudes toward the market were viewed through the distorting prism of Western media *and* socialist ideology, which had succeeded in inextricably linking "market" and "anarchy" together. Western media, with its imagery of mass consumption, had convinced the population in the region that all that was necessary to achieve the immense wealth and high standard of living of the West was a market economy. The market economy had become the end in and of itself.

III. The Transition to Market

The first step in implementing a market economy — freeing up prices to seek their own level—proved exceptionally simple and efficacious. Shortages that had grown ubiquitous in the late 1980s in the Soviet Union had evaporated within a month. The barren landscape of central planning left considerable room for once rare consumer goods, which now were available almost overnight. Even though large segments of the economy were still in state hands, the vast majority of resources in the economy were now allocated via the market. From this perspective, it is possible to say that the *transition* to a market economy was over almost as soon as it began.

The near instantaneous elimination of shortages came at significant cost. Freeing up prices instantly, for those unable to sell their home currency for dollars, quickly wiped out the meager savings of the population.[9] In what became known as the "transformation recession," official statistics indicated 50-percent declines in GDP over a three-year period.[10] Previously unheard of unemployment began to appear throughout the region, although it remained below U.S. and West European levels, especially in the Czech Republic and the former Soviet Union.

For many countries, unaccustomed to controlling the rate of money growth with indirect means, such as interest rates, inflation became a disquieting aspect of everyday life. After decades in which prices of most consumer goods had not changed at all or only slightly, prices of consumer goods rose 20 and 30 percent per month.[11] Consumers had serious difficulty adjusting to the new realities. Rapid inflation meant that prices changed weekly or daily, while wage increases tended to lag behind price increases. Rapid inflation created considerable "price dispersion" (situations in which identical goods in equivalent, or sometimes identical, locations sold for different prices).

Moving from the system where resources were allocated through connections to one where transactions were predictable and honest was complicated by the absence of regulatory oversight of product quality and quantity, and by the attitude that "anything goes" because of the (anarchic) market economy. Street vendors used multiple means of getting around the new rules of a market economy: using underweight scales, selling products past their expiration date, cheating on the total receipt, counterfeiting Western products, and so on. Many consumers countered by bringing their own weights for checking scales and calculators for checking receipts and sampling products before purchasing. For purchases of consumer nondurables, such as food, these measures were adequate; however, for purchases of more complicated durable goods, such as automobiles, consumers were at the mercy of sellers. Deceit and fraud coexisted with many transactions.

Moreover, most retailing and wholesaling activity took place in kiosks, vegetable stands, or from the backs of trucks. Few large-scale outlets in permanent locations existed, except the state stores, with their mediocre service and selection. Although small in scale, this form of kiosk retailing proved exceptionally flexible. If business turned sour, the probability of recovering one's capital, due to the robust market for kiosks, was high. Moreover, if the government, or the mafia, increased taxes or "cover charges" (*krisha)* to kiosk operators, the kiosk could be moved to another location. Very little risk and potentially high rates of return induced entrepreneurs to favor the kiosk. The disadvantage of kiosk capitalism was that operations remained small in scale, lacking focus and strategic vision.

The same flexibility, which was the paramount objective of most retail operators, could not be had through establishing retail facilities in a permanent location. Local government agencies might renationalize the shop, mafia might move in (or raise cover charges), and, given the nebulous property laws and government involvement in the transaction, reselling the shop might prove difficult and expensive. Moreover, permanent facilities were easier for local governments to monitor and collect receipts from for tax purposes, reducing one's profits. Tax evasion had become the new "game" for entrepreneurs and citizens alike. As transactions were predominately in cash with receipts easily altered, local governments found raising revenue a vexing problem. If tax rates increased to recover the lost revenue, the incentive to hide more receipts increased. The fact that local governments were deprived of revenue meant that they had little money to pay police, contributing to the overall sense of anarchy and providing greater incentives for corruption.

Although larger establishments began to appear in Russia in 1994 and 1995, kiosks still dominated retailing. This was not true in other formerly centrally planned economies. Visits to Warsaw in 1993 and the Czech Republic in 1995 revealed a more normal economy, where well-kept shops had specialized along well-defined product lines. Why had small-scale "kiosk capitalism" so persistently dominated the economy in Russia? Was the dominance of kiosk capitalism related to the "culture" of fraud?

It turns out that it probably was. In order to undertake larger scale operations, entrepreneurs would need to raise capital in order to finance their plans. Many directors I have interviewed over the past two years in Russia have had excellent strategies for navigating the turbulent waters of Russia's economy; however, they often failed to "think big," i.e., think long-term and on a large scale. When asked why they did not implement more grandiose plans, the universal response was "money." Banks would not lend to firms to finance anything other than acquisition of inventories, usually on a three-month basis. Another ingredient missing from Russia's newly formed market economy was a well-functioning capital market in which investors could channel their resources to entrepreneurs and receive a competitive rate of return with a reasonable level of risk. Russia had a market economy without capitalism.

In the Czech Republic, on the other hand, banks had taken a large equity position in formerly state owned enterprises, providing capital on reasonable terms.[12] Hungary and Poland, with a much longer history of small-scale ownership and significant levels of foreign investment, seemed to have obviated the Russian stage of kiosk capitalism. A prerequisite to the creation of capital markets is definition of property rights that will be maintained for the duration of the contract or life of the asset. Russia's political and social turmoil could not deliver a promise of a reasonable level of risk for most investors.

Two problems needed to be solved before this situation could be rectified. National and local governments needed to credibly commit to maintaining and enforcing property rights.[13] This would include the establishment of means of legal redress and dispute resolution. Also, it was necessary to mitigate the rampant crime and threats to property by mafia and other "hooligans." In the absence of these safeguards, investment for all but the most lucrative projects failed to materialize. These legal measures lie at the heart of a capitalist/market economy. Not only do they provide some insurance for investors, but, by increasing the potential risk of fraudulent activity, they also provide an incentive to retailers to engage in "honest" commerce. Very little economic activity, except for that at the most rudimentary level, takes place under conditions of anarchy.

Because capital markets cannot develop under conditions of anarchy, failure in the task of building a civil society destines the economy and the society to an existence of "petty capitalism" in which capital formation and other large-scale transactions are limited by the resources at the disposal of one's immediate friends and family. Under these conditions, a transaction or pool of capital can be no larger than the funds available to one's clan, limiting investment to small-scale, quick-payoff projects. Capital markets that exist outside the clan — for example, bank lending — are dominated by short-term, fully collateralized, highly liquid loans that do little to fundamentally restructure the economy. The best example of this type of lending is loans to finance acquisition of inventories for a retailer or wholesaler.[14] In short, the missing ingredient in Russia's economy is trust, and the mechanisms of legal redress that support, enforce, and build that trust. Once established, this state of affairs may easily create a stable equilibrium where trust outside one's clan does not exist, perpetuating mistrust and an environment of economic and social treachery.[15]

The primary source of uncertainty for investors in Russia remains political instability, and the inability of Russia's political system to establish conditions under which contracts will be enforced with sufficiently high probability. Understanding the links between political stability, the development of capital markets, and overall economic health is essential to understanding the differences between Russia and its Central European counterparts. By nearly all assessments, due to political and legal instability, Russia remains one of the riskiest countries in which to invest, second only to Iraq.[16]

IV. Conclusion

The most surprising aspect of Russia's transition is that in spite of the instability, lawlessness, and sense of anarchy, the economy has continued to move forward. Each year has seen improvements in the development of capital markets and the creation of instruments that improve on contract enforcement. Interestingly, many of these instruments are not the result of changes in government policy. Some are the result of criminal elements (mafia) wishing to ensure higher rates of return on "their" investments. Many are spontaneous private arrangements based on relationships that have built up during the past three years.[17]

Nevertheless, Russia remains in turmoil, and the economic recovery is extremely fragile. The single largest factor contributing to this turmoil is the fact that, unlike Hungary, Poland, Czech Republic, and Slovakia, Russia is not now, nor has it ever been, a democracy. Yeltsin was elected in 1991 before the coup and the breakup of the Soviet Union, and before the move to a market economy had begun. The current parliament was elected, literally under the barrel of a gun.

In contrast, Poland and Hungary have had peaceful transfers of power resulting from, more or less, fair elections. The government in the Czech Republic has enjoyed strong support, in spite of the difficult economic situation and in spite of the split with Slovakia. The economies in these countries are, consequently, attracting large amounts of foreign capital and are beginning to recover from the transformation recession.

By promoting some measure of stability and allowing majority expression in which societal goals are debated and discussed, democratic institutions create conditions in which investors may make rational decisions about expected risk and rates of return.[18] Once this process has taken place the range of parameters of political and social behavior becomes comprehensible, if not predictable. As the process continues and power is peaceably transferred, this range of possibilities narrows. The damning short-termism that characterizes the "noisy phase" of the transition evaporates, and investors and lenders undertake longer term projects that address the most serious economic problems of formerly planned economies.

Notes

1. For an excellent critique of the gradualist perspective see Joseph A. Brada, "A Critique of the Evolutionary Approach to the Economic Transition from Communism to Capitalism" in Kazimierz Z. Poznanski, ed., *The Evolutionary Transition to Capitalism* (Boulder: Westview Press, 1995).

2. This statement applies most strongly to Russia; however, crime and corruption are present in great abundance in all transition economies.

3. This is not to suggest that these principles are universally shared in market economies of the West. It is difficult to imagine competing drug gangs agreeing to arbitrate a territorial dispute.

4. At the height of central planning in the Soviet Union roughly 60,000 products were actually planned. By way of comparison, this was about the same number of products produced by Matsushita Electric and 3M. A typical American supermarket might stock 30,000 or so different product types.

5. In the 1930s in the Soviet Union, managers who failed to fulfill their plan were accused of "economic sabotage" and sentenced to labor camps in Siberia and occasionally were shot. In the latter years of communism, failure to fulfill the plan would result in reduction of bonuses (roughly 30 percent of salary for managerial personnel) and often demotion with loss of income and, more important, perquisites, such as the use of an automobile and preferred housing.

6. One notorious example of this was the manager of a light bulb plant in the Soviet Union who reduced the amount of tungsten in the bulbs by one-third, obviously shortening their operating life. Demand for bulbs on the black market increased substantially, which the enterprise was able to meet because, unknown to planners, it had added a third shift, selling the extra bulbs at a substantial profit, while still meeting its plan.

7. Once people get in the habit of this type of consumption it can apparently be hard to break. Up until 1994, a full two years after shortages were eliminated, one of my friends in Tver, Russia, purchased sugar, primarily to use for tea, in 20 kilogram bags—over 40 pounds' worth!

8. It should be noted that in Russia this attitude predates the imposition of communism by the Bolsheviks.

9. It is important to note that saving in a shortage economy is usually not voluntary. People save in a shortage economy because there is very little to buy. The fact that these "surplus" money balances were wiped out with the "big bang" may not have been such a significant problem as many had surmised.

10. There are many reasons to view the declines in output with skepticism. The old system overproduced and overconsumed many products such as coal, steel, and chemical fertilizers. Declines in the output of these products should be viewed as positive developments for the economy and the environment. Moreover, under the old system, managers had an incentive to overstate production. Now, under the new conditions, managers have an incentive to understate production in order to avoid paying taxes. Smaller, newly created firms that rushed in to fill the dearth of consumer services and retail trade outlets had the additional incentive of understating receipts in order to avoid some payments to mafia.

11. One notorious example is the price of bread in Russia, which had remained fixed at 60 kopeks from the 1950s until 1991.

12. Many Czech economists with whom I have spoken insist that Czech privatization, in which banks, through mutual funds, ended up controlling large sectors of the economy is best termed "bankitazation." The implication being that these banks were lending on terms that were too generous.

13. The role of local governments in Russia in influencing economic development was significant and had a visible impact on economic development in a particular region. In Nizhni Novgorod, where the local governor, Nemitsov, had a strong commitment to privatizing state buildings and shops, kiosks were much less prevalent than in Tver, Moscow, and Novosibirsk.

14. Interviews with enterprise directors and bank officials indicate that the typical loan in Russia is of three months' duration. Occasionally loans of up to one year are made, although this was becoming more common by 1995.

15. An excellent article on the game theoretic aspects of such an outcome is in Martin Nowak, Robert A. May, and Karl Sigmund, "The Arithmetics of Mutual Help," *Scientific American* 272, no. 6 (June 1995).

16. Several directors of former state-owned firms interviewed in the summer of 1995 told of how the situation improved throughout 1994 but then got markedly worse with the invasion of Chechnya.

17. One example of such an arrangement was the "trust letter." The trust letter was an agreement to exchange control of an asset (an apartment or car) without officially changing the title. The advantage of the "trust letter" was that it obviated the need to go through the tedious bureaucratic process of changing title and filing related papers. In Moscow this process usually took the commitment of several eight-hour days in line, and was rarely completed within two weeks. Interestingly, the road police (GAI) would honor trust letters as valid for ownership purposes.

18. It should be noted that "investors" refers not only to "outside" investors, but to any agent who trades current consumption in favor of future consumption. For example, a person deciding whether or not to pursue higher education, or a manager seeking to retool a product line.

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