

Socialist Economies: Reform and Transition

An overview of the basic
concepts and underlying
problems

The Difference between Reform and Transition

Economic reform is usually an effort to make the socialist economy work better.

- ❑ "Perfection of control" involves improvements in planning, changes in planners' preferences, adjustment to state prices, organizational changes, moving the "spotlight."
- ❑ Decentralization means moving the planning process to lower levels of decision-making.
- ❑ Radical reform usually involves a new reliance on markets, reduced role of plan in allocation and distribution, managerial autonomy in SOEs, price reform, and labor reform.

Economic transition is the path taken when the socialist economy is intentionally abandoned.

- ❑ Usually after the fall of the existing government, so it often takes place during democratic liberalization and domestic turmoil.
- ❑ Involves price liberalization, privatization, legal reform, tax reform, social reform, and macroeconomic stabilization.
- ❑ Gradual "evolutionary" approach versus a more rapid transition approach called "big bang" or "shock therapy" policy.

The basic problems of reform

- ❑ The principal-agent problem and the contradiction between state ownership and incentive. Autonomy + state ownership may be worse.
- ❑ Political resistance from cadres, apparatchiks, nomenklatura, urban workers, et cetera.
- ❑ Competition leads to reduced profits for state monopolies, which affects state revenues. Money-losing firms are usually subsidized, not shut down.
- ❑ The information needed to redesign the economy is initially much greater than the information needed for planning to work. Catch-22.
- ❑ Simultaneous existence of plan and market leads to opportunities for increased corruption.
- ❑ Kornai argues that the socialist economic system is an integrated system, so how can plan and market coexist for very long?

The Problems of Transition

Need for major changes in behavior and attitudes:

- Loss of legitimacy for the old system, its ideology and its adherents.
- Loss of moral compass – what was wrong is now right?
- Shortage economy attitudes and behaviors change slowly.
- Workers and managers may have difficulty adjusting to new expectations.

Privatization:

- Who gets to own it? auctions versus vouchers, insiders versus outsiders.
- How do SOE managers behave when they expect privatization?
- Accumulated “deadwood” from lack of fire, likelihood of conflagration.
- SOEs served as providers of social safety net, retirement, health care, housing, schools, et cetera. Who will provide it now?

Price liberalization:

- monetary overhang from forced savings likely to cause inflation.
- all prices are interdependent and relative.

Need for a supporting web of banks, insurance, stock markets, suppliers, retailers, et cetera.

- These capitalist market institutions evolved over a long period of time.

But also...

- **Macroeconomic stabilization:** the connection between government deficits and monetary growth.
 - Money-losing firms must be shut down (no buyers, and no coordinating system), but this threatens rising unemployment and a downward spiral in demand.
 - Falling government revenues, combined with rising subsidies and social costs.
 - Bank deposits and the moral hazard problem.
- **Reform of foreign trade and investment:**
 - Convertible currency, single exchange rate, increased transparency, and a level playing field.
- **Conditions for growth of new firms:**
 - contract enforcement, restraint of SOEs, legal reforms.

Russia under Boris Yeltsin (1991-99)



- Gaidar Reforms – Shock Therapy:
 - Ruble convertibility
 - Market liberalization
 - Privatization
 - Social Safety Net
- Political Troubles:
 - Conflict with Congress of People’s Deputies
 - Shelling of White House, Oct. 3, 1993
 - Yeltsin Constitution
 - New elections led to ascent of nationalists (under Zhirinovskiy) and communists (under Zyuganov)
- “Too much shock, not enough therapy” – Strobe Talbott

Transition Process

- Privatization:
 - State Property Committee (Chubais), 1992
 - Voucher Privatization – by 1993, 26% of workforce under private management, by 1994 33%, but half of all income through private sources.
 - Land Ownership Decree
 - "Shares for Loans" in 1995
 - Growth of New Private firms accounted for most growth.
- Price Liberalization:
 - Gradual reduction of price regulations
 - By 1997, most prices set by market forces, with exception to key sectors (e.g., oil & gas).
- Competition and the Private Sector:
 - 1995 Anti-monopoly law established Federal Anti-Monopoly Commission, restricted power of gov't to limit competition.
 - Oligopolies continued to dominate many markets.

Taxes and Inflation

- Tax Reform and Deficit Spending:
 - Taxes continued to be based on profit and VAT taxes, plus special taxes on exports, transportation, et cetera.
 - Poor record-keeping made personal taxes hard to collect.
 - High marginal tax rates, but low rates of collection.
 - Government revenue 44% of GDP in 1992, 29% in 1996
 - Government spending 66% in 1992, 37% in 1996
 - New Tax Code met delay after delay.
- Central Bank Policy and Inflation:
 - CBR created in 1990, replaced Gosbank in 1991 – chief monetary authority, regulated private commercial banking.
 - Gerashchenko headed the CBR – Sachs called him "the world's worst central banker"
 - Inflation rate was 2600% in 1992, 730% in 1993
 - Federal Law of the CBR in 1995 made it responsible for Ruble Stability – inflation fell to 20% by 1996, but Ruble's value had fallen 0.02 cents (5600 per dollar).
 - New GKO's provided government bonds for foreign investors.

Performance

- Official estimate is that Russian GDP declined by more than half in early 1990s, though this may be overstated – heavy industry hit hardest.
- Best estimate is a 30% decline in GDP between 1990 and 1995.
- Corruption
- Organized Crime
- Kleptocracy, oligarchy, and making money the Russian way
- Capital flight
- 1998 Financial Crisis
- Boris Yeltsin resigned in 1999, replaced by Vladimir Putin – a new crackdown on oligarchs and political dissent.

Labor Management and the Yugoslavian Alternative

- Historical context:
 - Battleground of three empires (Austro-Hungarian, Ottoman, and Russian)
 - WWI and Treaty of Versailles
 - Factions in conflict with long history of grievances – including Croatian Catholics, Bosnian Muslims, Orthodox Serbs, Albanians, Slovenians, Macedonians.
 - Civil War 1921-41, followed by Nazi Occupation, Croatian puppet government, and indigenous partisan resistance by communists.

Marshall Tito

- Josip Broz (Tito) ruled 1945-1980:
 - Sent by Comintern to Yugoslavia in 1937; reorganized communist party and led partisan resistance.
 - Initial policies included land redistribution and nationalization of foreign-owned capital, but resistance to Stalinist pressures for collectivization and withdrawal from trade relations with West.
 - First FYP used Soviet-style detailed planning and state ownership, initially successful.
 - Break with Stalin in 1948-1949 over foreign trade and investment.



Economic Reform under Tito

- The “Visible Hand” Reforms in 1951:
 - Decentralization of power to local and republic governments, workers’ councils.
 - Reduction of administrative pricing, more markets in rural and urban areas.
 - State enterprises set own output targets but planners retained control over investment and trade.
 - The idea was that state enterprises would be controlled through workers’ councils, and sell on markets, not for state quotas.
 - As in the Soviet NEP, this sparked a debate between the “left/conservative” faction and the “right/liberal” faction, but the liberal faction won!

Market Socialism, 1965

- More decentralization: investment decisions were transferred to *Basic Banks*.
- Workers were organized into *Basic Associations of Organized Labor* – perhaps many in a large enterprise, responsible for own contracts and self-management agreements.
- Price liberalization, enterprise autonomy, indicative planning, exchange rate devaluation and simplification, foreign trade reform, et cetera.
- But can the labor-managed economy succeed?

The Ward-Vanek-Domar Model

- Assume the capitalist firm maximizes profit
 $\pi = p \cdot Q - r \cdot K - w \cdot L$:
 - $p \cdot MPL = w$, $p \cdot MPK = r$: this determines optimal L^* , K^* .
 - If p rises, Q , L^* , and K^* all rise.
- Assume the labor-managed enterprise maximizes average residual $y = (p \cdot Q - r \cdot K) / L$:
 - $p \cdot MPL = y$, $p \cdot MPK = r$.
 - If $y > w$, then $L < L^*$; if $y < w$, then $L > L^*$.
 - If p rises, $y = (pQ - rK) / L$ rises more than proportionally, so L^* falls. Unless K increases more than enough to compensate, this means Q falls – a perverse price response!
- Furubotn (1976): the effect of investment on growth leads to a reliance on debt, not equity.
- The Property Rights solution – explicit share rights lead back to a two-class workforce.

Performance and problems

- **On one hand:**
 - Improving growth rates, worker productivity, and technology relative to traditional planned economy.
 - The Yugo was the only major industrial product from a socialist economy ever exported to the West.
- **But on the other hand:**
 - Bureaucracy became a significant portion of the BOAL. Inflation from reliance on debt from basic banks combined with BOAL control over lending, bad debts, and central bank bailouts.
 - High unemployment rates (>10% in 1980s).
 - Merger movement, rising industrial concentration, and many instances of monopoly pricing – a paradox.
 - Chronic balance of payments deficits.
 - Regional inequality issues led to transfers.

The End of Yugoslavia

Death of Tito led to collective presidency and regional conflicts in economic policy (esp. Slovenia vs. Serbia).

- By 1990s, Yugoslavia came apart – Slovenia and the Croatia seceded – and Serbian President Milosovic (who controlled the army) joined with local Serb populations to begin a brutal war on Croatia, then Bosnia, and finally Kosovo.
- After NATO war in Kosovo, Milosovic stole an election from his rival Kostunica and was then pushed from power.
- Serbia and Montenegro joined under a new constitution, but finally split apart in 2005. Kosovo is still officially part of Serbia but is administered by the UN. Bosnia-Herzegovina is divided into a Muslim/Croat Federation and Republika Srpska. Croatia and Macedonia are independent, along with Slovenia – which has joined the EU.



Reform and Transition in Central and Eastern Europe

- East Germany and future members of the EU: Poland, Czech Republic, Slovakia, Hungary, Slovenia, Lithuania, Latvia, and Estonia.
- Former Socialist Countries not likely to enter the EU soon: Bulgaria, Romania, Albania, other republics of the former Yugoslavia (e.g., Croatia and Serbia/Montenegro) and other European republics of the former Soviet Union (e.g., Belarus and Ukraine).

New Entrants to the EU

| Country | Pop | Per-capita GDP | By PPP Method | Growth 1980-1990 | Growth 1990-2001 | Growth 2001 | 2001 FDI/GDP | Trade Ratio |
|----------------|------|----------------|---------------|------------------|------------------|-------------|--------------|-------------|
| Czech Republic | 10.3 | \$5270 | \$14,550 | 2.0% | 1.1% | 3.6% | 8.8% | 123% |
| Hungary | 10.2 | \$4800 | \$12,570 | 1.5% | 2.1% | 4.0% | 5.8% | 124% |
| Poland | 38.7 | \$4240 | \$9,280 | - | 4.1% | 1.2% | 4.5% | 49% |
| Slovakia | 5.4 | \$3700 | \$11,610 | 1.6% | 1.9% | 3.2% | 11.8% | 134% |
| Slovenia | 2.0 | \$9780 | \$18,160 | - | 2.7% | 2.9% | 3.8% | 103% |
| Estonia | 1.4 | \$3810 | \$10,020 | - | -0.2% | 5.3% | - | - |
| Latvia | 2.3 | \$3260 | \$7,870 | - | -2.6% | 9.0% | - | - |
| Lithuania | 3.5 | \$3270 | \$7,610 | - | -2.3% | 4.3% | - | - |

Not Likely to Enter Anytime Soon

| Country | Pop. | Per-capita GDP | PPP | Growth 1990-2001 | Growth 2001 |
|-------------------|-------|----------------|--------|------------------|-------------|
| Russia | 144.8 | \$1750 | \$8660 | -3.9% | 5.5% |
| Ukraine | 49.1 | \$720 | \$4150 | -8.0% | 10.0% |
| Belarus | 10.0 | \$1190 | \$8030 | -1.0% | 4.4% |
| Romania | 22.4 | \$1710 | \$6980 | -0.4% | 5.5% |
| Bulgaria | 8.1 | \$1560 | \$5950 | -1.0% | 5.1% |
| Serbia/Montenegro | 10.6 | - | - | 0.3% | 4.9% |
| Croatia | 4.4 | \$4550 | \$8440 | 1.3% | 4.1% |
| Albania | 3.4 | \$1230 | \$3880 | 2.9% | 5.6% |

Historical Background

- Before 1919, most CEE countries were not independent sovereign states. Treaty of Versailles wrote the borders.
- In 1944-45, Soviet Red Army occupied all of CEE except Yugoslavia and Albania. Churchill's "iron curtain" came down, and Soviets established new policies.
- Joint Allied Occupation in Germany and Austria: East German Soviet Zone became DDR, Berlin Blockade and Airlift, building of Berlin Wall.
- U.S. Policy of Containment, Cold War, Marshall Plan, and NATO.
- Soviet established Warsaw Pact and CMEA (Comecon).

Pre-1989 Hungary

- Matyas Rakosi's "salami tactics," fraudulent elections in 1947, Stalinist First FYP.
- Imre Nagy's **New Course**, 1953-1955, ended forced collectivization and focused more on consumer goods.
- **Hungarian Revolt** in 1956 followed conflict between Nagy and Rakosi. Attempt to leave Warsaw Pact led to Soviet Invasion under Khrushchev. West distracted by Suez crisis. New leader Janos Kadar walked a tightrope.
- **New Economic Mechanism**, 1968-73: indicative planning, limited market, profit motive, foreign trade, no decentralization, labor management, or political reform. Not very successful.
- **Reform of Reform**, 1979-88: Dismantling of monopolies, bankruptcy, some new firm types.

Pre-1989 Czechoslovakia

- ❑ Successful and growing industrial democracy from 1919-1938.
- ❑ Free elections in 1946, but communists siezed government in 1948.
- ❑ 1963 Reforms were resisted by Nomenklatura.
- ❑ 1968 **Prague Spring** led by Dubcek. Takeback of unions, workers councils, free speech and press, foreign trade, and invasion by Brezhnev and Warsaw Pact. Set **Brezhnev Doctrine**.
- ❑ Under Gustav Husak, Czechoslovakia became one of the most conservative CEE economies.
- ❑ **Charter 77** on Human Rights, playwright Vaclav Havel would spend years in prison.

Pre-1988 Poland

- ❑ Old Empire until 1600s, weak government due to Sejm veto power. Dissolved into Russian, Prussian, and Austrian empires. Reemerged from 1919-1939. New borders after 1945.
- ❑ Worker Uprising in 1956 – collectivization abandoned, planning decentralized.
- ❑ Worker Uprising in 1970 – Geirek increased wages, imports, borrowing from West.
- ❑ 1970s debt crisis led to austerity policies.
- ❑ 1980 uprising at Lenin Steelyard in Gdansk (Danzig) led to creation of **Solidarity**, Lech Walesa. Government recognition, negotiation, and concessions.
- ❑ Soviet Military Exercises in 1981 led General Jaruzelski to declare martial law and outlaw Solidarity.
- ❑ New austerity policies, popular resistance, and economic stagnation. Inflation was 25% in 1987, high for a socialist economy.

Events of 1988-1990

- ❑ Gorbachev signaled end of **Brezhnev Doctrine**, encouraged CEE countries to try reforms – both economic and political – to resurrect their slowing economies.
- ❑ Poland, 1988: Roundtable Talks led to recreation of Sejm, partially free elections, return of Catholic Church's nationalized property. Solidarity took all seats in 1989 elections, Walesa would win presidency in 1990.
- ❑ Hungary, 1988: Kadar ousted by HSWP, followed by Grosz, Pozgay. In 1990 elections, HDSP got 8% of vote.
- ❑ June 1989, China's Tiananmen demonstrations, crackdown.
- ❑ East German emigration through Czechoslovakia. Rumors led to a massive crowd that tore down the Berlin Wall, government falls.
- ❑ Czechoslakian "Velvet Revolution" in 1989.
- ❑ In Bulgaria, Zhivkov's government overthrown. Romanian Demonstrations in December 1989 led to bloody crackdown in Timisoara. Ceausescu and his wife overthrown and shot. Albanian government falls apart in 1990-91.

Poland

- ❑ **Balcerowicz Plan** under new Solidarity-run government beginning in 1990 – market liberalization and *shock therapy* most rapid in CEE economies.
- ❑ Privatization: public sales, then “mass privatization.” Rapid growth of new firms, rising FDI.
- ❑ Collapse of Soviet trade slowly replaced by growth in trade with Germany & EU.
- ❑ Macroeconomic stabilization helped: Inflation was 553% in 1990, 33% in 1994, 16% in 1997.
- ❑ First CEE economy to recover: growth began in 1992, highest in Europe by late 1990s.
- ❑ High unemployment: 16% in 1994, 13% in 1999.
- ❑ Political stalemate after 1991, return of renamed communists in 1995 elections led to no retreat on reform.

Hungary

- ❑ **1988 Economic Stabilization and Structural Reform Program:** a radical, but *gradual*, move towards the market. Western laws, economic integration, tax and banking reforms, ending of state firm subsidies, privatization, political reform, et cetera.
- ❑ 1990 Elections gave power to Hungarian Democratic Forum under Antall: gradual economic reforms continued. Deficits (10%), slow privatization, GDP fell by 18%, rising unemployment (12%), foreign debt (250%).
- ❑ 1994 Elections to Socialists under Horn: aggressive privatization (80% by 1998), export promotion, austerity, crawling exchange rate peg, falling inflation, rising FDI (1/3 of total, 1/3 from U.S.), rising trade and faster growth (4.4% in 1998, rising to 6%).

Czech Republic

- ❑ Husak resigned, free elections, Vaclav Havel new President and Civic Forum in power. Vaclav Klaus new finance minister.
- ❑ Jan. 1, 1991 – central planning abandoned, most subsidies ended, koruna becomes convertible, liberalization of most prices, foreign trade and tourism.
- ❑ Government surpluses helped cut inflation from 45% to 0% by end of 1991. Inflation relatively low through 1990s.
- ❑ Privatization through small firm auctions and *Kuponova Metoda*, FDI and new firm growth, while remaining large SOEs and state banks slid towards bankruptcy.
- ❑ Political stalemate by mid-1990s.

East Germany

- Most advanced of CEE Soviet-bloc economies. Yet when the wall came down in 1989, West Germans discovered a weak economy with inefficient factories, unproductive workers, and terrible environmental damage. Trabants on the Autobahn.
- 1990 – Reunification: monetary, economic, social union, followed by a political union.
 - Extension of West German legal system, labor and other regulations, social insurance, codetermination, et cetera.

Currency Conversion

- 1:1 parity conversion for prices, wages, small savings, pensions; 2:1 conversion for other savings
- 4:1 the official rate, 12:1 the black market rate.
- Political decision with terrible consequences.
- East German goods and labor overpriced given relatively low labor productivity and quality.
- Normally, free trade with Europe would be an advantage for such an economy, since exchange rate would fall and make exports cheaper.

Market Restructuring

- Treuhandanstalt (THA) – privatization agency:
 - East German industry organized into 221 Kombinate, large inefficient monopolies that made privatization difficult.
 - No new investment before privatization, reliance on market restructuring.
 - Difficulty of determining property ownership.
 - Environmental damage made many factories too risky to purchase under German environmental rules.
 - In defiance of expectations, THA eventually completed its mission and shut down.

What happened?

- ❑ Fiscal cost of reunification led to deficits, offset by Bundesbank policy. High interest rates led to savings inflows from the rest of Europe, and caused European financial crisis in 1992, and European recession.
- ❑ Contrary to expectations, the eastern Länder did not catch up. Unemployment much higher than in west, productivity much lower, growth rate slower so gap is widening. The cost of reunification also helped to slow growth in the west.
- ❑ Ossie vs. Wessie social conflict, Neo-nazi problems, blaming Gästarbeiter for unemployment.

Lessons

- ❑ Big Bang vs. gradualism.
- ❑ Privatization of SOEs vs. new growth.
- ❑ Macroeconomic Stabilization is key; it depends on getting government budget under control.
- ❑ Creation of an honest government and a safe investment climate (Olson).
- ❑ Importance of trade relations, foreign investment.
- ❑ Social Safety Net and long transition period.
- ❑ Democratic political shifts may not alter economic reality, and policy is not ideological.
- ❑ Lots of things can go wrong.
