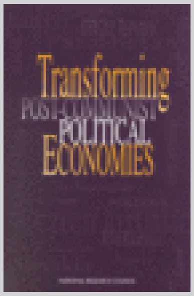


# Transforming Post-Communist Political Economies

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# Transforming POST-COMMUNIST POLITICAL ECONOMIES

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Task Force on Economies in Transition

Commission on Behavioral and Social Sciences and Education

National Research Council

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We also thank the Research Council staff who oversaw the myriad technical details associated with this project, especially Janine Bilyeu and Heather Schofield. We are particularly grateful to Rona Briere for her editorial expertise. Most important, Lee Walker, the project director, was the linchpin who directed the study, from its earliest glimmer through five workshops and innumerable drafts of papers, keeping us all focused on both the substantive tasks and the administrative realities. This volume would not exist without her work.

Finally, we acknowledge the critical and intellectual contributions of our fellow members of the Task Force. We are a small group, and the scope of the topics and the substantial tasks entailed in the project demanded active and substantial contributions from the Task Force members. We are grateful to have had the opportunity to work so closely on this important project with such dedicated, thoughtful, and congenial colleagues.

Joan Nelson and Charles Tilly, *Cochairs*
Task Force on Economies in Transition

# Contents

# Transforming POST-COMMUNIST POLITICAL ECONOMIES

# Introduction

The dissolution of the Soviet empire in Central and Eastern Europe and the demise of the Soviet Union have created unprecedented opportunities for social, political, and economic change in Europe and Eurasia. Current reforms will alter fundamentally the way post-communist societies, political systems, and economies function and interact. More than 5 years into the process, what do we know about social change at this pace and scale? What do we not know that we should know? What should we be tracking and analyzing in order to improve our understanding of this unprecedented transformation?

In 1994, the Joint Economic Committee of the U.S. Congress, the U.S. Agency for International Development, and the Office of Research and Development of the Central Intelligence Agency brought a series of issues relating to the post-communist economic transition to the National Research Council (NRC) for investigation. In response, the NRC established a Task Force on Economies in Transition. The task force's main charge was to improve understanding of the economic transformation in Central and Eastern Europe and the New Independent States, and to determine what we know about the interdependent economic, political, and social processes currently taking place in the region. The NRC also asked the task force to develop a research agenda that would direct efforts and funding to those areas, issues, and methods most likely to improve understanding of the complex and interrelated socioeconomic processes encompassed by the terms "transition" and "transformation." This volume responds to that charge.

From its inception, the task force doubted that present versions of any existing theories—including various theories preferred by its own members—

could adequately encompass these extraordinarily complex processes and explain the very different rates and patterns of transformation across the post-communist world. Most established economic theory aims to explain marginal and incremental changes. It is therefore at best partial, and at worst misleading, in the context of sweeping, rapid changes in entire systems. Moreover, conventional theory assumes the existence of underlying formal and informal institutional arrangements that are radically different from those prevailing in many parts of Central and Eastern Europe and the New Independent States. Similar difficulties beset our explanations of political change: models that fit more or less adequately the representative systems of capitalist democracies leave unstated both the underlying institutional forms and conditions for drastic transformation.

At the outset of the transformation, these shortcomings of Western theory and knowledge were compounded by the widespread assumption that these societies would "naturally" evolve into systems closely approximating those of the industrialized West. These teleological and deterministic assumptions are not inherent in existing theories, but nonetheless have had a powerful influence on policy advice and action in the post-communist world. The ascendance of neoliberal economic philosophy during the 1980s, both in the industrialized West and in poorer regions of the world, seemed vindicated by communism's collapse in Central and Eastern Europe and the New Independent States. For a brief period, many observers and advocates believed that Western models of market economies and democratic polities were the wave of the future, and that the post-communist world was embarking down the same road to the same destination (though some countries were expected to move more rapidly than others). Moreover, many people thought that road was plainly marked: stabilization, liberalization, and privatization would transform highly bureaucratized, statist economic systems into dynamic, competitive capitalist economies. Similarly, contested elections, political parties, and decision making by representative assemblies would provide the path to democratic stability.

Experience during the 1990s has confirmed the crucial importance of certain (mainly macroeconomic) policies as necessary, though far from sufficient, underpinnings to resumed growth. But the failures and disappointments of initial efforts at transformation in parts of the post-communist world and the varied patterns and ongoing problems in even the most successful cases have led most thoughtful reformers and analysts to back away from single-track assumptions. There is now much greater recognition that different paths of transformation, and different destinations, are likely to be generated by different histories (before and during the communist era); the different ways in which communism collapsed; and contrasting geography, social structure, ethnic composition, and cultural values. Some of these destinations may look similar to one or another of the multiple models of mainly market economies already established elsewhere in the world, while others may look quite different from any existing market or communist model. Some of each group may thrive while others prove unworkable.

The task force began its work roughly at the same time that the initial phases of the transformation process were yielding to later phases, with different goals and emphases, in much of Central Europe and the Baltic states. Initially, the overwhelming priorities were stabilization and liberalization—particularly the dismantling of old controls on prices, trade, and investment. As these measures took hold in Poland, the Czech Republic, Slovakia, Hungary, Slovenia, and the Baltic states, the attention of policymakers and advisors shifted to the much more diverse and complex tasks of creating new institutions and frameworks for effective governance and economic growth, while continuing to keep a watchful eye on macroeconomic management. Elsewhere in Eastern Europe, and in most of the New Independent States, the early phases of transformation, characterized by the struggle for stabilization, liberalization, and privatization, has taken longer and been much less decisive. In these areas, the challenges of designing institutional reforms and creating new regulatory and social-sector frameworks appropriate to mainly market economies will be more difficult, and will have to be tackled simultaneously with the yet-to-be-completed initial phase of transformation.

As more post-communist countries move into later phases of transformation, the policy guidance provided by neoliberal economics becomes more limited and partial. While there are criteria for restructuring financial sectors consistent with the requirements of market economies, there is no single template from which one can draw the precise outlines of any of the components of an economic system (including central banks, monetary policies, investment incentives, monitoring systems, and savings institutions) that will foster both well-being and economic growth. Still less is there a single formula, or even a great deal of technical agreement in the West, regarding how to design new pension or educational systems or the most appropriate labor market institutions. Indeed, many semi-industrial and industrial nations outside the post-communist world continue to grapple with similar issues. Far from being able to apply a well-understood model to achieve predictable outcomes, analysts and practitioners are groping at the frontiers of knowledge, seeking better insights and ways of grasping the complex, dynamic, and interacting processes of transformation.

In seeking to contribute to these efforts, the task force looked for innovative ways to determine what is occurring in these diverse systems, to unravel some of the unexpected consequences of policies, and to trace the strategies and networks different actors are using to cope with the uncertainties of transformation. The task force recognizes that many approaches are useful and that no single approach will be adequate in such a complex endeavor. It has, however, chosen to emphasize one approach in this volume—the analysis of institutional change. It has done so for several reasons. First, task force members and those who participated in the workshops conducted for this study found this approach both thought-provoking and fruitful. Second, many of the papers included in this volume demonstrate the utility of the approach. Finally, this approach has been largely neglected to date in analyses of post-communist transformations. Rather than surveying all possible interpretations of current changes in post-communist economies, together with all possible objections to their major arguments, this volume aims to stimulate thought and discussion, identify crucial gaps in current knowledge, and motivate new research.

To address the challenges posed by its mandate, the task force:

- Commissioned a series of reports from specialists in East European and Eurasian social change and the processes of economic transformation, ranging from broad conceptual surveys to investigations of developments in specific sectors of particular countries.
- Organized a series of five workshops at which practitioners, analysts, and policymakers could debate those reports.
- Produced a set of critical syntheses of the results, including the essays that introduce each section in this volume and the overall framework essay by Douglass North.

Four different components of the task force's mandate should be distinguished: (1) setting goals, (2) identifying potentially useful conceptual approaches and methodologies, (3) explaining current changes, and (4) identifying research priorities. For all four components, the stakes are high, and sharp disagreements exist among analysts, policymakers, and citizens as to the best course of action.

With respect to goal setting, for example, most observers and participants would welcome the eventual establishment of productive, prosperous, self-sustaining economies and democratic regimes throughout the zone of former state socialism. Disagreement begins, however, with the extent to which such economies and regimes must imitate existing Western models; whether the pursuit of economic growth and democratization conflict in the short run; the extent to which the social services and rights established under state socialism should be preserved; the relations post-socialist economies should have with the evolving international capitalist system; and the extent to which even long-run goals should differ for, say, Uzbekistan and Estonia. Among our contributors, the variation in views with regard to these issues is striking. Some think the immediate adoption of Western economic models is both desirable and feasible. Others argue that the future economies and polities of post-communist regions will inevitably differ significantly from those of present-day Western, capitalist democracies. The analyses included here help identify and probe these goal-setting issues, but do not attempt to resolve them.

As noted earlier, many of the chapters and essays included in this volume stress the value of institutional analysis for understanding economic transformation and social change in Central and Eastern Europe and the New Independent States. To recognize the significance of institutions is not to announce a list of precisely six (or six hundred) social arrangements that underlie functioning markets or market systems, but to see that all systems of production and exchange rest on organizations, routines, guarantees, relationships, and understandings that are not themselves obvious elements of production and exchange. It should be understood at the outset that the term *institution* is used differently here than in common parlance or, for example, in the field of political science. The institutional approach defines institutions as the indispensable framework within which human interaction takes place—as the "rules of the game," the humanly devised constraints, that determine incentives and shape human interactions in all societies (North, 1990:3-4). Some institutions, such as laws, tax regimes, and the explicit operating rules of organizations, are formal, while others, such as cultural norms and established conventions, are informal. Formal rules are only a small subset of the constraints that govern choices and human interaction, while informal constraints and conventions are so pervasive that one is often misled into underestimating their role and importance. Institutions, both formal and informal, reduce uncertainty, structure incentives, define property rights, limit choices, and ultimately determine transaction costs (North, 1990).

Economic and political liberalization has dismantled a great many of the formal communist institutions—the laws, regulations, and organizations characteristic of the communist era. At the same time, however, informal institutions from the communist as well as the pre-communist past, including relationships, norms, and rules of behavior, persist in varying degrees and continue to shape expectations, incentives, and behavior. Moreover, new informal institutions are emerging alongside the new formal laws and organizations. While reformers and policy advisors are attempting to design and introduce new, formal institutions, it should be understood that these measures will confront and interact with remnants of old arrangements and spontaneously developing informal institutions (North, 1990). Conflicts and inconsistencies between formal and informal institutions can produce unanticipated consequences, including noncompliant behaviors and underground economic activities. No one has a formula for setting the optimum level of institutionalization, or even the certainty that a single such level exists. To the contrary, the task force wishes to emphasize the great diversity of institutions and institutional patterns that have existed, currently exist, and are emerging in the course of transformation.

Analyzing transformation in terms of institutional change alerts policymakers and scholars to the critical need for market infrastructure, without which markets can not form or function. It focuses attention on the necessity for secure property rights without which investors are unlikely to invest, and capitalists are unlikely to undertake the risks of entrepreneurship. It emphasizes how transaction costs—the costs associated with measuring, monitoring, protecting, and exchanging property rights—affect incentives for the production, trade, and use of goods and services. Finally, it highlights the importance of path dependence—the ways in which cultural norms and inherited ways of conducting business and governing societies structure a society's institutions, setting the parameters within which, and the stock of knowledge with which, change will occur.

The path dependence of economic, institutional, and political change means that major processes—such as monetization of exchanges, privatization of property, and integration into international markets—will operate differently in different socioeconomc systems as a function of previously existing social arrangements. Just as a skyscraper's lightning rod acts as a conduit for electrical discharges from storm clouds, established social, economic, and political connections and routines channel economic transformations. As a result, changes may sometimes proceed with unexpected rapidity, with an entrenched and previously clandestine second economy suddenly becoming a relatively unfettered legal vehicle of exchange. Changes may also move more slowly than reformers anticipate, encountering obstacles created by the old system. Path dependence governs the itinerary more than the speed of economic change.

Analysts concerned about institutional change and path dependence have no choice but to take concrete histories seriously. Starting with the synthesis provided in North's framework essay, many of the authors in this volume step back to examine the longer-term implications of the transformation taking place in underlying social and economic institutions. Most critically, they raise questions about which institutions are likely to impede, promote, or prove irrelevant to the emergence of productive economies and self-sustaining democracies. These inquiries examine changing property rights, transaction costs, power structures, household coping strategies, and interpersonal networks. They call attention to the paths and sequences by which institutional transformation actually occurs, with an eye to the likely perverse effects of attempts to install replicas of specific Western organizational forms where the necessary institutional contexts have yet to emerge.

Effective economic change depends on changes in formal noneconomic organizations, such as courts, schools, and hospitals. But it also depends on webs of understanding, expectation, and social relations that cut across formal organizations: norms of honest work and decent pay, networks of friends and relatives who pass on news of economic opportunities, devices for pooling capital, and much more. These arrangements constitute the informal and only partially visible side of institutions underlying economic activity and change. They increase or decrease the likelihood that the performance of markets, investments, monetary flows, and producing firms in rapidly changing economies will be similar to that of their counterparts in long-established capitalist economies.

Authors in this volume display an acute awareness of institutional effects, both formal and informal. Rather than dismissing such pervasive and striking phenomena as official corruption, theft of government property, pyramid schemes, rising mortality, and mass emigration as obstacles or temporary misfortunes on the road to economic transformation, they seek to explain and trace the implications of ostensible setbacks, obstacles, and perverse effects. Such changes, properly understood, provide valuable signals concerning the extent to which post-communist economies and polities are actually behaving as conventional theories of market expansion and democratization would lead us to expect. Even more important, individuals' short-run responses to economic and political change depend heavily on their societies' inherited, and often entrenched, institutional arrangements. Their responses may be constrained or facilitated by patron-client networks, ethnic and religious solidarities, organized access to government resources, incentives for short-term profit taking rather than long-term investment, and social structures that facilitate the evasion of taxes. Therefore, actual behavior provides crucial information about institutional constraints on the array of possible choices and policies.

In each of the five workshops conducted for this study, the task force sought explicitly to integrate macroeconomic and microeconomic levels of economic analysis, while building bridges across the disciplinary divides between economics and the other social sciences and between Western and post-communist scholarship. Beginning at the base, the task force focused initially on transformation at the level of the individual household and the coping strategies employed by different actors to survive and surmount the challenges of change. Although the interrelationships between health and the stresses induced by socioeconomic change and uncertainty were discussed at the first workshop, papers addressing these issues were excluded from this volume in view of the fact that the NRC has just published a volume of papers on *Premature Death in the New Independent States*. Similarly, although the task force recognized the potential for ethnic and religious solidarities to influence the course of transformation, the NRC's recent work on *Balancing and Sharing Political Power in Multiethnic Societies* encouraged us to focus our attention elsewhere.

Progressing to increasingly complex levels of socioeconomic interaction, the task force examined the transformation of management, labor, and production; institutional change, property rights, and corruption; social trends, household behavior, and social-sector policies; and the transformation of the role of the state. The choice of topics was not intended to be exhaustive, but to direct attention and research to key elements of transformation. This work plan also enabled the task force to highlight the complex interactions among processes that are frequently analyzed separately, or with other things being held artificially constant. For example, the opportunities for rent seeking created by privatization are integrally related to the criminalization and corruption of state structures. Similarly, while the appearance of extensive quasi-currencies in Russia and some other countries is a creative (though not necessarily constructive) response to the strains of transformation, it contributes to the alarming erosion of central government authority and revenues.

The task force's series of workshops provided opportunities for social scientists, policy analysts, legislators, and development specialists to confer, debate, and refine their preliminary understanding of critical aspects of the transformation process. This in turn enabled them to transfer insights gained at the workshops to contemporary policy issues without awaiting the publication of this volume.

The volume opens with both an introduction and a framework essay. This introduction explains the task force's mandate, outlines its program of work, and provides a brief guide to the materials included in the volume. North's essay outlines the broad contours of the new institutional economics, demonstrates the analytic utility of the approach, and applies it to the study of economies undergoing transformation. His essay is followed by four substantively based sections: II "Institutional Change, Property Rights, and Corruption;" III "Management, Labor and Production;" IV "Social Trends, Household Behavior, and Social-Sector Policies;" and V "The Changing Role of the State." The chapters in each section were initially presented at one of the task force workshops, where they were subjected to intense debate, and were subsequently revised for publication. Compelled to make its selection from an extraordinarily strong and diverse group of papers, the task force chose to include those papers which provided cross-national and comparative analysis, addressed major problems of explanation, provided new conceptual approaches, connected explanations with policies for intervention, and shed the most light on institutions and institutional change.

Just as the volume opens with a framework essay, each section opens with a task force essay. These essays not only set the context for the specific papers included in each section, but, more important, provide an opportunity for the task force to synthesize the insights gained over the course of the project and elaborate their own views concerning the processes of transformation.

In the final section of the volume, "Research Priorities for Post-Communist Economies," the task force raises a series of questions about the transformation. These questions include conventional issues such as how labor markets are forming and what is happening to capital accumulation, but they also emphasize:

- Analysis of evolving incentives and transaction costs in the course of institutional transformation.
- Careful monitoring and explanation of what might seem to be short-term disturbances.
- Singling out of responses—successful or otherwise—to deliberate policy interventions as privileged evidence concerning the causal processes operating in post-communist countries.
- Treatment of current changes as evidence about the plausibility of competing explanatory models.
- Identification and explanation of different change trajectories within the post-communist world.

In general, the research agenda outlined in the final section of this volume stands as a warning against the straightforward application of models based on a stylized description of the world's richest economies, the assumption that the expansion of markets and private property will suffice to move post-communist economies to prosperity, and the use of checklists to gauge the approximation of any particular economy or polity to an idealized portrait of capitalist democracies. It also calls for broader and more penetrating efforts to identify and model the political, ethnic, and economic forces channeling institutional changes, and to determine the effects of these changes on incentives, perceptions, and relationships. What sorts of institutions, for example, guarantee contracts, promote productive long-term investment, discourage rent seeking and capital flight, give priority to state-backed legal tender, and encourage tax compliance?

The processes currently unfolding in the post-communist world challenge our capacity to limit the human costs and promote the potential benefits of this unprecedented transformation. They also offer a unique opportunity to expand our limited grasp of the kinds of changes that underlie economic restructuring and development more generally. Both the challenge and the opportunity demand broader and more flexible conceptual approaches than those which have dominated to date. This volume provides examples of such approaches, and marshals a formidable range of unanswered—and for the most part previously unexamined—questions for a larger and more probing program of research.

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# I

# Overview

# Understanding Economic Change

*Douglass C. North*

There are some fundamental characteristics of successful economic development that are common to economies everywhere. There is, however, no universal pattern for achieving these results. While we do have some idea of what has led to successful development in the past, we have very imperfect knowledge about how to achieve such results in the present. Awareness of the current limits to our knowledge is a prerequisite to understanding the problems involved in improving the performance of economies in transition from state socialism.

Economic growth results when the output of an economy grows because more land, labor, capital, and entrepreneurial talent are devoted to the production process and/or because the productivity of these factors of production rises. Growing markets, technological improvements, and additional investment in human beings (human capital) all have played a part in increasing productivity. While the new literature on growth economics has formalized some of these findings, they have been broadly understood for some time by economic historians, development economists, and specialists in growth accounting. But how do we explain the continuation of poverty in much of the world if the sources of growth are known? The answer is to be found in the failure of humans to organize themselves to undertake the improvements that would result in increasing output. The institutional framework of a society provides the incentive structure that directs economic (and political) activity. We do know a good deal about the institutional foundations of successful economic growth. A number of recent empirical studies have made clear the importance of the institutional matrix. Stable political structures, well-specified and enforced property rights, and low-cost enforcement of contracts (typically through the rule of law) have resulted in the low transaction costs underlying the success of the developed economies. Throughout history, humans have all too often failed to provide the institutional framework necessary for productive activity.

Until we understand more than we currently do about the process of economic change, we are fundamentally hampered in improving economic performance. The theory from which we start is static and frictionless—critical limitations to our understanding of the process. Moreover, path dependence matters, and we are still unclear about exactly what it is that makes the path we have trod such a critical factor in constraining present and future choices. However, the discussion that follows provides a loose structure designed to be an aid in thinking about the issues involved in this process.

An economy can be characterized by innumerable statistics on its demographic, economic, technological, and institutional features, but what we really need to know is the interplay among all these features that makes it work. The foundations of that interplay are three: the demography, which describes the quantity and quality of human beings; the stock of knowledge the society possesses, which determines the human command over nature; and the institutional framework, which determines the rules of the game. The demographic characteristics include not only fertility, mortality, and migration characteristics and labor force composition, but also the stock of human capital (derived from the stock of knowledge). The stock of knowledge includes not only the scientific knowledge a society possesses, its distribution in the society, and its application to solving problems of scarcity, but also the beliefs the society holds that influence the choices made. That stock of knowledge determines the potential upper bound of the well-being of the society. The institutional framework determines the incentive structure of the society. It is the interplay among these three that shapes the features of the economy. We know very little about this interaction, although we do have some limited hypotheses about certain of its aspects. But self-conscious modeling of this interaction at a moment in time, much less over time, has not been part of the agenda of economists, development economists, or economic historians.

Yet we do construct in our minds a synthetic framework designed to explain how the economy works. This framework is derived in part from the culturally determined belief systems we possess and in part from the available evidence. The structure is both a positive model of the way we perceive the economy and a normative model of the way the economy should work. The model is always a very imperfect reflection of how the economy really works. In some cases the defects are fatal, as in the case of the communist models that disintegrated in 1989. From this (typically implicit) model, we, or those political and economic entrepreneurs who are in the position to make choices that shape micro- and macroeconomic performance, erect an elaborate structure of rules, norms, conventions, and beliefs embodied in constitutions, property rights, and informal constraints that in turn shape economic performance. This "scaffolding" not only constrains the choice set at a moment of time, but also is the source of path dependence. When political or economic entrepreneurs seek to alter some aspect of economic performance, they make choices that are limited not only by the standard constraints of technology and income, but also by this scaffolding. The intention is to alter economic performance in a particular direction. The aggregate of such policies is continually altering the way the economy works. In turn that leads to gradual alterations of the models we devise in a never-ending process of economic change. I should complicate this all too brief account by pointing out that nonhuman forces, such as climate change in history, also influence the performance.

Throughout history, humans have typically gotten it (at least partly) wrong in (1) their understanding of the way the economy works, (2) the synthetic frameworks they construct, or (3) the policies they enact (at best blunt instruments to serve their purposes), producing unanticipated consequences. We may write economic history as a great success story of an enormous increase in material well-being, which has reflected the secular growth in the stock of knowledge. But it is also a vast panorama of decisions that have produced death, famine, starvation, defeat in warfare, economic decline and stagnation, and indeed the total disappearance of civilizations. And even the decisions made in the success stories have typically been an admixture of luck plus shrewd judgments and unanticipated outcomes. Take American economic history as an example. From the earliest attempts at settlement, through the colonial era, to the perceptions leading to the Revolutionary War, the colonists had it, at best, half right. The Constitution, surely a classic of shrewd judgment, was aided by chance (the events of the 1780s), luck (the boycott of the convention by the antifederalists), and unanticipated decisions (the development of the independent judiciary and the Marshall court).

I wish to emphasize the limits to our understanding because there is a certain amount of hubris evident in the annual surveys by the World Bank and in the writing of orthodox economists who think we now have it right. It is important for us to understand that even if we do have it right for one economy, it will not necessarily be right for another, and that even if we have it right today, it will not necessarily be right tomorrow. I am not suggesting that we have failed to learn a good deal about determinants of economic performance. I began this essay by asserting that we have. But the implication of my brief survey is that in the sequence from our understanding of an economy, to the scaffolds we erect, to the policies we then enact to alter economic performance, there are innumerable junctures where we can and do get it wrong. Let me focus on three such junctures that are central to the issues of improving the performance of transition economies: the "scaffolds" we erect, the policies we enact, and time.

It is the scaffolds we erect that make path dependence so important. They consist of the political structure that specifies the way we develop and aggregate political choices; the property rights structure that defines the formal incentives in the economy; and the informal constraints of norms, conventions, and internally held beliefs. They have evolved over many generations, reflecting, as Hayek (1960) has reminded us, the trial-and-error process that has sorted out those behavioral patterns that have worked from those that have failed. Because the experience of every society has been unique, the scaffolds erected will differ for each economy. They constrain the choice set not only because the organizations of the economy have been built on the foundations of that institutional structure, so that their survival depends on its continuance, but also, and perhaps more fundamentally, because the belief system that is a complementary part of that scaffolding tends to change very slowly. Not only is the scaffolding what makes path dependence so important, but it is equally the explanation for the difficulties involved in reconstruction when much of the scaffold crumbles, as happened in 1989 in Eastern Europe.

The second critical juncture is the policies we enact to alter the performance of an economy. Even when we have a "correct" understanding of the economy and a (more or less) "correct" theory about its operation, the policies at our disposal are very blunt instruments. They consist of alterations in the formal rules only, when in fact the performance of an economy is an admixture of the formal rules, the informal norms, and their enforcement characteristics. Changing merely the formal rules will produce the desired results only when the informal norms are complementary to that rule change, and enforcement is either perfect or at least consistent with the expectations of those altering the rules.

Finally, time is important because change is a process in time, not a once-and-for-all occurrence as we are accustomed to thinking in static theory. Not only are the economies themselves continually changing, but also the policies we enact will have downstream consequences through time that must be taken into account. Specifically, a policy will typically affect the distribution of income, and those adversely affected, if they have access to the political process, may act to negate or alter the policy. In the extreme, the policy may produce a violent reaction. While nothing as elegant as a formal dynamic theory is even on the horizon, recognizing that policy enactment is a process in time is the beginning of the political economy we seek.

The implication of the foregoing analysis is that path dependence can and will produce a wide variety of patterns of development, depending on the cultural heritage and specific historical experience of the economy. Indeed, the success in China of TVEs (town, village enterprises)—a form of organization that is neither a firm nor a cooperative and does not fit our preconceptions about successful institutional/organizational structures—has been a sobering reminder of how much we still have to learn about the process. A description of that process in China from the enactment of the household responsibility system traces a unique path that has produced (so far) rapid economic growth. I would hope that this essay would put to rest any simplistic general nostra such as "big bang" or "shock therapy" theories about magically overcoming a lack of development.

If path dependence can help us understand the variety of development patterns, it also speaks forcefully to the constraints that the "scaffolds" erected in an economy impose on institutional change. The historically derived constraints are supported not only by the existing organizations that will oppose change, but also by the belief system that has evolved to produce those constraints. The rate and direction of change will be determined by the "strength" of the existing organizations and belief system.

The demise of communism in Eastern Europe in 1989 reflected a collapse of the existing belief system and a consequent weakening of the supporting organizations. Policymakers were confronted not only with the restructuring of an entire society, but also with the blunt instrument that is inherent in policy changes that can only alter the formal rules, but not the accompanying norms. And even policymakers have had only limited success in inducing enforcement of policies. The relative success of policy measures (such as the auctioning of state assets and the reestablishment of a legal system) in the Czech Republic as compared with Russia resulted from the heritage of informal norms that made for the relatively harmonious establishment of the new rules.

In addition, we know all too little about political economy. One of the shortcomings of research is a lack of attention to the polity and the problem of aggregating choices through the political system. We simply have no good models of polities in Third World, transition, or other economies. The interface between economics and politics is still in a primitive state in our theories, but its development is essential if we are to implement policies consistent with intentions.

Let me conclude by talking about time. If one accepts the crude schematic outline of the process of change set forth above, it is clear that change is an ongoing, continuous affair, and that our institutional prescriptions typically reflect learning from past experience. But there is no guarantee that past experiences are going to equip us to solve new problems. Indeed, an historic dilemma of fundamental importance has been the difficulties of shifting from a political economy based on personal exchange to one based on impersonal exchange. An equally wrenching change can be the movement from a "command" economy to a market economy. In both cases, the necessary institutional restructuring—both economic and political—has been a major obstacle to development, and it is still the major obstacle for Third World and transition economies. The difficulty comes from the fact that the belief system that has evolved as a result of the cumulative past experiences of the society has not equipped its members to confront and solve the problems. Path dependence, again, is a major factor.

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# II

# Institutional Change, Property Rights, and Corruption

# Underground Activity and Institutional Change: Productive, Protective, and Predatory Behavior in Transition Economies

*Edgar L. Feige*

"The more corrupt the state, the more numerous the laws."
Tacitus, *History,* v. III (c. 100 A.D.)

"Laws like cobwebs, entangle the weak, but are broken by the strong."
Ascribed to Solon (c. 575 B.C.)

## INSTITUTIONS AND ECONOMIC PERFORMANCE

North (1990) has persuasively argued that institutions matter insofar as they affect economic outcomes, but we still lack an explicit formulation of the critical relationship between institutional arrangements and economic performance. From the perspective of economic history, the institutional change that shapes the evolution of societies is seen as "overwhelmingly incremental" and highly "path dependent." How are we to reconcile this "glacial" view of institutional change with the radical transformations now under way in Central and Eastern Europe and in the New Independent States (NIS)? Are these revolutions less revolutionary and less discontinuous than they appear? What will ultimately determine their outcomes? North (1990:91) suggests that the outcomes of revolutionary changes will depend on "the ongoing tension between informal constraints and the new formal rules." Formal institutions have indeed changed radically in the transition economies, but informal institutions much less so. What then can we learn from a closer examination of the informal conventions, particularly when these include norms of noncompliance with the formal rules?

Each of the chapters in this section contributes to our effort to obtain a more explicit formulation of the complex relationship between institutional arrangements and economic performance. Benham and Benham properly identify the centrality of property rights and transaction costs as key elements in the relationship between institutions and economic performance. Eggertson's generalization of the traditional theory of economic policy elaborates the theme that "institutions are of critical importance for economic performance because they affect both incentives and the cost of information." Polischuk's analysis reveals how transaction costs are increased during transitions by missing markets and how the institutional incentives that encourage acquisitive rent-seeking behaviors adversely affect economic outcomes. Verdery's ethnographic study alerts us to the complexity and "fuzziness" of property rights in practice. Leitzel's analysis of rule evasion highlights the importance of noncompliant behaviors for economic performance before and during the transition period.

These contributions help us identify some of the critical components of the institutional matrix that motivate behavior, the types of behaviors most likely to affect economic performance, and the complexity of the relationship linking the two. They provide us with valuable hints as to where we must look to discover just how institutions determine economic performance.

The historical laboratory of the transition economies has revealed that liberalization, stabilization, and privatization may be necessary but are by no means sufficient conditions for creating "market economies." Every market presupposes the existence of property rights to be traded. When these rights are established, supported, and enforced in a transparent, even-handed manner under the rule of law, the transaction costs of exchange are significantly reduced, and economic outcomes are likely to be improved. Many of the transition economies have yet to establish the rule of law, and suffer instead from the legacy of regimes of arbitrary discretion that encouraged noncompliant behavior as the informal norm.

If we are to understand why some transitions have been relatively rapid and successful while others have languished and suffered from huge adjustment costs, we must examine how each society has structured the relative incentives for productive, protective, and predatory behaviors. These incentive structures are unlikely to be transparent, particularly when there is a lack of coherence between formal and informal institutions. When formal and informal institutions clash, noncompliant behaviors proliferate, forming various underground economies. Many of the centrally planned economies suffered from fundamental inconsistencies between formal and informal institutions. Consequently, the transition process had to deal with a legacy of noncompliant behaviors involving protective and predatory activities. One of the great challenges for a successful transformation is determining how to restructure institutions and incentives so that resources are redirected toward productive outcomes.

## PRODUCTION, PROTECTION, AND PREDATION

Nations have traditionally allocated scarce resources to acquire, protect, and produce wealth. A nation's growth—its ability to produce new wealth—

will be determined by its technology, the quality and quantity of its total resource endowment, and the amounts of resources employed in the protection and redistribution of existing wealth. Those resources not devoted to protective and acquisitive activities can be allocated to the production of new wealth.

As the administrative mechanisms of central planning give way to market allocations, and state ownership is replaced by private property rights, economic behavior is guided by a radically altered system of incentives, sanctions, and opportunities. Given these new institutional rules, individuals and organizations must make strategic decisions about the allocation of their scarce resources among productive, protective, and predatory activities. We might conjecture that the most constructive form of institutional change is that which provides incentives to direct resources away from protective and acquisitive activities and toward productive ones.

Production costs reflect the costs of transforming inputs into outputs. Transactions costs are associated with the acquisition, protection, and transfer of property rights. The linkage between institutions and economic performance depends critically on the incentive structures that flow from property rights. Efficient institutions provide incentives to minimize the sum of production and transaction costs. When property rights are uncertain and insecure, difficult to measure and monitor, costly to enforce, and inconvenient to trade, transaction costs are high, and considerable resources must be employed for the protection and redistribution of wealth. Conversely, when institutions are successful at reducing these transaction costs, resources are freed to enhance economic performance.

Institutions generate and enforce rules of behavior and rules of procedure. Rules of behavior structure incentives and constraints on permissible activities; rules of procedure specify acceptable means for amending and modifying the existing rules. Institutional change can occur in either a prescribed or a proscribed manner. Prescribed institutional change is in accordance with a society's rules of procedure, whereas proscribed institutional change comes about when behavioral and procedural rules are broadly violated. Prescribed change is typically smooth and gradual, whereas proscribed change, resulting from noncompliance with existing rules, typically appears to be traumatic and radical.

Underground economies are characterized by noncompliant economic behaviors involving evasion, avoidance, circumvention, abuse, and/or corruption of the rules, as well as accompanying efforts to conceal these illicit behaviors from the view of public authorities. Noncompliance is responsible for many of the unintended consequences that often result from policy reforms. The effort to conceal underground activity systematically distorts conventional information systems and thereby complicates efforts to observe and monitor the consequences of policy reforms. These consequences and the way they are perceived thus depend in large measure on the extent to which individuals and organizations comply with the new rules. The choice to comply or not depends upon the relevant incentives and sanctions and is often conditioned by the institutional structure that prevailed in the pretransition period. Therefore, institutional change is likely to be path dependent.

When rules are circumvented by widespread noncompliance, economic performance is likely to be powerfully affected. Since institutional change is the defining feature of transition economies, any inquiry into the causes and ultimate consequences of the transition must include an analysis of the incentives and sanctions governing various types of underground economic activities. Indeed, the perception, nature, and consequences of noncompliant behaviors depend on the particular rules being violated. Any analysis of institutional change in the context of transitional economies must address the consequences of noncompliant behavior as manifest in different underground economies. These include the widely observed occurrences of bribery, corruption, organized crime, financial scams, tax evasion, property theft, smuggling, money laundering, and extortion.

## Formal and Informal Institutions

Institutions represent the rules that constrain human behaviors by affecting the expected payoffs for economic actors. But there are many types of institutions, spanning formal legal systems and informal customs and norms. Particularly in times of social transformation, the rules of different institutions may be discordant. Eggertsson (in this volume) points out that "the primary weakness of the economics of institutions is its limited understanding of the amalgam of formal and informal rules and their attendant enforcement mechanisms."

When the institutional amalgam is hierarchical, consistent, and complementary, we most easily discern the effective rules by studying their codification in formal institutions. Coherence between formal and informal norms simplifies the task of defining and enforcing acceptable behavior. Compliance with the existing institutional rules is the dominant behavior.

When formal and informal rules are inconsistent or in conflict, the effective rules germane to economic performance will depend on the extent to which individuals and organizations comply with the formal rules. Observation of widespread noncompliant behavior signals a formal system in distress. The study of noncompliant behaviors (underground activities) and the incentive structures that induce these behaviors provides a powerful diagnostic tool for identifying which informal institutions effectively motivate relevant economic outcomes. Leitzel (in this volume) points out that "while evasive behavior complicates the effort to analyze the impact of policies, it can promote reform" by attracting the attention of policymakers, who can then either increase enforcement or legitimate the noncompliant behavior through liberalization of the rules.

## Noncompliant Behaviors

Changing incentive structures affect the relative costs and benefits of complying with a newly evolving system of rules. Noncompliant behaviors—evasion, avoidance, circumvention, abuse, and/or corruption of institutional rules—comprise what can be termed underground economies. A variety of underground economies can be differentiated according to the types of rules violated by the noncompliant behaviors.

Noncompliant behaviors are often the source of the unintended consequences observed in the aftermath of policy reforms. Moreover, since such behaviors are subject to penalties, rule violators will attempt to conceal them from public view. Successful concealment distorts information and hinders our ability to perceive and interpret correctly the outcomes of policy reforms.

Radical institutional reform often creates a climate rife with noncompliant behaviors. The extent, nature, and consequences of underground economic activity will affect the impact of institutional change on economic outcomes. The study of noncompliance in transition economies is likely to yield the most revealing view of the effective prevailing incentive structure, of the critical strategic behaviors induced by that structure, and thus of the outcomes of policy changes.

## Institutional Economics and Underground Economics

The focus of the new institutional economics is on the consequences of institutions—the rules that structure and constrain economic activity—for economic outcomes. Underground economics is concerned with instances in which the rules are evaded, circumvented, and violated. It seeks to determine the conditions likely to foster rule violations, and to understand the various consequences of noncompliance with institutional rules. The greater is the expected net benefit from noncompliance, the higher is its expected incidence. Since rules differ, both the nature and consequences of rule violations will depend on the particular rules violated. Institutional economics and underground economics are therefore highly complementary. The former examines the rules of the game, the latter the strategic responses of individuals and organizations to those rules. Economic performance depends on both the nature of the rules and the extent of compliance with them.

There are, of course, as many noncompliant activities as there are rules to be violated. Feige (1990a) has shown that underground economies comprise similar types of noncompliant behaviors. For example, when fiscal rules are violated, tax evasion and benefit fraud behaviors are said to comprise the *unreported economy*. As suggested earlier, rule violators, mindful of penalties, will typically seek to conceal their behavior from public authorities. When income-producing activities are concealed, and thus cannot be appropriately included in national income accounts, accounting conventions are violated, creating an *unrecorded economy*. Corruption, extortion, financial fraud, smuggling, organized crime, and theft of state property are examples of *illegal economy* activities.

## Consequences of Noncompliance

There is a growing literature expressing concern about the prevalence of illegal activities and their corrosive effects. However, Leitzel (in this volume) reminds us that the consequences of various noncompliant behaviors depend critically on the nature of the rules being violated. The violation of "bad" rules, "those that prohibit voluntary exchanges—in the absence of negative third party effects," may actually have positive economic consequences. (Similar arguments can be found in Leff, 1964, and Huntington, 1968.) De Soto (1989) argues that noncompliant behaviors that circumvent onerous regulations in developing countries effectively reduce transaction costs and therefore should be encouraged and legitimated. Corruption can also be viewed as a means of circumventing bureaucratic obstacles with "speed money," and even organized crime has been cited as a means of providing enforcement of property rights when the state is weak and ineffectual.

The evasion, circumvention, and violation of "good" rules—those that prohibit and regulate coercive behaviors—are likely to make society worse off. In the parlance of institutional analysis, whenever noncompliance increases uncertainty and the costs of measuring and monitoring behavior, it raises transaction costs and is likely to have damaging social consequences. Indeed, the weight of the evidence appears to be shifting in the direction of uncovering the long-term damage that results from pervasive noncompliance, particularly in the form of corruption and organized crime (see Benham and Benham [in this volume] on the role of the Sicilian mafia). Bribery and corruption often encourage the bureaucracy simply to create additional artificial administrative hurdles in order to receive side payments for their removal. At the same time, organized crime and corruption are seen as a growing menace to new business establishments and as a major barrier discouraging foreign capital investments.

The extent of noncompliance is also an important factor when threshold effects dominate the dynamics of institutional change. Low levels of noncompliance with bad rules might provide a useful buffer against the negative effects of the bad rules, but widespread noncompliance can undermine the social fabric, thereby jeopardizing the fundamental principle of the rule of law.

There is now an ongoing debate concerning the consequences of various types of noncompliant behaviors (see Grossman, 1992; de Soto, 1989; Klitgaard, 1988; Leitzel et al., 1995; Trang, 1994; Alexeev, 1997; Lotspeich, 1995; Shelley, 1995; Tanzi, 1994; Anderson, 1995; Mauro, 1995). Analysis of noncompliance under the Soviet regime suggests that the circumvention of price and production controls contributed to a more efficient system and served to buffer some of the most costly consequences of allocation by administrative control. The buffer function may have extended the lifetime of the Soviet regime by ameliorating some of the costs of misallocation. But, as discussed below, the pervasiveness of noncompliance under the Soviet regime has had a pernicious effect on subsequent economic reforms.

## The Legacy of Noncompliance

If we are to understand the severe adjustment costs sustained during the transition process, particularly in the NIS, we must examine the institutional structure of the earlier Soviet regime and the legacy of noncompliant "second-economy" behaviors induced by its perverse incentive systems (Grossman, 1992). The Soviet Union's criminal code prohibited most of the private economic activities regarded as normal in Western market economies. Despite heavy penalties, however, noncompliance with the formal laws was the rule rather than the exception. Handleman (1995) describes the Soviet Union as the "world's most heavily policed state." Yet paradoxically, it functioned as an essentially lawless society.

Grossman (1992) has pointed out that if one were to attempt to characterize the conditions likely to "maximize the scope and size of a country's underground economy," one would effectively describe Soviet-type socialism. A shortage economy with state-controlled prices well below black market prices created significant incentives for internal arbitrage and speculation. Similar gaps between world prices of tradeables and controlled domestic prices encouraged international smuggling. The prevalence of amorphous property rights and lax controls over state assets made the theft of state assets a pervasive predatory activity. Low administrative salaries combined with powerful governmental authority created rent-generating opportunities for bribery and corruption to flourish. In short, the economic incentives to engage in economic crimes were substantial, but so were the penalties.

Fedbrugge (1989) describes how the formal legal system treated economic crimes. Economic activities regarded as normal in market economies not only were prohibited under Soviet law, but also carried heavy penalties. Private enterprise and commercial middleman activities carried a maximum penalty of 5 years in prison, while speculation drew a 7-year term. Bribery and theft of state property were punishable by 15 years' imprisonment and death. Despite this stiff menu of punishments, these activities were commonplace, and indeed virtually necessary to maintain minimum living standards.

In fact, economic crimes were broadly tolerated by the Soviet regime. They served to buffer the economy from the misallocation failures of the administrave system, and acted as a means of enforcing strict political control. Tacit permission to engage in economic crimes served as a means to reward the *nomenklatura* and its clients, while the arbitrary threat of enforcing the law provided a means to maintain strict control over political dissent.

Noncompliance with the rules was so pervasive that illegal activities comprised a vast underground economy known as the "second economy" (Grossman, 1977). Virtually every citizen was a de facto criminal by dint of engaging in one or more common economic crimes. Citizens were reinforced in the expectation that no punishment would be exacted if one complied with the strict codes for appropriate political behavior. These included informal conventions signaling the extent to which different levels of the political hierarchy could dip into the pot of forbidden economic riches. Permitting a pervasive underground economy served as a means of controlling political dissension, rewarding elites, and buffering the hardships imposed by the inefficiencies of central planning. The resulting regime of arbitrary discretion was the antithesis of the rule of law.

## The Rule of Law and the Regime of Arbitrary Discretion

Under the rule of law, conduct is governed by formal statutes and judicial agencies that offer and deliver access and equal protection to all citizens. Institutional control is exercised by the even-handed application of formal rules. The norm for behavior is compliance with the rules. When the rules are violated, a credible system of effective punishment of violators comes into play. Thus control is based on " the application of the law."[1]

Under the Soviet regime of arbitrary discretion, most common conduct was prohibited by formal law, but enforced capriciously at the discretion of those in authority. Access to the system's institutional rewards and protections was reserved for the privileged few, but even then remained uncertain and uncontrolled by law. The norm of behavior was noncompliance with the rules. Penalties were assessed only rarely, and then only at the discretion or whim of the privileged elite that held effective power. Control was based on infringement of the rules, and involved both the carrot and the stick. The carrot consisted of granting the *nomenklatura* use rights over scare resources, whereas the stick consisted of the threat to exact punishment for the commission of economic crimes.

## Implications of the Legacy of Noncompliance

The regime of arbitrary discretion was the legacy and operative institution

[1] In describing the prereform Hungarian system, Gabor (1989) distinguishes between "control based on the application of rules" and "control based on the infringement of rules."

that survived the collapse of communism. Polishchuk (in this volume) ascribes some of the lack of progress in Russian reforms to the "institutional void" characterized by "missing markets." But astride the "institutional vacuum" were the dominant informal rules that guided resource allocation in the second economy. Rent-seeking and rent-creating activities were pervasive.

In the transition period, policymakers hoped that "organic growth" would produce the political and economic institutions needed to support market activities, essentially leaving the market to create the market. But this policy of benign neglect failed to produce the desired rule of law. This was due not only to the lack of a broad constituency for building market-supporting institutions, but also to the inertia of the informal norms of noncompliance.

When reforms did occur, they often legitimated the system of noncompliance that was already in place. World Bank (1996) estimates of unofficial activities suggest that in a sample of Central and Eastern European countries, the underground economy increased from 18 to 22 percent between 1989 and 1994. For a sample of NIS countries, the underground economy appeared to grow from 12 to 37 percent during the same period. Increased noncompliance was associated with weakened political controls, higher tax rates, and incomplete liberalization.

Liberalization served to legitimate the pervasive black markets by legalizing behaviors associated with speculation and arbitrage. The freeing up of prices conferred marketable value on many of the inventories accumulated as illegitimate wealth stocks under the Soviet regime. The creation of internal and external ruble convertibility and the liberalization permitting the accumulation of cocirculating foreign currencies legitimated illegal stores of monetary wealth. Thus the reforms simply lent legitimacy to much of the behavior that had already existed in the pretransition period. In this sphere, the revolution was less than revolutionary and proved to be highly path dependent.

Privatization legitimated the personal appropriation of state property by placing previously amorphous property rights to state assets directly in the hands of private actors. Privatization created the opportunity for privileged elites with information and network advantages to convert limited de facto use and income rights into more valuable de jure alienable rights. Not only did privatization legitimize de facto property rights, but it offered a huge incentive to allocate resources to protective and acquisitive activities. The preference for predation over production was tied to the opportunity to capitalize long-term income streams by obtaining de jure alienation rights.

The uncertainty associated with tentative property rights also encourages appropriation of state property and discourages the type of productive investment that would normally be associated with longer economic horizons. The expected rewards from rent-seeking activities simply dwarf the expected returns from productive activities. Rent seeking will continue to dominate as long as there are valuable unassigned property rights in the public domain, still available for privatization.

The legacy of noncompliance inherited from the pretransition period was accompanied by a pervasive distrust of government. A history of policy reversals and arbitrary confiscations had destroyed the credibility of government pronouncements and policies. Thus, the informal norm of distrusting government policy militates against every effort to establish the formal rule of law. In the absence of effective state institutions that can protect and enforce newly created property rights, these rights will remain uncertain, and their exercise will involve high transaction costs.

In this effectively stateless environment, organized crime can provide a locus of authority for contract enforcement and the adjudication of contested property rights. Thus, organized crime performs a substitute enforcement service that reduces uncertainty, albeit at a high social cost. Unfortunately, the economies of scale that normally accrue to legitimate governmental institutions now accrue to the mafia. Those public officials who retain the bureaucratic power to assign remaining public-domain property rights will continue to exploit their authority, reinforcing the legacy of corruption.

Although tax evasion existed in the pretransition period, most taxes were collected implicitly—by paying labor less than the value of its marginal product and by limiting the consumption of goods and services. In market-oriented economies, resources are paid the value of their marginal product, and taxes are subsequently collected explicitly on resource earnings. When liberalization eliminated price controls for goods and factors, the implicit tax revenue collection mechanisms collapsed, and the state suffered a significant loss of revenue, which in turn bloated budget deficits. These deficits could be financed either by creating money or by borrowing from the public. Printing money to finance the deficit simply fueled inflation and compounded the disruptive effects of the transition. It eroded the fixed incomes of the working poor and pensioners, and disguised the relative price signals of the fledgling market economy with shocks to the general price level.

The legacy of distrust of government also precluded the government from financing its deficit with the sale of public debt. In desperation, the government embraced the same informal convention of nonpayment that had been adopted by large firms. Nonpayment by firms created interindustry arrears. When the government refused to make payments for wages and pensions, it effectively forced an unwilling public to accept government debt in the form of government expenditure arrears.

The final legacy of the prereform system was a highly skewed distribution of wealth and information. Although incomes were distributed quite equitably, differential access to state resources and selective opportunities for illegal wealth accumulation created a highly unequal distribution of de facto property rights. The opportunity to convert these de facto rights into de jure rights created a small but powerful constituency for selective privatization, but not necessarily one that would support generalized property rights.

Corruption is perhaps the most troubling legacy of the pretransition period, and it threatens the dynamic stability of the transition process. Corruption occurs at the juncture where public and private sectors meet. When public officials are granted authority to licence, prohibit, tax, or subsidize economic activities; allocate favorable exchange rates; enforce trade restrictions or price controls; and distribute valuable property rights and natural resource endowments—monopoly powers are created in the public domain. Thus, corruption, which involves noncompliance with the rules governing appropriate conduct in public office, is a form of government failure that occurs when public officials, acting as the agents of the state, exploit the state's monopoly powers for their personal advantage.

The extent of noncompliance will depend upon the size of the expected gains and penalties. According to Klitgaard (1988), these will be determined by the monopoly power to be exploited, the extent of discretion granted the agent(s) of the government, and the degree to which the agent is held accountable. However, the economic cost of corruption depends not only on its extent, but also on its nature. Shleifer and Vishny (1993) present an industrial organization model of corruption that shows that corruption is less costly when it is controlled by an effective cartel, like that of the Communist Party during the Soviet period. In this case, the payment of a bribe is sufficient to assure the predictable transfer of scarce property right(s) and the bribe price is kept in check. The most costly form of corruption occurs when independent monopolists vie for bribes. This model best describes the current situation in the New Independent States, where corruption is omnipresent, yet property right transfers remain uncertain and unpredictable even after the bribes are paid. With vast, highly prized property rights remaining in the public domain, controlled by independent monopolists whose actions are unconstrained by accountability and the rule of law, predation dominates over production with devastating economic consequences.

## Building a Constituency for the Rule of Law

The legacy of noncompliance with formal rules and the concomitant distrust of all public policy have resulted in great resistance to the necessary establishment of the rule of law to support and complement the still fragile property rights and market institutions of the transforming economies. The earliest privatization schemes proposed to transition governments attempted to build a powerful constituency for reform institutions by creating a massive class of private shareholders (Feige, 1990b, 1990c). It was hoped that the creation of a new egalitarian base of holders of residual property rights would produce a political lobby for protection of property rights and create political pressures to improve corporate governance structures. These structures, in turn, would maximize the value of the residual property rights themselves. In addition to these incentive effects, it was hoped that the equitable distribution of valued assets would serve as a safety net to cushion the inevitable decline in other government support programs.

Polishchuk (in this volume) argues that this program failed in its first goal, "to prevent the rapid growth of inequality and to compensate for the loss of private savings to inflation," while it is still unclear whether the program has helped build a constituency to protect property rights. In Russia, the scale of the privatization program was massive, creating a class of 50 million shareholders.[2] Nevertheless, the failure to include "anticarpetbagger" provisions to protect the residual property rights of the poorly informed public permitted wealth holdings to become even more highly skewed. Russian enterprise insiders now possess, on average, two-thirds of the mass privatization shares.

## SUMMARY

The stubborn legacy of informal pretransition norms and behaviors dominates the post-transition economies. Those pretransition economies whose formal and informal institutions were relatively coherent had less of a legacy of noncompliance to confound the transition adjustment. But those economies in which the formal rules were observed largely in their breach inherited a profound legacy of noncompliance and distrust of government. They are also characterized by acceptance of a wide range of protective and predatory behaviors that impose severe adjustment costs on the transformation process. In this important sense, institutions matter, institutional change is highly path dependent, and it is less revolutionary than may appear at first blush.

Institutions do affect economic performance, but it is not always obvious which institutional rules dominate. Where formal and informal institutions are coherent and consistent, the incentives produced by the formal rules will affect economic outcomes. Under these circumstances, the rule of law typically secures property rights, reduces uncertainty, and lowers transaction costs. In regimes of discretionary authority where formal institutions conflict with informal norms, noncompliance with the formal rules becomes pervasive, and underground economic activity is consequential for economic outcomes.

Many of the behaviors that violated the formal rules of pretransition soci-

[2]Nellis (1996) reports that by the end of 1994, the 15 transition countries of Central and Eastern European and the NIS had privatized more than 30,000 large and medium-sized firms. In Russia, 16,000 large and medium-sized firms and 75,000 small business had been privatized. However, an estimated 10,000 large and medium-sized firms are as yet not privatized.

eties have now become legitimated in the post-transition period. Legitimation has been accomplished by efforts to liberalize, privatize, and legalize. Incomplete liberalization—the maintenance of arbitrary gaps between buy and sell prices—produces incentives for rent-seeking and acquisitive behaviors. Incomplete privatization—the maintenance of valuable assets in the public domain with amorphous property rights—produces incentives for predation. Incomplete legalization—the maintenance of arbitrary discretion in place of the rule of law—sustains high levels of uncertainty and high transaction costs, and discourages the reallocation of resources to productive activities.

The formal rules in most of the former Soviet republics are still very far from being incentive compatible, and many aspects of the old system persist unchanged. Regulatory burdens and the number of regulatory agencies have ballooned, yet the legacy of noncompliance prevails, and independent monopolists willfully exploit property rights that remain in the public domain. The government's tax regime is confiscatory, organized crime extorts private taxes, and the wealth still open to rent-seeking is immense. In short, the incentive structure is such that protective and predatory behaviors continue to dominate productive behaviors, resulting in lost output and a growing disparity in wealth that threatens the fragile transition.

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# 1

# Property Rights in Transition Economies: A Commentary on What Economists Know

*Alexandra Benham and Lee Benham*

If Adam Smith were suddenly here today, what would impress him? The affluence of the developed world? Almost certainly. The progress in science and in medicine? Almost certainly. Advances in our understanding of the sources of economic growth or the transformation paths from state ownership to market economies? This is much more problematic. To reflect on the list of fundamental new insights we could present to the author of *The Wealth of Nations* is indeed sobering.

If compelled to argue the case that we have learned something important on this subject in the intervening two centuries, what concepts would we emphasize, and what evidence could we offer? We might choose property rights as a focus. Well-defined property rights are widely viewed as a source of improved economic performance.[1] They occupy a central place in discus-

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[1]The concept of property rights has been clearly articulated by Thráinn Eggertsson. Citing Alchian, Coase, Calabresi, and Demsetz, he writes (1990:33-35):

> We refer to the rights of individuals to use resources as *property rights*. A system of property rights is "a method of assigning to particular individuals the 'authority' to select,

sions concerning transformation in Central and Eastern Europe and the former Soviet Union. This general approach would not be new for Smith. Indeed, his students and admirers were involved in attempts at privatization in Russia in the early nineteenth century. We begin with a discussion of that early privatization approach. We then consider some theoretical insights of the twentieth century that may help us do better this time around.

Even before the publication of *The Wealth of Nations*, Smith's ideas were circulating in Russia, where they received support from those in high authority.[2] Russia's first Minister of Economics, N. S. Mordvinov, who served in the Ministry from 1810 to 1825, had studied in England and was unbounded in his enthusiasm for Smith. He described Smith as "one of the greatest geniuses" among those "benefiting mankind" and ranked him with Bacon and Newton (Alekseev, 1937:427).

Mordvinov envisioned splendid prospects if Smith's principles were implemented in Russia (Alexandrin, 1993:176):

> Russia is gifted by nature and is destined to become wealthy once the spirit of competition starts to burn among the people; when productive forces are joined together, when private gain will be employed for social leadership, and when the government's leaders with warmth in their hearts . . . realize that private and public poverty is caused only because all the roads to wealth are barred, that the free action of the people is chained and that there is an artificial distinction between the wealth of the government and that of the people.

To achieve this goal, Mordvinov proposed an extensive set of reforms. They included opening land ownership to merchants, citizens, and even state-owned serfs; reducing tariffs; building roads between cities; redesigning com-

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for specific goods, any use from an unprohibited class of uses. . . ." It is common to distinguish three categories of property rights: First, there are the rights to use an asset—user rights—which define the potential uses of an asset that are legitimate for an individual, including the right to transform physically or even destroy an asset. We should note that restrictions of rights that shrink the set of permissible uses will lower the economic value of an asset if highly valued uses are excluded. Second, there is the right to earn income from an asset and contract over the terms with other individuals. Third, there is the right to transfer permanently to another party ownership rights over an asset—that is, to alienate or sell an asset.

[2]In 1761 two Russian students, S. J. Desnitsky and I. A. Tretiakov, were sent from Moscow University to Glasgow University. Both studied there under Adam Smith and subsequently returned to Moscow. In 1768 Desnitsky was appointed to the Chair of Roman Law and Russian Jurisprudence at Moscow University, where he was a strong advocate for Smith's ideas. In 1772 Tretiakov lectured as a professor at Moscow University on "The Causes of Abundance," discussing a needle factory to illustrate the theory of specialization. In 1774 N. S. Mordvinov, later an admiral of the Russian fleet and Russia's first Minister of Economics, was sent to England to further his education. He, too, became a great advocate of Smith's work (see Alekseev, 1937:424-427).

mercial banks; denationalizing government-owned factories; redesigning the financial system; and reducing military expenditures.[3]

Mordvinov tried for many decades to implement market reform.[4] Writing in the last decade or so of his long life (1754-1845), he lamented (Alexandrin, 1993:178):

> There will come a year in which people will turn towards the measures here proposed, but the times will be covered with a black shroud and we will realize that the time for doing good deeds has passed by. . . . There will be sorrow about such a great loss, but the quarrels and recriminations will be in vain—that time which is lost will never be regained.

Today's list of proposed reforms—in Russia or in any transitional country—differs little from Mordvinov's. Privatization was a central concern then and remains so now. What do we have to say to Adam Smith?

There are two theoretical insights closely intertwined with the concept of property rights that would be new for Smith, and that lend some insight to our understanding of the transition process. We discuss these briefly and then consider some historical examples that demonstrate the conditional nature of our understanding. We then ask why we do not know more by examining the revealed preferences of the economics profession concerning emphasis and

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[3]In November 1801, Mordvinov proposed to the Council of State that property rights be reformed to allow all kinds of people to purchase land. His memorandum to Czar Alexander I, "Notes Regarding the Right of Acquiring Land," was subsequently ratified and became an ukase on the Czar's birthday, December 12, 1801. Mordvinov commented, "The law regarding the right to purchase property may be called the law of the true freedom of the people; the basic law of the entire Russian people; the great Russian writ, our Magna Carta." He argued that opening the land for purchase would increase the number of products planted, improve forestry, and lower prices (see Alexandrin, 1993:174).

[4]The enthusiasm in Russia for Adam Smith's ideas extended beyond the circles of academics and economic advisors. In Alexander Pushkin's great poem *Eugene Onegin*, the first chapter of which was published in 1825, the title character—a young aristocrat—is described in these terms:

> Homer, Theocritus disdaining,
> From Adam Smith he sought his training
> And was no mean economist;
> That is, he could present the gist
> Of how states prosper and stay healthy
> Without the benefit of gold. . . .
>
> I.7 (Pushkin, 1981:8)

This attitude did not persist. In 1829 a character of Pushkin's in *A Novel in Letters* wrote to a friend:

> . . . you have fallen behind your times, by a whole decade. Your grave metaphysical musings belong to the year 1818. At that time an austere code of behavior and political economy were in vogue. We made our appearance at balls without taking our swords off; we were ashamed to dance, and had no time to devote to the ladies. [But nowadays the] French quadrille has replaced Adam Smith; all flirt and make merry as best they can (Pushkin, 1983:60).

approach. Finally, we offer some comments on improving the supply and distribution of new knowledge concerning these issues.

## PROPERTY RIGHTS, TRANSACTION COSTS, AND SOME HISTORICAL EXAMPLES

Ronald Coase (1960) provided a fundamental insight into the role of the determinants of property rights. He showed that in a hypothetical world in which it is costless to measure and monitor goods, to ascertain ownership, and to transfer goods, initial ownership will have no effect on the efficient allocation of goods. In that world, no matter what the initial allocation, property rights will flow to their highest valued use. However, that world is not ours. Coase (1988:174) is clear that the world we live in is *not* a world with zero costs of measuring, monitoring, enforcing, ascertaining ownership, trading, and obtaining information. In our real world, transaction costs determine property rights, ownership, the extent of trade, specialization, and productivity.[5] If transaction costs decrease, property rights will be more clearly defined, more goods and services will be traded, the benefits of specialization will increase, and greater economic gains will be realized.

Improving the clarity of ownership is valuable in that it permits owners and potential owners to seek out more highly valued uses across a wider set of individuals and over a longer time horizon. For example, clarity of ownership allows the owners of assets to access capital markets by using those assets as collateral. Land reform that prevents the sale of land will eliminate land as collateral, greatly diminish the capital markets, and limit development. This argument for increasing the gains from trade by increasing clarity of ownership is the central economic argument for privatization, efficient court systems, stable rules, stable prices, low taxes, and the elimination of barriers to trade. Transaction costs are fundamental attributes of institutional innovation, and the entire character of the economic organization of a society will reflect these costs. Within any institutional structure, those organizations which have a comparative advantage in terms of transaction costs will tend to survive.

The second insight we wish to emphasize as a substantive conceptual advance is the Arrow (1963) impossibility theorem. This theorem proves that with two or more individuals and three or more alternatives, no social choice rule satisfying some minimal conditions of fairness can guarantee a transitive social ordering of the alternatives. This means that without some institutional

[5]Barzel (1989:2) says: “I define transaction costs as the costs associated with the transfer, capture, and protection of rights. If it is assumed that for any asset each of these costs is rising and that both the full protection and the full transfer of rights are prohibitively costly, then it follows that rights are never complete, because people will never find it worthwhile to gain the entire potential of ‘their’ assets.”

structure to restrict choices in all but trivial cases, disequilibrium will prevail. Any alternative can be defeated by some other alternative.

Constitutionally enforced property rights can be viewed in this context as ". . . an attempt to remove issues from the domain of politics so as to reduce the opportunities to create unstable social outcomes" (Ordeshook, 1993:216). This view implies that placing more property under the direct control of the state will lead to greater instability of the polity because coalitions will form to compete for property in the public domain.[6] This competition takes many forms. In systems with extensive state ownership of enterprises, controversies frequently arise concerning the amount and allocation of state subsidies. The budget deficits, capital market distortions, and inflation engendered by these subsidies add instability to the rights individuals hold over private property.

While the general principles emphasized in the work of Smith, Coase, and Arrow—low-cost trade, clear property rights, and credible constraints to limit instability—are all fundamentally important, the specific policy applications are often conditional on the circumstances. The following cases are chosen to illustrate two points. First, the general principles do provide great insight into organizational adaptation to specific circumstances. Second, although some choices may be invariant with respect to history, local conditions, the experience of the parties involved, ethnic configuration, and so on, others are not. This implies that a knowledge of history, of the paths previously taken, of the nature of the governance structure, and of the existing formal and informal enforcement mechanisms is necessary to understand the likely outcomes of alternative paths.

## Transaction Costs: The Old Believers and Other Self-Governing Groups

The case of the Old Believers in Russia can be used to illustrate the insights of Coase and Arrow. Coase shows that in a setting with sufficiently low transaction costs, the initial distribution of property rights need not determine subsequent efficiency. This implies that even where individuals' property rights are not protected by the state, those groups which are able to lower transaction costs sufficiently can contract around the lack of enforcement by the state. They may do this, for example, by renting assets from those who do have property rights, be they other private individuals or agents of the state. In this way the gains from trade are not limited by the particular configuration of property rights.

Successful groups must also overcome Arrow's voting paradox problem. If low-cost transactions are to be achieved and maintained, the rules of the game within the trading group cannot be subject to rapid or arbitrary change. Collective decisions must have some stability. This stability can be accom-

[6] See the discussion of this issue in Riker and Weimer (1995).

plished in a variety of ways: by limiting those who can participate in decision making; by constitutionally constraining the items that can be placed on the agenda; or by making the preference ordering homogeneous through selection, socialization, or education. Often this is accomplished in the context of a group that shares strong religious beliefs. The likelihood that such groups will succeed depends on the extent of traditions of cooperation and self-governance, internal homogeneity, knowledge concerning what has worked elsewhere, and impediments caused by the government or by extralegal groups (Benham and Keefer, 1991). Groups that effectively resolve these problems can be expected to do well economically.

A case in point is provided by the experience of Russia's Old Believers (Gerschenkron, 1970). The Old Believers arose as a religious group in the 1600s to resist the state's ecclesiastic reforms. They subsequently opposed the enormous costs associated with Peter the Great's modernization programs.[7] The Russian state began persecuting them in 1666 and continued discriminatory policies against them for almost 250 years. Initially, official state policy was extremely harsh: much of their property was confiscated, many of them were banished, and some were burned at the stake. Even during periods of less severe persecution, their rights were significantly restricted: on occasion they were assessed double taxes; they were prohibited from testifying in civil courts against members of the established church; they were excluded from holding local elective office; and they were forced to wear special conspicuous clothing, including, for women, hats bearing horns. Even in relatively good times, the state was not a reliable enforcer of contracts for them.

However, even under these circumstances, the Old Believers managed to be highly productive. In the eighteenth and nineteenth centuries, they became extremely successful economically, and they founded a number of merchant dynasties. Gerschenkron (1970:21) describes the contradictions thus: "The worshippers of religious immobility, the fanatical enemies of ecclesiastic reforms, the irrational adherents to letter and gesture appear as energetic modernizers in their very rational economic pursuits." How did this come about?

The external difficulties they confronted increased the desirability of cooperation within the group. Because exit from the group was costly and difficult, the relative costs of forging internal cooperation were reduced. Over time, the Old Believers came to emphasize cleanliness, honesty, reliability, frugality, industry, thrift, sobriety, and literacy. Since the state would not enforce their contracts, they learned to rely heavily on self-enforcing contracts. The bonds of mutual trust—derived from external pressures and from

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[7]Among his many changes, Peter the Great placed the church under the absolute authority of the state and even levied a tax on souls (Gerschenkron, 1970:26-27).

their religious faith—dramatically reduced their costs of obtaining reliable information, gaining access to capital, making credible commitments, and conducting trade generally.

All this gave them enormous flexibility in mobilizing resources. They were able to transact among themselves at very low cost, contracting across time and space at lower cost than others could. They contracted around impediments, state-imposed and otherwise. Members even borrowed funds from other members to buy their freedom from serf status. Their reputation for integrity and sobriety also made them attractive to outsiders as employees and as trading partners. They accumulated sufficient wealth to bribe state officials not to enforce the discriminatory laws. Through all these means, the Old Believers created great added value.

These results are consistent with the implications of Coase's argument. Formal state enforcement of property rights is not absolutely essential for a group to do well. If transaction costs are sufficiently low, even a group initially disadvantaged in the assignment and enforcement of property rights can still become highly productive. If extraordinary trust can be forged, if the voting paradox can be resolved, and if informal mechanisms of contract enforcement are sufficiently low in cost, extensive specialization and trade can still take place.

When are self-governing groups at the local and regional levels able—as the Old Believers were—to lower transaction costs and overall production costs for themselves? Within a country, the various ethnic, religious, and social groups are likely to vary widely in their ability to overcome the voting paradox, to define, enforce, and transact. There are many documented histories of groups—even relatively small homogeneous groups—that failed to cooperate although the prospective gains from cooperation were great.[8] This is not surprising theoretically. More surprising are the instances of success. The elements associated with such success have been systematically investigated in a number of studies. Ostrom (1990:180) has examined the design principles used by a variety of self-governing groups in diverse settings, ranging from Japanese mountain villages to Mojave groundwater basins, and considered their relationship to successful or unsuccessful performance. Putnam (1993) has investigated the differing levels of cooperative behavior within regions of Italy and their implications for political and economic performance.

One detailed study of groups' choices concerning rules of the game and their subsequent economic performance examined more than 120 irrigation systems in Nepal, some farmer-managed and some government agency-managed (Ostrom, 1994:19-24). The investigator devised a scale of institutional

[8]Libecap (1989) provides several case studies that contrast different levels of success achieved in mitigating losses from the common pool.

development based on monitoring and sanctioning rules.[9] While 75 percent of the farmer-managed systems scored high on this scale, only 29 percent of the agency-managed systems did so. The farmer-managed systems averaged 20 percent more crop yield than the agency-managed systems.

When such groups prosper themselves, does the process benefit the larger society? Isolated ethnic or religious groups with low transaction costs can provide lessons concerning gains from trade and can induce transaction-cost innovations through competitive pressures in the larger society—and successful societies will recognize that these innovations are to be encouraged. These isolated successes, however, do not necessarily lead to overall development. Russia as a whole benefited from the economic activities of the Old Believers, but, as Mordvinov lamented, development in Russian was greatly hindered because the formal and informal rules leading to low transaction costs were not imbedded in the larger society.

## Property Rights, Land Privatization, and the Mafia in Sicily

Privatizing the land has been a principal objective in almost all countries recently undergoing transformation. The historical experience of Sicily after the removal of feudal restrictions on land holding and the later privatization of church properties provides a cautionary tale, illustrating that a state-initiated program of privatization can have unanticipated and undesired consequences (Gambetta, 1993).

Feudalism was formally abolished in Sicily in 1812. A principal reform associated with its abolition was the removal of feudal restrictions that made land an inalienable commodity. For the first time, land was treated as a market commodity that could be traded. Between 1812 and 1860, the number of large landowners increased tenfold, from 2,000 to 20,000. Between 1860 and 1900, the number of hectares of land in private hands nearly tripled.

Land reform was accompanied by considerable strife, which persisted until after the conclusion of World War II. A major source of conflict throughout Italy was the hostility between church and state. Early Italian liberals were strongly anticlerical, and after the unification of Italy in 1861, the church's estates and property were expropriated, and much was auctioned off to private purchasers. Pope Pius IX countered by rejecting the legitimacy of the newly formed Italian state. In 1877 he ruled that no Catholic could run or vote in national elections. This policy reduced the legitimacy of the Italian state

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[9]A system received 1 point for meeting each of the following criteria: (1) information was kept about water withdrawal rights, (2) information was kept about levels of water appropriation, (3) information was kept about farmers' individual contributions to maintenance, (4) information was kept about levels of rule conformance to the system's rules, (5) sanctions were included that varied from low to high, and (6) water withdrawals could be forfeited for some infractions.

and increased the reliance on private enforcement of contracts. Gambetta (1993:80) describes the process that began at that time:

> At the same time [as the land reform], protection—the demand for which was dramatically increased by the abolition of feudalism and the widespread introduction of private property rights—did not undergo the customary process of centralization to become the monopoly of the state. Unlike land, protection, according to standard political theory, is not supposed to find its way onto the markets; but in southern Italy it did. The skills developed in the cities by the self-policing of trade fraternities and in the country by private guards, once released from baronial control, found new applications.[10]

Although the Mafia is associated with Sicily in general, in fact the Mafia's level of power and control differs significantly across regions (Gambetta, 1993:82, map). Eastern Sicily has been little influenced by the Mafia, while western Sicily has been severely affected by it. Gambetta suggests a reason for this striking regional difference. On the eastern side of Sicily, the ruling classes were relatively cohesive and included few absentee owners. In the words of a nineteenth-century observer, "The upper class [in the east] has managed to preserve the monopoly over force and has so far prevented villains rising from the lower classes from sharing it" (Gambetta, 1993:83). In those regions, the state managed to implement enforcement with relative ease. On the other hand, in much of western Sicily the local elites—particularly new landowners—were divided by conflict, and the state was less successful in establishing its authority. Where effective enforcement of property rights by the state was absent, landholders often turned to private contract enforcers to resolve their differences. As a result, the private protection industry flourished. The Italian state attempted to restrict the activities of this industry, but the protection groups made various adjustments to sustain a comparative advantage in many forms of trade.

The series of land reforms in nineteenth-century Italy thus had significant unintended consequences.[11] The reforms that ended feudalism, confiscated church holdings, and allowed land to be bought and sold also increased the opportunity for private suppliers of protection—that is, private contract enforcement—to become independent and well established. Subsequently, as those suppliers established their credibility, that credibility itself became an asset for expanding into other activities, and the industry became self-sustaining.

[10]See also North and Thomas (1973).

[11]Another example of a "market" reform that created downstream liabilities is the case of market socialism. Has market socialism on net created more assets or more liabilities? Åslund (1994) comments: "Many are inclined to say it was an asset, but that may not be true. In Poland, for example, workers' councils are very strong within enterprises, because previously it seemed that only market socialism reform was feasible. Now the workers' councils tend to be factors of resistance in the transition to markets." These reforms—perhaps all reforms—create property rights in governance structures that limit other options downstream.

The maintenance of the Mafia's credibility and its power to resolve disputes has not come without enormous costs. The Mafia has been deeply involved in manipulating the political process, including murdering judges and collaborating with politicians at the highest level. In 1992, the rate of Mafia-related murders per capita in the south of Italy was 48 times as high as the rate in the north (Leonardi, 1995). The Mafia continues to deform normal business practice, raise transaction costs, and reduce productivity. This is particularly the case in those activities where entry can be effectively controlled—such as the fish market in Palermo—or where resources are allocated through the political process. The similarity between conditions in nineteenth-century Sicily and conditions in late twentieth-century Russia is particularly striking.

The Mafia prospered by excluding other methods of contract enforcement and by taxing transactions. The evolution toward the Mafia type of specialized private enforcement industry is not inevitable. Nonetheless, in the Italian case, where the ex ante gains from privatization of land appeared to be so obvious, the experience is sobering.[12] Privatization led to a new, sustained, and undesirable enforcement industry. This example is offered not to argue that privatization is bad (for very substantial costs are associated with state-owned property), or that incremental change is preferable to a big bang strategy, but to illustrate that many conditions are necessary for successful privatization. Privatization with and without effective state enforcement will proceed along very different paths. These paths need further examination by economists.

## Credibility and the Glorious Revolution of 1688

When self-governing groups achieve cooperation to overcome common-pool problems, the groups involved clearly benefit. The larger society often benefits to some extent as well, but benefits at the national level also depend on the survival and expansion of these patterns of behavior and credibility. To this end, constitutional arrangements at the national level have frequently been crucial in facilitating cooperation and reducing transaction costs.

Microeconomists and macroeconomists, theorists and empiricists all agree: the economic rules of the game must be credible if the transition to a market economy is to succeed.[13] A successful economy with a high degree of

[12]"In deliberating on economy-wide economic reforms, economists should remind themselves that their theories are incomplete metaphors, rather than precise instruction manuals laying out the path to progress in a clear and definite way" (Murrell, 1992:36).

[13]Kornai (1993:325) discusses credibility in the context of financial discipline: "The outcome depends greatly on whether the public, particularly the economists' profession, can extract binding pledges from the government and make sure it keeps them. Whatever happens, the test of the credibility of the government's promises about financial discipline will be the practice it pursues in the years to come."

specialization requires low costs of impersonal exchange across space and time. If this is to be achieved, a fundamental determinant of these costs—the state's commitment not to interfere arbitrarily in the functioning of the economy—must be credible.

When macroeconomic policy rules lack credibility, the resulting uncertainties about taxes, deficits, and inflation raise the costs of entering and enforcing contracts. Individuals respond on many margins, such as lending to the government only for short periods of time at high rates of interest, or investing and trading primarily in personalized contexts within the informal sector. During hyperinflation, time horizons shrink dramatically, and trade may be reduced to barter.

At the microeconomic level, a lack of credible rules concerning contract enforcement, property rights, or regulations raises the costs of exchange.[14] Without low-cost impersonal exchange, the gains from specialization are lost.[15] At the extreme, trade will be limited to spot-market exchange and personalized trade with self-enforcing mechanisms. As official third-party sources of contract enforcement become less certain, the comparative advantage of organizations such as the Mafia increases (Gambetta, 1993).

The significance of credibility in contract enforcement can be illustrated by the fall in interest rates following the Glorious Revolution of 1688 in England (North and Weingast, 1989). During the 10 years after the revolution, the interest rate the English Crown had to pay to obtain long-term loans fell from 14 to 7 percent. Over the next four decades, this rate continued to fall by more than half, to 3 percent. This was an extraordinary development that had profound implications for the subsequent prosperity of England.

How did this happen? North and Weingast argue that the revolution credibly constrained the ability of the Crown to manipulate the rules to the advantage of itself and its favored constituents. Prior to the revolution, the Crown had repeatedly reneged on previously agreed-upon terms. It had sold grants of monopoly that expropriated the value of existing investments and reduced the expected returns on all investments. Titles had been sold with promises of a fixed maximum number of sales, promises that were soon broken. Assets stored in the Tower of London for safety had been seized by the Crown. The Crown had paid judges' salaries and openly fired those who disagreed with it. All executive,

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[14]For a discussion of the role of political authority in originating property rights, see Riker and Sened (1991).

[15]North and Weingast (1989:831) make the following observation: "We are convinced from the widespread contemporary Third World and historical evidence that *one* necessary condition for the creation of modern economies dependent on specialization and division of labor (and hence impersonal exchange) is the ability to engage in secure contracting across time and space. That entails low transaction costs per exchange."

judicial, and legislative powers had been combined in the Crown, and few external checks existed.

The revolution changed the rules of the game. Restrictions on monopoly were enforced, all cases involving property were tried at common law, the Crown's control over the judiciary was eliminated (judges served subject to good behavior instead of at the King's pleasure), modifications in land tenure favored private rights and markets, and new political rights protected citizens against arbitrary violations of their economic rights. The dethroning of Charles I and James II provided visible precedents for retribution against irresponsible behavior by the Crown. The Crown could no longer legislate unilaterally or bypass Parliament. In short, the Crown was constrained.

Parliament also agreed to put the government on a sound financial footing. After these changes were instituted, people were more willing to trade over longer time spans, private long-term investments became more attractive, and interest rates fell. The lowered rates made clear the benefits of the new institutional arrangements to all parties, thereby helping to win permanent support for the new system.[16]

In many countries today, as in seventeenth-century England, private property is subject to excessive political influence and control. A study by Torstensson (1994) shows a strong negative relationship between rates of growth and an index of risk of arbitrary governmental seizure of private property. Boycko et al. (1995), as well as others, have argued that depoliticization is the major property rights issue for economies in transition: "When firms are subject to political influence, they cater to politicians by producing goods that consumers do not want, employing too many people, delivering output below cost to buyers favored by politicians and engaging in other grossly inefficient practices" (Boycko et al., 1995:11). In Russia, VAZ—the state-owned producer of Lada cars—was able to develop a privatization program that directly served the bureaucrat-managers' interest. The total value of the firm as reflected by share price after "privatization" was $45 million. This was 2.3

[16]In one of the best empirical studies on credibility, Levy and Spiller (1996) examine regulatory structures and performance in the telecommunications industry in a variety of countries: Jamaica, the United Kingdom, Chile, Argentina, and the Philippines. The telecommunications industry requires highly specific long-term investments that can easily be expropriated through changes in regulatory policy. Levy and Spiller argue (1996:1): "The credibility and effectiveness of a regulatory framework, and so its ability to encourage private investment and support efficiency in the production and use of services, vary with a country's political and social institutions. Performance can be satisfactory under a wide range of regulatory procedures, so long as three complementary mechanisms are in place to restrain arbitrary administrative action: substantive restraints on discretionary actions by the regulator, formal or informal restraints on changing the regulatory system, and institutions to enforce the restraints." Credibility often requires a strong element of precommitment. However, such precommitment reduces the flexibility to respond to changes in the environment. The appropriate balance between these conflicting requirements will vary with the political climate.

percent of what Fiat had allegedly offered the Russian government previously for the firm.[17]

Systematic information concerning state-owned enterprises and characteristics of the environment that lead to different levels of performance and reform has been assembled in a World Bank (1995) study, *Bureaucrats in Business*. The study examines state-owned enterprises in 12 countries and finds the losses generated by this type of enterprise to be staggering. In India, the transfers to state-owned enterprises are over five times the central government's education budget. The World Bank study also examines reform efforts in these countries and the conditions under which these reforms are likely to succeed—when reform appears to be desirable, feasible, and credible. A remarkable feature of this study is that it appears to be the first large-scale, international empirical study of state-owned enterprises after more than a century and a half of heated debate about the merits of state ownership and socialism.

## Discussion

The previous examples illustrate several points. First, even where official policy is hostile toward property rights and contract enforcement, a group with sufficiently low transaction costs may still prosper. Some systematic empirical studies illuminate the specific conditions under which such cooperation is more likely: local conditions, group homogeneity, incentives, and governance procedures affect the likelihood that the high transaction costs associated with common-pool problems can be overcome. Defection is not surprising, but not inevitable. Success at the national level involves in part learning from these islands of cooperation and efficiency, or at least not suppressing them. Second, privatization efforts can produce undesirable consequences, such as a high-cost system of contract enforcement with significant spillover consequences for the polity. This does not argue against privatization per se; rather it emphasizes that serious and systematic attention should be paid to historical privatization experience. Finally, political control over assets frequently increases transaction costs, induces inflation, diminishes time and trade horizons, and reduces asset value.[18]

The preceding discussion has illustrated how certain paths in certain cir-

[17] As mentioned earlier, Riker and Weimer (1995) hypothesize that countries with more economic resources under direct political control will show higher degrees of political instability and hence shorter horizons, greater transaction costs, and lower productivity. Although this hypothesis was not systematically examined in these studies, the results are strongly suggestive. Extending the argument, economic rent seeking for resources in the public domain is likely to have spillover consequences for private assets. Consequently, windfalls in the public domain are likely to lead to higher transaction costs in the private sector. Thus windfalls to the government may reduce productivity.

[18] For discussion of a political equilibrium that impoverished Iceland for a thousand years, see Eggertsson (1994a).

cumstances have played out, but the question is how much systematic information economists possess on these issues. The ideas that dominate the field of economics influence the terms of debate and are often invoked by those who are structuring rules to implement policy. Our reading of the economics literature—which we view as indicating the revealed preferences of economists about which ideas are important—suggests that many issues at the core of the new institutional economics, such as transaction costs, credibility, and rules of the game, receive lip service, but scant systematic attention. We provide some information concerning this issue in the next section.

## ECONOMISTS' REVEALED PREFERENCES IN THE LITERATURE ON TRANSITION

Within the literature concerning transition, reform, and property rights in Central and Eastern Europe and the former Soviet Union, manuscripts are being published more rapidly than any individual can read them. From sampling a few hundred of the thousands of published studies in this area, we gained certain impressions. Much of the work on reform appears to cluster in distinct islands of thought, leaving substantial gaps unfilled. Macroeconomic performance, privatization schemes, and "shock therapy" versus gradual reform have received much attention. These issues are indisputably important. But other significant issues have received little attention. When alternatives or tradeoffs are discussed, it is usually in the loosest of terms. There is little discussion of historical context considered at any level of generality. Although most economists agree that institutional reform is fundamental to successful transformation, little systematic attention has been given to many of the core elements of institutions: path dependence, transaction costs, incentives, measurement and monitoring, credible commitments, corruption, and local and regional government.[19]

To explore more systematically the allocation of resources within the economics profession, we investigated the frequency with which published works in economics include various terms and concepts. This method provides a proxy, albeit a rough one, for measuring the attention given to different concepts. It reflects the choices made by individual economists concerning their allocation of effort to specific research topics, as well as the preferences of journal editors and reviewers. The exercise obviously measures the average rather than the marginal effort.[20] The average effort, however, indicates the ideas and approaches that are widely diffused through the profession. Broadly based efforts are particularly important for any research program that requires the systematic efforts of many investigators. One or even a few

[19] A powerful critique along similar lines is given by Murrell (1995).

[20] This approach does not single out path-breaking papers.

brilliant papers will not provide the systematic body of knowledge needed to document patterns of institutional constraints and institutional change.

To measure the distribution of concepts, we conducted a computerized search through the titles and abstracts of the recent economics literature in English, using the bibliographic database EconLit.[21] For selected subsets of this literature, we searched all titles and abstracts for mention of selected key words or groups of words. Our rationale was that if a concept is a central part of a study, it most likely will appear in the title, which is the author's statement of the issues of concern, or in the abstract, which summarizes the author's key arguments. Concepts important to authors and editors will obtain a large market share here; concepts considered unimportant will not. For each term, we counted the number of documents in which it appeared.

Various categories of concepts were included: a set of basic terms such as *micro*, *macro*, *labor*, and *capital*; concepts central to the new institutional economics, such as *property rights, path dependence, credibility, transaction costs*, and *rules of the game*; terms often mentioned in the work on transition, such as *privatization* and *stabilization*; and terms associated with research inquiry, such as *model*, *hypothesis, data,* and *test*.

We analyzed the frequency of terms for three distinct subsets of the economics literature (see Annex 1-1 for a detailed tabulation of the results): (1) all EconLit documents published January 1989-September 1995, (2) the subset of these documents dealing with transition and reform in Central and Eastern Europe and the former Soviet Union, and (3) the subset of these documents whose authors recently received tenure in high-ranking American economics departments.[22] The general set of all economics documents pro-

[21]EconLit, produced by the American Economics Association, is a comprehensive indexed bibliography of world economic literature published in the English language. It covers over 400 major journals, plus books, working papers, articles in collective volumes, dissertations, and book reviews. To date it includes information on more than 300,000 documents.

[22]The general set of economics literature we examined consists of all documents in EconLit published January 1989-September 1995 (N = 132,005).

The transition set (N = 2,564) consists of all documents in the general set that (1) refer—in title, abstract, or geographic descriptor—to Central or Eastern Europe or the former Soviet Union, or to a specific country in that region, *and also* (2) mention—in title, abstract, or subject descriptor—*reform*, *transition*, *transformation*, *post-communist*, or *post-socialist*. We believe the result is a reasonable representation of the body of economics literature in English on issues of transformation in Central and Eastern Europe and the former Soviet Union.

We created the recently tenured set (N = 949) by asking 20 high-ranking American economics departments for the names of all economists promoted to tenure during or after the academic year 1988-1989. Of these, 13 departments replied in time for this analysis: Brown, Columbia, Cornell, Harvard, Minnesota, Pennsylvania, Princeton, Rochester, Stanford, UC Berkeley, UCLA, Wisconsin, and Yale. They reported a total of 41 such promotions between September 1988 and February 1996. The publications of these 41 individuals between January 1989 and September 1995 constitute the recently tenured set.

vides a benchmark against which to compare the emphases and approaches displayed in the literature on transition. The publications of recently tenured faculty indicate the choices made by economists operating under the most competitive pressure and scrutiny.

In the general economics literature, many concepts emphasized in the new institutional economics show up rarely (see Figure 1-1). *Property rights* appears in the title or abstract in only 0.4 percent of the documents, *governance* in 0.3 percent, *institutional change* in 0.1 percent, *transaction costs* in 0.4 percent, and *new institutional economics* in 0.1 percent.

In the transition set, the terms that appear frequently are not surprising: *market*, *privatization*, *macro*, and *monetary* are among the ten most common terms. However, many terms central to the new institutional economics appear either rarely or not at all. *Transaction costs*, *corruption*, *criminal*, *civil service*, and *path dependence* each appear in 5 or fewer documents (out of 2,564). *Opportunity cost*, *bribery*, *organized crime*, *contract enforcement*, *rules of the game*, and *social capital* do not appear at all.[23]

The set of publications by recently tenured economists in high-ranking departments should be congruent with the areas and approaches currently enjoying high recognition and reward in the economics profession. Although concepts of the new institutional economics receive more frequent mention here, most appear in 1 percent or fewer of the documents. This highly recognized and rewarded body of literature also includes very little work on transition and reform in Central and Eastern Europe and the former Soviet Union. Among these 949 documents, only two fall within the transition set, and these appear to be versions of the same working paper.

Overall, the market share of the new institutional economics concepts in the economics literature is in the 1 percent range. The procedures used here may understate the absolute level of interest in these topics among economists, but we have no reason to believe the relative ranking is skewed. There is little ambiguity about the market share these concepts receive in economists' writings, whether in the overall literature published in English, in the literature on transition, or in the publications of recently tenured faculty in highly ranked economics departments.

We also examined some questions concerning methods of investigation in the economics literature. In many disciplines, studies typically present a theoretical issue, model, or hypothesis for investigation. In work that is not purely theoretical, there is then some discussion of phenomena relevant to this issue—data, case studies, historical examples, and so on. Comparisons or

[23]Some terms related to concepts in the new institutional economics—*privatization*, *liberalization*, and *incentive*—do occur with some frequency in the literature on transition. On the basis of our reading of this literature, these concepts are seldom used to address issues central to the new institutional economics. However, we have no systematic evidence on this point.

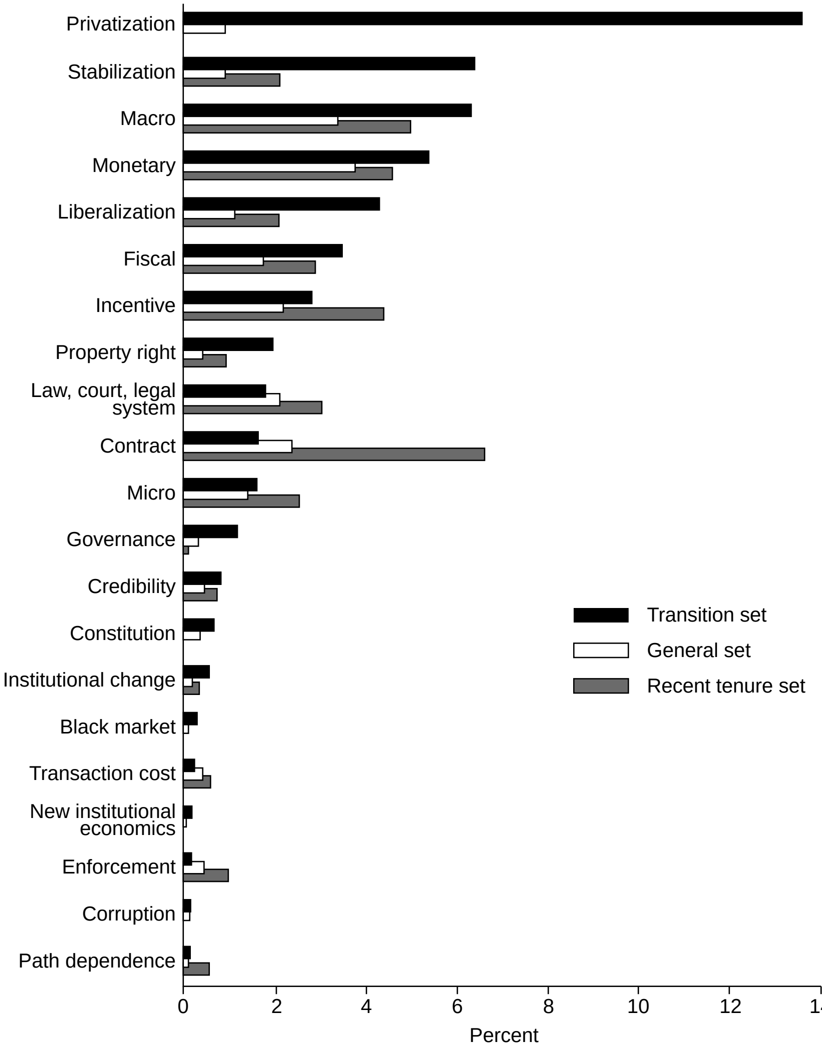


FIGURE 1-1 Works in economics that mention various subject terms in title or abstract (in percent). SOURCE: Data from EconLit database, January 1989–September 1995.

measures or estimates are made. There is some assessment of whether the results are consistent or inconsistent with the original hypothesis. To what extent is this approach observed in the economics literature?

To investigate this question, we grouped terms referring to (1) theories, models, or hypotheses; (2) empirical observation, broadly defined; (3) testing;

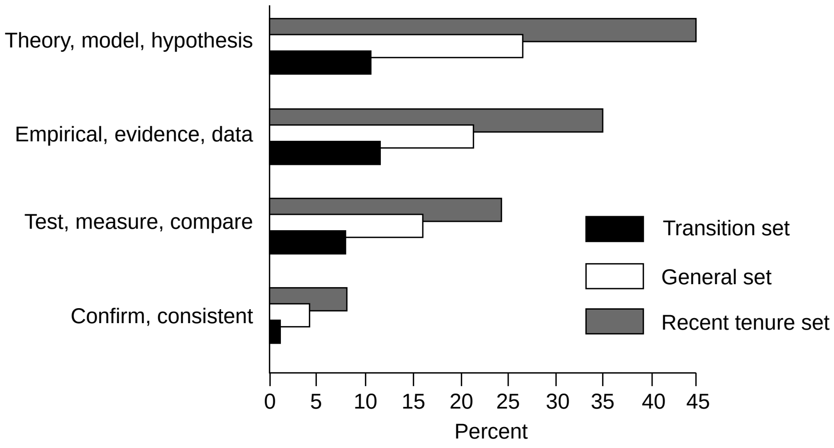


FIGURE 1-2 Works in economics that mention various methodological terms in title or abstract (in percent). SOURCE: Data from EconLit database, January 1989–September 1995.

and (4) evaluation of findings.[24] Figure 1-2 shows the frequencies with which these categories of terms appear in the three bodies of literature. The highest frequencies occur among the publications of recently tenured economists and the lowest in the transition literature. The degree of underrepresentation in the latter as compared with the other two bodies of literature is striking. There are many reasons why the standard approach of testing theory with evidence has been difficult in the transition literature, but these numbers are not reassuring. It is also noteworthy that among the 2,564 documents in the transition set, only 22 include terms from each of the three categories referring to theory, empirical observation, and testing; none include terms from all four categories.

There do exist outstanding examples of comparative studies with long-term perspectives that collect the relevant institutional detail and link institutions with

[24]Various key terms were grouped to create these broad summary categories. To reflect any concern with theory, one category counts any of the following terms: *theory*, *theories*, *theoretical*, *model*, *models*, *hypothesis*, and *hypotheses*. A document scores a hit if it contains any term from this list in its title or abstract. To count any consideration of data, a second category contains these terms: *data*, *evidence*, *empirical*, *empirically*, *history*, *histories*, *historical*, *observation*, *observations*, *case study*, *case studies*, *sample*, and *samples*. To indicate testing or comparison of ideas, a third category includes the terms *test*, *measure*, *compare*, and *estimate* (it also counts their plurals, past tenses, and gerunds). A fourth category reflects some assessment of the results with respect to the original hypothesis: *consistent*, *inconsistent*, *confirm*, *reject* (and plurals, past tenses, and gerunds of the verbs).

property rights and performance. Excellent examples include the work of Ostrom (1990) and her colleagues on common-pool problems, a new volume edited by Weimer (1997) on the political economy of property rights, and the previously discussed World Bank (1995) study of state-owned enterprises in 12 countries. An elegant survey of the new institutional literature is provided by Eggertsson (1994b). A good overview of the state of the literature on transition is given by the World Bank (1996). It is noteworthy that most studies of this type were undertaken outside departments of economics.

## CONCLUSIONS

A conversation with Adam Smith today on the issues just raised would not be particularly comfortable. When told of the current number of economists in the world, he might reasonably ask, "What have they been doing?" Our rather lame response is that we have done some things and that we can do better by focusing on improvements in incentives and trade for ideas.

Our own basic perspective is that successful reform will depend on local specialized knowledge and general technical skills, plus the aggregated knowledge of past experience in many locales. The inhabitants of an area have a comparative advantage in knowing about and dealing with the idiosyncratic features of their locale; however, they may lack the technical expertise of outside specialists. Also, the locals often do not know how reform experiments have played out elsewhere. There are obvious gains to be realized here from trade.

These considerations suggest the need to improve the marketplace for reform proposals. Economists emphasize the benefits of specialization. But for these gains to be realized, trade must take place. We believe there are gains to be made from specialization in terms of local knowledge and technical skills, but a coordinating mechanism—a counterpart to the market—is needed to aggregate this information effectively. Well-functioning markets depend on information that reflects the opportunity costs of the decisions made. The marketplace for reform proposals on Central and Eastern Europe and the former Soviet Union is underdeveloped along these dimensions. In their own scholarly work, economists often neglect to trade ideas and information beyond their own specialties.

Why does this state of affairs exist? One reason is that the academic reward system strongly emphasizes the quantity of publications produced. The 41 economists recently tenured at major economics departments each produced on average 23 publications and working papers in less than 7 years—one every 3.5 months. Empirical work, particularly that involving data collection, typically takes longer than papers that are purely theoretical. In addition, the rewards for doing collaborative work are diminished by the difficulty of appropriately crediting the various authors for their individual contributions.

The major economics journals rarely publish a discovery of significant facts without theoretical or technical accompaniment, although studies of this type appear frequently in the natural sciences. Finally, in the economics profession there is more consensus concerning the ranking of theoretical than empirical work; that consensus increases the emphasis on this field as a criterion for hiring and promoting. Thus for academic economists, the types of research recommended here go relatively unrewarded on virtually every margin. It is not surprising that a disproportionate share of the salient work of this type is being done outside of economics departments, and outside of academic settings.

These problems do not pertain solely to academic economists. As a referee has pointed out, and consistent with our experience, local experts in transitional economies often seem obsessed with their own uniqueness and pay little attention to the body of experience acquired elsewhere. The local experts' incentives to collaborate on long-term comparative studies are often very weak.

One key here is providing incentives for individuals and groups to collect and disseminate information about the performance and outcomes of different reforms.[25] At present, the costs of gathering local policy information on a timely basis are considerable. The substantial efforts required to collect and aggregate such information have implications for the efficiency with which reform proposals can be assembled, assessed, and communicated.[26] In contrast with chess, there is much ignorance about the games that have been played previously. Old mistakes are likely to be repeated.

Some policies have failed many times in many contexts. Why try them yet again? Some policies have succeeded in a variety of settings. These data should at least be known. Access to reliable information concerning reform experience elsewhere is important. Local experts can take this information, consider their own conditions and constraints, and try to predict what will work better or worse locally.

Klitgaard (1995a:143-145) suggests that economists approach the transformation of economies and nations in the manner of soil scientists. We must carefully study the local conditions. We must discover the specific qualities of the local soil. We need to consider the wisdom accumulated from experience concerning which plants grow well in which conditions. For some questions, local conditions may not matter. But the ultimate goal is to produce full flowering and a rich harvest in the soil at hand.

Improved trade in reform ideas would improve reform performance. It

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[25]Klitgaard (1991, 1995b) has written eloquently on the structuring of incentives for both local practitioners and outside actors.

[26]Without the World Bank newsletter *Transition*, the costs of gathering information for this study would have been substantially higher.

would also provide examples to inspire hope. An expert on the Glorious Revolution of 1688 has commented (Jones, 1972:6): "None of its architects could have predicted its effectiveness in securing the liberties, religion, property and independence of the nation after so many previous attempts had failed." They could not know, but we can.

## ANNEX 1-1

For each term listed, Annex Table 1-1 shows the number of documents in the transition set and in the general set in which it is mentioned in title or abstract. (These sets of documents are described in footnote 22.) Terms are arranged by descending frequency of appearance in the transition literature.

Note that some of the terms are composite groups formed from several related concepts. In these cases, a positive hit is counted if *any* term in the group is mentioned. For example, *consequence*/*implication* is counted as being mentioned if either *consequence* or *implication* is mentioned. In general, applicable common variants (e.g., plurals and gerunds) of the terms shown are also counted as positive hits. In some cases, searches were conducted on root words that include several variants; for example *brib** picks up *bribe*, *bribes*, *bribery*, *bribing*, and so forth. For clearer communication of the ideas, terms in the text are indicated in a fully spelled-out variant rather than in truncated form.

ANNEX TABLE 1-1 Number of Works in Economics That Mention Various Terms in Title or Abstract

| Term | Transition Set *(N = 2,564)* | General Set *(N = 132,005)* |
|---|---|---|
| *Market* | 663 | 15,710 |
| *Policy* or *Policies* | 545 | 18,540 |
| *Privatiz** or *Privatis** | 350 | 1,232 |
| *Theory, Model, Hypothesis* (+pl) | 266 | 34,819 |
| *Test, Measure, Compare, Estimate* (+v) | 189 | 21,140 |
| *Consequence, Implication* (+pl) | 179 | 8,087 |
| *Empirical, Evidence, Data, Case Study, Sample* (+v, pl) | 169 | 24,324 |
| *Macro** | 163 | 4,547 |
| *Labor* | 161 | 7,081 |
| *Monetary* | 138 | 5,040 |
| *History, Histories, Historical* | 115 | 4,540 |
| *Capital* | 113 | 7,337 |
| *Liberaliz** or *Liberalis** | 111 | 1,492 |
| *Fiscal* | 89 | 2,378 |
| *National* | 82 | 4,274 |
| *Incentive** | 72 | 3,022 |
| *Stabiliz** or *Stabilis** | 72 | 602 |
| *Business, -es* | 60 | 4,223 |
| *Property Right** | 51 | 578 |
| *Law,-s, Court,-s, Legal System* | 46 | 2,780 |
| *Sequenc** | 45 | 467 |
| *Contract** | 42 | 3,130 |
| *Micro** | 41 | 1,879 |
| *Decentraliz*, Decentralis** | 34 | 625 |
| *Federal* | 33 | 2,319 |
| *Centraliz*, Centralis** | 32 | 341 |
| *Governance* | 30 | 339 |
| *Ideolog** | 28 | 537 |
| *Local* | 27 | 2,470 |
| *Entrepreneur** | 27 | 775 |
| *Priorit** | 27 | 504 |
| *Big Bang* | 27 | 39 |
| *Bureaucrac*, Bureaucrat** | 26 | 419 |
| *Shock Therapy* | 24 | 33 |
| *State-Owned Enterprise** | 23 | 103 |
| *Income Distribution* | 19 | 733 |
| *Constitution** | 16 | 483 |
| *Credibil** | 16 | 432 |
| *Institutional Change* | 14 | 142 |
| *Inequality* | 13 | 1,047 |
| *Reject, Inconsistent* | 12 | 1,458 |
| *Private Enterprise* | 9 | 43 |
| *Black Market* | 7 | 96 |
| *Monitor** | 6 | 614 |
| *Trade Off*, Tradeoff* | 5 | 725 |
| *Substitute,-s* | 5 | 587 |

| Term | Transition Set (N = 2,564) | General Set (N = 132,005) |
|---|---|---|
| *Transaction Cost** | 5 | 493 |
| *Self-Govern** | 5 | 29 |
| *Confirm, Consistent* | 4 | 3,534 |
| *Enforcement* | 4 | 495 |
| *Fair, Fairness* | 4 | 483 |
| *Norm,-s* | 4 | 315 |
| *New Institutional Economics* | 4 | 78 |
| *Corrupt** | 3 | 153 |
| *Unanticipated, Unintended, Unexpected* | 2 | 543 |
| *Criminal** | 2 | 134 |
| *Transparen** | 2 | 118 |
| *Civil Serv** | 2 | 72 |
| *Path Dependen** | 2 | 67 |
| *Feedback* | 1 | 257 |
| *Illegal** | 1 | 141 |
| *Bottom Up* | 1 | 27 |
| *Top Down* | 1 | 18 |
| *Opportunity Cost** | 0 | 214 |
| *Self-Enforcing* | 0 | 59 |
| *Brib** | 0 | 37 |
| *Enforc* Contract** | 0 | 36 |
| *Rules of the Game* | 0 | 35 |
| *Social Capital* | 0 | 25 |
| *Organized Crim** | 0 | 11 |
| *Local Knowledge* | 0 | 6 |
| *Mafia* | 0 | 5 |

NOTE: See text for discussion of terms and notation.
SOURCE: Data from EconLit database, January 1989–September 1995.

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# 2

# Rethinking the Theory of Economic Policy: Some Implications of the New Institutionalism

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## INTRODUCTION

The early postwar domination of welfare economics (Samuelson, 1947: Ch. 8; Bergson, 1938), the Keynesian revolution, and the new field of development economics (Kindleberger, 1958) ushered in an age of excessive expectations for the potency of economic policy. To organize their thoughts about the contribution of economics to policy, and confident of their capacity to control social systems, many economists relied on a popular framework, the theory of economic policy (Tinbergen, 1956). In the 1970s, this excessive optimism changed as policy failures and a clearer recognition of the role of private incentives buried naive hopes of fine-tuning the economic system or individual markets (Lucas, 1976; Posner, 1986:Part III). Events also diminished early hopes that development economics would provide strategies for rapid transition in the Third World (Hirschman, 1981). In economics, a new emphasis on information scarcity suggested that transaction costs seriously limit effective social engineering and complicate economic organization (Furubotn and Richter, 1993; Kreps, 1990; Milgrom and Roberts, 1992; North, 1990; Stiglitz, 1994; Williamson, 1985).

Growing pessimism about traditional approaches produced neither systematic reevaluation of development strategies nor a new consensus on the appropriate scope for public policy. Economists offer conflicting explanations of economic successes and failures among Third World countries, while the Eastern European revolution of 1989 took social science unawares when it required guidance for rapid transition to markets. Mainstream economics has lacked a general theory of economic systems and structural change. In recent years, however, a new theory of institutions based on the economics of property rights and transaction costs has earned a measure of recognition among economists.

Although institutional analysis could potentially complement standard macro- and microeconomic theory in the design of policies for economic development, it has yet to develop a strong policy orientation.[1] This chapter introduces institutional analysis to the old theory of economic policy—to its policy models and its instruments, targets, and policy measures—in the hope that the new institutionalism will reveal its policy implications when viewed against the background of the traditional policy world. More particularly, the chapter explores the ways information scarcity affects policies aimed at social transformation.

The next section briefly summarizes the old theory of economic policy, associated with the Dutch economist Jan Tinbergen (1956). This is followed by an examination of three policy issues that were not a central concern of mainstream economics in the early post-war period: (1) the requirements of structural policy, (2) the need to extend the policy model, and (3) the implications of information scarcity. The chapter then presents a public policy view of the new institutionalism; problems of incomplete data and control and of incomplete models and decisions suggest an intricate policy world. Next is a discussion of the policy determinacy implicit in rational-choice political economy. The final section looks at the general policy implications of institutional analysis for major social transformations, such as those attempted in Eastern Europe and in the Third World.

## THE OLD THEORY OF ECONOMIC POLICY

In a perceptive discussion of the theory of economic policy, Hansen (1963) emphasizes the central role of models in policy formulation. As almost all policy aims at influencing economic outcomes or processes, policymakers—politicians, administrators, social scientists, voters, or rulers—must rely on a model, or a description of the economic system, which sometimes is little more than a rough qualitative picture (Hansen, 1963:3). It is argued below that the information assumptions of institutional analysis assume that actors employ incomplete and variable models of their environments when attempting to advance their public or private policies.

[1]The recent interest in institutions has stimulated work along various lines, including studies that use biological and evolutionary metaphors. The old institutionalism also appears to be thriving once again. This chapter is concerned only with that segment of institutional analysis that is based on methodological individualism and is predicated on some form of rational behavior in various information environments (Eggertsson [1990] surveys this work). The alternative institutional approaches are even less concerned with policy than the work discussed here.

A formal model of an economic system, such as a firm, a market, or an economy, can be written in the following general way:

$$f_i(x_1, \ldots, x_n; a_1, \ldots, a_m) = 0 \qquad i = 1, \ldots, n \tag{1}$$

In equation (1), $x_1, \ldots, x_n$ are n *endogenous* variables, and $a_1, \ldots, a_m$ are m *exogenous* variables, lagged variables, or parameters, some of which (for instance, exchange rates, tax rates, base money, price ceilings, import restrictions, plan indicators, or agricultural production quotas) are controlled by the policy actor (Hansen, 1963:5). Note a subtle distinction here in the meaning of exogeny. All the exogenous variables in equation (1) are exogenous to the actors of the social system that the model attempts to describe. The policymakers are distinct from the social system and control some of the exogenous variables, whereas other exogenous variables constrain their actions.

The policy model describes the choices open to policymakers: their opportunities to reach *targets* (desired values of endogenous variables) by applying *instruments* (exogenous variables they control). Policy targets (goals) are derived from the preferences of policymakers. The structure of the policy model prescribes what target values are attainable and how they are attained. Policy targets may be absolute, or the policymaker may weigh target variables together in a *target preference function*, $T(x_1, \ldots, x_n)$.[2] *Economic policy* uses policy instruments either to attain absolute targets or to maximize the target preference function. When targets are fixed (or when target preference functions are maximized without limitations), basic logic suggests two well-known rules of thumb: (1) in general, "the number of instruments should be (at least) equal to the number of targets," and (2) individual instruments should not be assigned to specific targets, but all instruments should be coordinated and directed toward the set of targets (Hansen, 1963:7).

Finally, the structure of the policy model has important implications for policy. It describes the interrelationships among the variables in the model (equation [1]) and determines whether the model can be divided into autonomous departments. Following Simon (1953), all endogenous variables and instruments in a policy model can be arranged according to causal ordering from the first order to the highest, *n*th, order. Instruments of the *n*th order influence targets of the *n*th order without affecting lower orders of the system. However, the use of first-order instruments has repercussions not only for first-order target variables, but also for endogenous variables at higher levels, possibly throughout the system (Hansen, 1963:18-22).

[2]Instruments often are valued in themselves, which may prevent their use or limit the range in which they are used, as when high interest rates are socially objectionable (Hansen, 1963:12). When instruments are valued, they also appear in the target preference function.

## NEW PERSPECTIVES AND THE OLD THEORY

The Tinbergen (1956) framework continues to be an essential part of our mental apparatus. When prescribing policy, economists think, explicitly or implicitly, in terms of instruments and target preference functions, and the notion of a model intervening between preferences and policy remains relevant. A new outlook in social science, however, has weakened economists' belief in their ability to prescribe economic outcomes and mold economic systems. We turn now to three related issues: (1) the requirements of structural policy, (2) the need to extend the policy model, and (3) the implications of information scarcity.

### The Requirements of Structural Policy

The old theory of economic policy distinguished quantitative policy from qualitative or structural policy. *Quantitative policy* takes as given the basic structure of the economic system (or subsystem), i.e., equation (1), and seeks to manipulate existing economic relationships toward some particular end. Until recently, the findings of mainstream economic theory were relevant primarily for quantitative policy, because the theory made few attempts to endogenize or explain (parts of) the economic system. *Structural policy*, on the other hand, seeks to change the structure of equation (1), and sometimes to add new variables or new relationships. The (immediate) goal is not to achieve a new value for a target variable in the quantitative policy model, but to create a new relationship between (new) instruments and targets.

The discussion in this chapter emphasizes the distinction between quantitative and structural policy, although, as we shall see, the new emphasis on information and incentives has blurred this distinction. Economists have recognized that over time, what were assumed to be quantitative policy initiatives (e.g., rent control, increases in tax rates, or new welfare benefits) have often altered the structure of equation (1). However, it is useful conceptually to distinguish fundamental system transformations from behavioral responses to changes in relative prices within a given system.

Structural policy obviously invites new quantitative policy (and a new quantitative policy model) because the new system must be managed. Furthermore, if the transition to the target structure is slow, appropriate quantitative policy is required to ensure the orderly operation of the system during the transition period (McKinnon, 1991).

Unlike quantitative policy, structural policy cannot be employed effectively without a theory of institutions and institutional change. Policymakers can conserve their mental energy and use relatively simple models, however, as long as low-order instruments can generate spontaneous adjustments in higher-order variables—i.e., in critical institutions—throughout the system. For instance, policymakers would not require complex policy models to guide the transition to markets in Russia and Eastern Europe if they believed that appropriate market institutions and organizations will emerge autonomously once "prices are set free" (Murrell, 1995). In the final analysis, the structure of the social system is an empirical question, but as a rule of thumb, policymakers in a world of scarce information usually do well to search for powerful low-order instruments.

## The Need to Extend the Policy Model

The old theory, which was concerned primarily with quantitative micro- and macroeconomic relationships, assumed that the target preference functions of policymakers coincide with the normative standards of economic theory. Traditional policy analysis usually ignored the incentives and behavior of political actors or the influence of political processes on targets for growth, stability, pollution abatement, regulation, or the division of investment funds among sectors. Macroeconomics was concerned with stability and growth, while microeconomics focused on allocative efficiency, assuming that policymakers shared these goals.

In recent decades, various scholars have extended the policy model to incorporate endogenous politicians, and analyses of the latter's policies now appear in the literature. Fields such as public choice, political economy, and political macroeconomics attempt to endogenize the choice of targets and instruments, and to provide the elements for a positive theory of structural change (Mueller, 1989; Alt and Shepsle, 1990; Hettich and Winer, 1993; Alesina, 1991).

Pure quantitative economic policy typically (though not always) leaves the political equilibrium intact, particularly when the policy achieves the intended results. In political equilibrium, those in power tend to agree on traditional normative economic goals, such as stability, growth, and allocative efficiency, within the existing institutional framework.[3] Of course, the prevailing institutional framework may leave little or no scope for economic progress. In a relatively stable world, the role of those who control and coordinate key policy instruments is usually well known and clearly established. Generally, there is little doubt about the policy sphere of actors such as the central bank, the finance ministry, the environmental protection agency, or the central planning bureau. Policy analysts have *relatively* little need for elaborate positive political theory to identify the set of politically sustainable policies.[4]

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[3]In the language of welfare economics, politicians agree to seek Pareto optimum outcomes for the economy on the basis of the existing initial allocation of resources, power, and wealth.

[4]Even though *successful* quantitative economic policy is not a major source of political instability, the political system may be in disequilibrium for other reasons. In an unstable environment, quantitative policy is likely to involve uncertainties about available instruments and politically sustainable policies.

Structural policy, on the other hand, is frequently associated with political instability. Substantial structural measures usually alter the distribution of wealth and power and often emerge in times of political upheaval. The choice of new economic structures frequently involves political disputes and struggles that render the control and coordination of policy instruments uncertain, especially over time. To formulate viable economic policy in an unstable environment and minimize the likelihood of policy reversals, the analyst needs to model interactions among economic, political, and social forces. The need to expand the policy model to incorporate this interaction is particularly obvious when policy experts seek strategies for instituting economic measures that (at least in the short run) have tenuous support among the general public, those in power, and those seeking power. Some policy analysts, for instance, recommended shock treatments or big-bang measures in part because strong measures are likely to overwhelm a disillusioned public and unreliable politicians. They are also more likely to create irreversible structural change (Åslund, 1995).[5]

## Implications of Information Scarcity

The last decades of the twentieth century have seen increasingly explicit concern with the role of information in social systems and in social science (Coase, 1960; Diamond and Rothschild, 1989; Hirshleifer and Riley, 1979, 1992; Stiglitz, 1994). The very concept of a social system operating with full information staggers the imagination, yet the impression that early postwar neoclassical economics assumed full information is widespread.

A theory of social systems that explicitly models the information environment of its participants confronts three types of information problems: (1) data are scarce, (2) actors economize on scarce information by formulating simplifying models of their environments (as do scientists), and (3) actors have limited capacity to absorb and process data (learn and make decisions). These three issues can be characterized as *incomplete data*, *incomplete models*, and *incomplete decisions*, respectively. The information revolution that has taken place in the social sciences during the last few decades has focused on problems of incomplete data, although the notion of incomplete models and decisions has received some attention.[6] Yet it can be argued that a new theory of economic policy must recognize all three information problems. It must also determine their impact on public policy and the interaction between private and public policy.

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[5]The moral standing of policy experts who advocate policies to induce changes that politicians and the public are reluctant to accept is an interesting normative issue that this chapter does not attempt to examine.

[6]In his recent work, Douglass North has been concerned with all three aspects of the information problem (North, 1990, 1993, 1994; Denzau and North, 1994). The present discussion of information scarcity is inspired by North's work.

The old theory of macroeconomic policy, or rather several scholars in that field, did acknowledge that incomplete data and models can undermine the efforts of policymakers (Hansen, 1963:31-36; Friedman, 1961). In particular, it was argued that various lags of uncertain length can pervert the timing of corrective measures and even turn them into destabilizing impulses.[7] In the 1970s, when macroeconomics acquired formal microfoundations, the theory even attempted to incorporate the interplay between public and private policy models. The early rational expectations school assumed that economic actors would be able to absorb the policy models used by the authorities, thereby enabling the actors to second-guess the authorities' intentions and undertake actions that would undermine economic policy. Random policy measures, however, would not produce this effect (Lucas, 1976).[8]

Similarly, the interactions between public and private policy models in individual markets are implicit in the work of Steven N. S. Cheung, who pioneered the economics of contracts (Cheung, 1969). For instance, in his studies of rent control in Hong Kong, Cheung recognized that public policy models were incomplete in that regulators lacked knowledge of how economic actors would establish a new equilibrium in response to official price ceilings in rental markets (Cheung, 1975, 1976). As rent control constrained the price mechanism, the new equilibrium (and private policy) involved various nonprice margins, including the transformation of residential buildings into unregulated warehouses and (premature) demolition and rebuilding. Cheung's empirical work demonstrates, however, that skillful regulators are often able to use trial and error to acquire knowledge about private models, which they may then use to revise the public policy model, design more effective policy measures, avoid unwanted side effects, and eventually come tolerably close to their policy targets.

## INSTITUTIONS, INFORMATION, AND CONTROL

We now turn to a discussion of the general implications of the new economics of institutions for the theory of economic policy.

In its initial phase, as is common for new fields of scholarship, the economics of institutions has emphasized explanation, empirical work, and policy analysis—in that order. Most studies, whether examining institutional change or the economic consequences of alternative institutions, are concerned with

[7]Lags of uncertain length include the interval between an exogenous disturbance (such as an oil shock) and its impact on target variables, the interval between corrective policy measures and their impact on target variables, and the interval between policy recommendations and their acceptance by the political process and their implementation by administrative bureaus. Also, the size of the various effects is incompletely known.

[8]Ragnar Frisch, the Norwegian economist, criticized Tinbergen in 1938 for his policy models, arguing that model structures would shift when policy regimes changed (Heckman, 1992).

the link between institutions and wealth or the social dividend. Therefore, wealth is frequently the (implicit) policy target in these studies. The distribution of power and wealth usually enters into these works as a determinant of economic outcomes or as an important force propelling institutional change.

## Incomplete Data and Control

Information and incentives are the driving forces behind theories of social systems that rely on methodological individualism. Institutions are of critical importance for economic performance because they affect both incentives and the cost of information. The economics of institutions derives the structure of the policy model (our equation [1]) from the systems underlying institutions or, in other words, from the rules that, in the language of game theory, affect the expected payoffs of the actors.[9] Therefore, a change in the formal or informal rules that leaves all payoff equations unaffected does not count as institutional change. Institutions emerge from the fusion of social customs and habits; formal rules and regulations; and various enforcement mechanisms, including internalized social norms. The primary weakness of the economics of institutions is its limited understanding of this amalgam of formal and informal rules and their attendant enforcement mechanisms. Most studies ignore social values, while others treat them either as constants or as exogenous variables.[10]

In the economics of institutions, the notion of information scarcity usually enters into the analysis through the assumption of incomplete data, but it is the union of incomplete data and what may be called the *control problem* that gives the new institutionalism its distinctive flavor.[11] Simply stated, costly measurement is responsible for incomplete data. Incomplete data raise the cost of verifying quality and monitoring behavior. This draws attention to one of the central complexities of economic life: commodities and behavior usually have multiple valuable dimensions or margins. Rising marginal cost in acquiring data suggests that actors are usually unable to control fully all margins of the resources over which they have nominal control. Therefore, in-

[9]The new institutional literature often refers to these rules as property rights, using the term in a more general sense than most people (including lawyers) do.

[10]In this context, social values are rules that govern human interaction and are shared by a community. The observance of social values provides actors with direct utility (the rules are internalized). Reputational effects that are motivated by economic gain are not considered social values by this definition.

[11]Standard economics also recognizes the control problem now, as in agency theory and in models with asymmetric information. The formal mathematical models of microeconomics tend to simplify the control problem by reducing the number of valuable margins for which control is required—presumably to keep mathematical complexities under control (Werin and Wijkander, 1992).

complete control is a general condition, and, as economics first recognized in the case of open-access fisheries, lack of control generates incentives that can lead actors to dissipate wealth (Barzel, 1989).

The control actors exercise over resources can derive from both external and internal sources: institutions, which represent socially assigned control, are external sources; the various measures actors take themselves, such as monitoring, fencing and locking up valuables, and contracting with other actors, are internal sources. In the literature, the costs of establishing and maintaining control over resources both in exchange and in use are commonly known as transaction costs. High transaction costs act as barriers to productive activities. The policy lesson is clear: structural policy that seeks to increase the capacity of an economic system in order to generate wealth must design institutions that lower transaction costs (North, 1990).

An increase in the social dividend has the potential to benefit all members of a social system, but imperfect institutions (imperfect in terms of the wealth criterion) often persist. To explain imperfect institutions, the new institutionalism typically looks to the political domain and uses high transaction costs in the political process to explain why actors are unable to agree on institutions that would be more conducive to economic growth (Bates, 1990; Moe, 1990; Weingast, 1995). The literature also recognizes that many social institutions and structures that facilitate economic growth emerge spontaneously and not through design. The role of shared social values in economic growth is of particular interest (North, 1990). Scholars in the rational choice tradition have had little success in explaining the emergence and evolution of social values, and it is not clear how policymakers could target social values. Consequently, the role of norms and customs in structural policy is ambiguous. A poor society that attempts to create incentives and information environments for economic growth by launching institutional change can hope for rapid success (1) if its underlying social values are consistent with the new institutions of growth, (2) if social values are malleable and adjust quickly to other aspects of the institutional environment, and (3) if the importance of social values in lowering transaction costs has been overrated. We return to these issues in the final section of the chapter.[12]

## Incomplete Models and Incomplete Decisions

In a world of scarce information, those who seek to accomplish structural

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[12]There is some confusion in the literature in the use of the terms *informal institutions* and (internalized) *social values*. These terms are used interchangeably in the present discussion. Some writers, however, include under informal institutions rules that originate with and are enforced by economic and social organizations, such as the internal rules of a factory, a condominium, or a clan. Unless they are internalized, such rules are not categorically different from those emanating from political organizations such as legislatures or town councils.

change must recognize that they are dealing with incomplete, competing models. Although the theory of economic policy has always been stated in terms of policy models, institutional analysis and the information perspective suggest that additional elements are needed:

- When attempting to advance their private goals, the subjects of public policy (economic actors, households) rely on private policy models of the physical world, the social system, and the moral order.
- Successful structural policy must allow for interactions between public policy models and private models, and revisions to both in response to new data.
- An important aspect of public policy is to provide the subjects of policy—actors whose behavior the policymaker seeks to change—with the information needed to revise their private models. This will assist in coordinating models at different levels.[13]

When we recognize that revision of models (learning) is often critical for the success of public policy, the revision process itself becomes of great practical interest. Rational-choice social science relies on rules drawn from logic, mathematics, and probability theory, and assumes that social actors use the universal logical rules of science for updating their beliefs or models. Even when this approach treats the origins of private models as exogenous, the assumption that actors use the general rules of science to update their models (for instance, Bayes' rule) implies that the models originate as purely logical or statistical interpretations of available data. In general, the logical approach cannot explain creative and selective interpretation of available data.

For many purposes, however, scholars can use standard logic to explain how actors revise their models and behavior. For instance, in a recent study, Bates and Weingast (1995) investigate revolutionary transformations in Zambia (movement to democracy) and in the former Yugoslavia (eruption of violent communal conflict) in terms of the updating of shared private beliefs (models). Bates and Weingast model interactions among the players as signaling games, where Bayes' rule is used to update models when new data (signals) become available. The paper demonstrates how a policymaker (Milosevic) can bring about a major change in social systems by manipulating signals.

Some scholars question whether actors use standard mathematical logic to update their models. Cognitive psychology and evolutionary biology argue that the human mind relies on "a large and heterogeneous network of functionally specialized computational devices," rather than functioning as a general-purpose computer (Cosmides and Tooby, 1994:329; Tooby and Cosmides, 1992). A union of evolutionary psychology and economics "might be able to create a science of preferences" (Cosmides and Tooby, 1994:331) and im-

[13]Of course, valuable information and influence also flow in the other direction.

prove our understanding of how actors model their environment, especially the moral order.

In sum, a new theory of structural policy must recognize variable and incomplete models at different levels and allow for interactions between public policy models and private models. In its present state, social science is equipped to do this only on the basis of the general-purpose rational methods of science.

## A DIGRESSION ON POLICY DETERMINACY

Rational-choice social science, which assumes that all actors optimize under constraints, implicitly suggests a high degree of policy determinacy. As long as neither social nor political actors were seen as rigorous optimizers, analysts believed there still was considerable scope for reforms. However, when the policy model was expanded to include political and social activity, and optimization under constraints was assumed throughout the social system, the policy choice set seemed to shrink and approach an empty set. This meant that structural policy appeared to have zero degrees of freedom.

The notion of incomplete data, incomplete models, and incomplete decisions changes this picture and expands the policy choice set. The changing fortunes of the Nordic welfare state illustrate this point. Lindbeck (1994, 1995) discusses the ways in which welfare state policies created not only a virtuous circle of benefits, but also an unexpected, undesired, and vicious circle of problems. The problems were associated with delayed changes in the behavior of households, interest groups, public-sector administrators, and politicians. These changes in behavior affected work effort, labor force participation, savings, asset choice, entrepreneurship, and short-term macroeconomic stability, and thereby shrank the tax base of the welfare state.

In analyzing these changes in behavior, Lindbeck recognizes the importance of incomplete data (for instance, delays in obtaining information about new welfare programs), but he puts the greatest weight on what might be called incomplete and variable private policy models. As the welfare system unfolded, the various types of actors, from households to politicians, revised their policy models. Lindbeck (1995) argues that the actors did more than revise their positive models of the social system and adjust their strategies for a new environment; they also revised their models of the moral order and updated their shared social values.

Lindbeck's analysis suggests, therefore, that we need to examine social policies in the Nordic welfare state in terms of incomplete public and private models. At the highest level, public policy models (presumably) did not allow for delayed regime changes in various structural relationships with the system as a whole (for instance, in labor supply or in savings ratios). This policy failure at the top is related to a misreading of private policy models, in particular a failure to recognize that actors will revise their models, targets, and policies. A revision of private policy models may change not only individual behavior, but also the structure and performance of organizations (households, social networks, firms, public agencies) that are the engine of social action (North, 1990). In Nordic social networks, the interactive revision of private models apparently first lowered the cost (stigma) of being a bona fide welfare recipient, and then the cost of being a welfare chiseler (Lindbeck, 1995).

The notion of policy determinacy, which introduced this section, is an in-house problem in the social sciences and relates to broader ambiguities in the concept of efficiency in the economics of institutions (Furubotn, 1994). A world of incomplete information cannot be determinate: with variable and changing policy models, there is ample scope for new policy directions.

## PUBLIC POLICY AND SOCIAL TRANSFORMATIONS

The new institutionalism has paid little attention to the role of policy-makers and to the specification of policy instruments for institutional change. With few exceptions, the theory provides only implicit policy lessons.[14] The chapter concludes with a few thoughts about these implicit lessons for major structural transformations.

### A General Theory?

Institutional analysis emphasizes that the creation of wealth depends in complex ways on institutions, and argues that institutions are rooted in political and social domains. Social science, however, is fragmented into insular disciplines and offers only partial, and often contentious, insights, rather than a reliable, comprehensive view of social systems.[15]

[14]The work by Elinor Ostrom and her colleagues on the governing of common pool resources comes close to a public policy perspective. For instance, see Ostrom (1990) and Ostrom et al. (1994). Eggertsson (1994) discusses some policy implications of the new institutionalism for the transition to markets in Eastern Europe and Central Asia. See also Benham et al. (1995).

[15]The absence of a general theory of structural change is apparent from economists' responses to the 1990s transitions of the former Soviet-type regimes. The economists' natural response has been to focus on topics in which they have a comparative advantage. Benham et al. (1995) scan the transition literature in economics for the years 1989-1994 and find that standard macroeconomic issues (stabilization policy) dominate this subset of the economics literature. These studies usually assume (perhaps not unreasonably) that traditional models of stabilization also work (tolerably well) in the transition environment. As for structural policy, the economics literature is concerned primarily with (1) formal schemes for privatization, and (2) the relative merits of shock treatment and gradual change for privatizing assets and liberalizing exchange. The literature has little to say about deeper institutional issues, such as the multifarious dimensions of legal reform or the structure of economic organization and public administration. The arguments for or against gradual change usually rely on casual theorizing about social and political factors (Murrell, 1995). Little is known about how far transition economies can go in substituting private rules and private enforcement for a full-scale legal system.

Furthermore, major advances in social science need not provide policymakers with the means to orchestrate major structural changes. Successful transition requires a strategy that will overcome opposition, particularly when the short-term costs of structural adjustment are high, which they frequently will be. In a world of uncertainty, this is a formidable task (Dewatripont and Roland, 1995). As social science evolves and provides better strategies for institutional change, it is also likely to supply the opponents of change with more sophisticated counter-policies. More knowledge can be a two-edged sword, unless conflict over structural policy involves primarily dispute over the effectiveness of different means to a common end.

## Complexity, Learning, and Feedback

The current strength of the new institutionalism (and related fields, such as the new theory of the firm, industrial organization, and positive political economy) lies in partial or sectoral analysis where theory offers various policy insights. The policy implications include (1) methods for containing the control problem and thereby reducing misallocation and the waste of resources, and (2) measures to facilitate the revision of incomplete private and public policy models, thus allowing actors to reach their goals more effectively. The old theory of economic policy explicitly demanded the coordination of a set of policy instruments toward clear-cut goals, but many of the policy insights of institutional analysis are far less specific, particularly concerning the measures needed to restructure actors' information environments.

The literature on property rights, agency theory, asymmetric information, organization, and related topics contains a growing body of theories that examine how to structure control and align incentives with policy goals (Milgrom and Roberts, 1992; McMillan, 1995; Williamson, 1985).

At the macro level, the state contributes to low transaction costs and effective control structures in several ways:

- By providing stable standards of measurement in exchange, including stable prices, and generally by creating a solid macroeconomic environment.
- By credibly committing to honor ownership rights and avoid using state power to seize resources capriciously, and by following a stable and predictable policy of taxation (Weingast, 1993).
- By protecting economic actors from each other through various means, including legal processes, and by facilitating (central) organizations that help establish reputation and detect fraud (Greif et al., 1994).

The extent to which private rules and private enforcement are able to substitute for an effective legal system and provide the necessary foundation for long-term economic growth is an unresolved issue. Recent empirical evidence shows that private actors often invent mechanisms for strengthening control and lowering transaction costs when they encounter permissive regimes (China) or bureaucratic and inefficient states (Latin America) (McMillan, 1995; Stone et al., 1996). Although these private arrangements often appear to be quite effective, two types of uncertainty surround them: first, private arrangements may create forces that eventually challenge the political status quo, and thus it is uncertain how long permissive or bureaucratic regimes will tolerate unofficial control systems; and second, it is uncertain whether in the long run, private control systems are capable of supporting a modern, integrated national economy.

A final point about the design of control systems concerns the choice between centralization and decentralization. The direct links among measurement costs, incomplete data, and control, combined with the propensity of measurement costs to increase with distance, slant structural policy toward decentralization in structuring both economic organizations and public administration. As a result, concern with the limits of central control is a recurrent theme in the new institutional analysis (Ostrom et al., 1993).

The idea of incomplete and competing models has various implications for policy, although the literature is particularly weak in this area. This outlook weighs against attempts at great experiments or the rapid implementation of structural changes, and suggests modesty, incrementalism, and learning by doing. A new category of instruments emerges in a world of incomplete models: measures for changing the information environment and for creating incentives for actors to revise their models and make them more compatible with policy targets. In a closed society, for instance, policymakers can alter the information environment dramatically by opening the system and facilitating international contacts, such as trade, telecommunications, direct investments, and educational exchanges. Although such measures may have profound implications for structural change, the actual outcome in a dynamic environment is inherently uncertain and generally cannot be modeled in specific terms as a relation between instruments and targets in a Tinbergen policy world.

Various feedback mechanisms are crucial both for coping with incomplete and competing models and for directing outcomes in social processes. Makers of public policy can advance their aims if they are able to design, or facilitate, feedback mechanisms that inform or punish actors who operate with policy models, data, or even goals that are inconsistent with public policy. A properly structured competitive market provides effective feedback in terms of the aggregate wealth criterion. Public policy can push economic enterprises in the direction of more efficiency by fostering various forms of competition and by providing suitable institutions for structuring exit and entry. Empirical evidence from various parts of the world, including China, indicates that not only private firms, but also various hybrid forms of organization will operate relatively efficiently in a competitive environment (McMillan and Naughton, 1996).

The feedback from competition also constrains political units. If the members of agricultural cooperatives operated by local governments can easily exit and join more desirable cooperatives in other localities, poor management is likely to bring corrective feedback and compel local authorities to revise their policy models or targets. Similarly, free entry and exit discipline higher political units, such as the states of a federation, as Weingast (1995) has shown in his work on market-preserving federalism.

## Policy Lags and Pathological Path Dependence

With incomplete models, there will be lengthy lags between when a policy is initiated and when relevant actors have the new structures right. During transitions, public and private actors need to experiment for some time once the fundamental incentives are in place before they are able to master the organizations of a modern market economy, including financial organizations, manufacturing firms, apolitical legal systems, and public administration. Few scholars doubted that structural change would involve substantial lags in learning and adjustment, but the institutional literature increasingly refers to far more dramatic lags, which are attributed to increasing returns and path dependence (Arthur, 1994; David, 1994; North, 1990). Several scholars have argued (1) that communities that share specific private policy models (and related informal institutions) resist public policy measures aimed at lowering transaction costs and increasing efficiency, and (2) that these models are extremely durable, enduring sometimes for centuries or even millennia.

In his study of modern reforms in regional administration in Italy, Putnam (1993) explains regional variations in the success of these reforms by variations in social capital and finds the roots of perverse policy models in the twelfth century. For Russia, Hedlund and Sundström (1996:32) trace perverse policy models to the Middle Ages and argue “that the future for Moscow represents a choice between a hierarchy dominated by strong, authoritarian ‘organs’, or a total breakdown of all organized societal functions.”

This strong version of path dependence (which is still controversial) can be compared to the discovery of debilitating genes in specific human groups, and the implications for structural policy are devastating. The new institutionalism does not appear to propose any instruments or measures for manipulating models at this level, which indicates a new type of policy determinacy and calls for more research.

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# 3

# Missed Markets: Implications for Economic Behavior and Institutional Change

*Leonid Polishchuk*

## WHY GOOD POLICIES FAIL: A SECOND-BEST PERSPECTIVE

Over the last few years, more than two dozen countries worldwide have undergone profound economic and political transformations, aimed at establishing market economies and pluralist democracies. The fact that most of these nations have launched their reforms more or less simultaneously, precipitated first by the erosion of the former Soviet Bloc and later by the collapse of the former Soviet Union, naturally invites comparisons of the results achieved to date. The call for such a comparative analysis is especially compelling as—despite the close proximity, if not coincidence, of both the content and schedules of their reform programs—the outcomes vary dramatically from one country to another.

This paper is concerned with Russia—the largest of the post-communist nations to embark on the transformation of its economy and society. Despite recent signs of economic and political stabilization, few will disagree with the proposition that Russian reform has hardly been a success story. Economic decline has slowed, but only after the country's gross domestic product (GDP) shrank to approximately 50 percent of its prereform level. One independent and credible source estimates that real personal per capita income has fallen to 60-70 percent of its 1990 level (Zaslavskaya, 1995). But per capita measures may be seriously misleading. The reform period has been characterized by dramatically increasing economic inequality, with a few earning extremely high incomes and the vast majority suffering grave losses. Official estimates indicate that 64 percent of the country's population has "below average" incomes, while approximately 30 percent live in poverty (Goskomstat, 1995).

This record is in striking contrast with that of the post-communist reform front-runners—the Czech Republic, Poland, and Hungary. While such heterogeneity is not necessarily surprising, given the broad differences among post-communist nations, the main challenge is to explain its causes and to identify factors underlying the successes and failures of the various countries.

Explanations and answers abound, reflecting different analytical perspectives and schools of thought, as well as divergent political and ideological platforms. While no one denies the importance of historical, social, political, and economic contingencies, attempts to identify those which may have been of particular relevance have stirred great controversy. Whether there is a universal set of policy prescriptions that, if properly implemented, could ensure a successful post-communist transformation regardless of such contingencies is also actively debated.

Most scholars seem to agree that, no matter what the underlying realities, on the surface reforms are advanced or derailed by concurrent political processes. "The diagnosis usually centers on the political sphere, with dilatoriness, rent seeking, and lack of policy credibility the prime suspects" (Murrell, 1995:164). The dramatic failures (until quite recently) of the Ukrainian reform effort, which in many ways mirrored that of Russia, are ascribed to the actions of powerful blocs that obstruct reforms that would have (1) reduced or eliminated the "rents" they received, and (2) undermined the bases of their political and economic power in the system (Havrylyshyn et al., 1994). As for Russia itself, in the opinion of Sachs (1995:72), "the major weakness came in the conception and execution of reform measures." Although Sachs denies that political or social opposition to reform in Russia played any significant role in blocking change, a position that is scarcely corroborated by the facts, his analysis remains focused on the policy side.

Indeed, Russian policy misconceptions and failures are too obvious for any analyst to question their share in the responsibility for the current crisis. Nevertheless, the puzzle remains of why financial stabilization, economic liberalization, and other indisputably sensible policy prescriptions were implemented relatively easily in some former communist countries, while elsewhere, and particularly in Russia, they met with so much resistance. This chapter examines that question, attempting to bring an analytical perspective to bear not only on the choice and implementation of policy prescriptions, but also on the reasons for their rejection and failure. It argues that major lacunae and deficiencies in the institutional infrastructure of the Russian economy, and in particular the unavailability of functional markets for factors of production, are largely responsible for the lack of progress in the Russian reform enterprise. Policy measures that would have enhanced efficiency if implemented in a completely functioning institutional environment in fact stimulated counterproductive behavior and imposed substantial efficiency losses when they were implemented in what might be termed an "institutional void."

These institutional deficiencies were particularly destructive in Russia as they compounded, and greatly complicated, the task of correcting the economy's profound structural distortions—the legacy of seven decades of central planning. With restructuring stalled, few economic agents could earn adequate returns to the factors of production they did possess in the marketplace. Since these underutilized factors, first and foremost, comprised human resources, economic agents were left to seek redistributional gains by extra-market means, or to resort to inefficient subsistence production.

Classical, evolutionary theories of institutional change suggest that correctives to these institutional deficiencies will emerge spontaneously, in response to market forces. However, given the pervasive structural distortion, the prevalence of distorted incentives, and the narrowness of those pockets within which productive activities are properly rewarded, the missing components of the institutional framework of a fully operational market economy stand little chance of emerging spontaneously in Russia. Russian reformers chose the spontaneous scenario in the first place largely in response to the perception that the weakened central state structures would not be capable of creating the necessary new institutions. These expectations, however, were frustrated as unanticipated behavioral patterns became entrenched as conventions and then themselves became institutionalized, thereby producing a stable low-level equilibrium.

The possibility of abandoning the current "bad" equilibrium and replacing it with a "good" one hinges on the incentives facing, and the resources under the control of, the participants in the process of institutional transformation. The democratic political system, which has been established de jure in Russia, should provide the means to surmount narrow, entrenched interests, as the vast majority of the country's population would benefit from a streamlined institutional environment. This mechanism, however, is precluded from fulfilling its role by the Russian electorate's split into constituencies controlled by the very same interest groups the democratic process was supposed to supplant. This means the choice among multiple possible equilibria is taking shape not on the basis of abstract theory or policy prescriptions, but as the result of distributional conflicts. Unfortunately, the most powerful parties to these conflicts, and the probable victors, are those least interested in departing from the status quo or altering the institutional arrangements on which their power and privileges depend.

At the same time, it should be recognized that a sufficiently strong proreform constituency does not exist in Russia. The majority of the population has suffered economically and become disillusioned politically over the course of the last 5 years. Earlier policy measures, including privatization, were based on the premise, derived from laissez-faire, liberal theory, that institutional reform should be kept separate from distributional considerations. However, in Russia's distorted economic environment, and in the absence of adequate regulatory controls, these measures produced a highly skewed distribution of costs and benefits across society. As a direct consequence, the very sustainability and credibility of the new allocation of property rights and economic roles are called into question, and the reforms are threatened with reversal at the polls. Further, it remains unclear whether forces capable of and interested in providing support for policies aimed at economic stabilization and growth will develop. The emergence of these forces will depend critically on whether the benefits of reform spread across the Russian economy and society and diffuse down to the grass roots. The institutional deficiencies of the Russian market make such an outcome anything but a sure bet.

The remainder of this chapter examines in turn the principal institutional factors that threaten the success of reform in Russia: a weak state and the "organic growth" of institutions, the institutional void in the exchange economy, structural distortions and suppressed input markets, market reallocation versus extra-market redistribution, monetization of the economy and rent seeking, nonpayment as a spontaneously developed institution, evolving patterns of rent seeking, and what is termed the B-o Law."

## A WEAK STATE AND THE "ORGANIC GROWTH" OF INSTITUTIONS

Russian radical reform began in earnest in 1992 in the context of the rapid disintegration of the central institutions of the state. By that time, the spectacular failures of Gorbachev's ill-fated *perestroika* campaign had discredited any socialist alternative to economic liberalism as the desired end state of the transformation process, not only among the political elite, but also among the Russian public generally. Still, the question of whether the transition to such an end state should be hands off (left to the operation of market forces) or guided (controlled by the state) was actively debated.

In the guided, gradualist scenario, a proactive state would create the institutions of the new economy and would lift controls over private economic activities only after the required institutions were already in place. The state also would be actively involved in correcting the inevitable failures of emergent transition markets and, most important, would provide an adequate safety net to cushion economic and social shocks.

Despite the appeal of such a scenario, the opinion that ultimately prevailed was that the choice between gradual and liberal transitions was anything but a purely academic exercise, to be determined on the merits of abstract theories. Since there were no functioning public institutions capable of implementing a program of gradual economic transformation, reform would have to proceed without them. After the demise of the Soviet Union, Russia was faced with the formidable task of (re)creating its state structures virtually from scratch. According to Gaidar (1993:12), "tectonic processes within society and the economy" left the reformers with no choice, not only over the end state of the reform, but even over the process by which it would arrive. The laissez-faire scenario for establishing a free market economy was viewed as the only practical option.

As a result, during the early stage of the Russian reform process, the government made no attempt to play a significant role either in establishing new economic institutions or in shaping economic restructuring. Institutional changes occurred primarily as the result of the removal of old mechanisms and structures of governance (which were routinely ignored anyway), with no attempt made to create a new institutional nexus in their place. The only notable exception was the government's pursuit of financial stabilization, a policy aimed at supporting economic freedoms by creating a reliable medium of exchange.

Of the standard LSI (liberalization, stabilization, institutional reform) reform triad (Balcerowicz, 1994), only the first two components were initially on Russia's reform agenda. Economic institution building was consciously postponed until a more propitious time—after the threat of economic and social collapse had been averted, new political institutions were firmly established, and a growing economy was providing sufficient resources to fund the provision of public goods.

It was further expected that by assuming a low-profile role, the government would gain some breathing space and, in particular, would reduce the lobbying pressure that is inevitable when a government is broadly involved in running an economy. More generally, reducing the domain of public decision making was viewed as conducive to political stability as the market, rather than the government, would become the arena for resolving social and economic conflicts.

Operating on these premises, Russia became a gigantic laboratory, testing the "organic growth" model of economic and political institutions. This represented a dramatic break with Russian historical tradition, in which the state almost invariably constituted the key agent in advancing economic development. The state's active role in the economy, both in the tsarist and Soviet periods, and the perpetual failure of reform efforts were traditionally attributed to a lack of grass roots demand or support for institutional, organizational, and technological changes (see, e.g., Gerschenkron, 1962). In sharp contrast, post-Soviet reform was predicated on grass roots demand becoming the locomotive that would propel the process forward.

## THE INSTITUTIONAL VOID IN THE EXCHANGE ECONOMY

During its first few months, the liberal reform project fared reasonably well. The initial price shock, along with the release of previously repressed inflation, was largely compensated for by two powerful sources of economic gain. First, freedom to trade unleashed the no-trade equilibria typical of an economy characterized by controlled prices and barter exchanges. Repressed inflation, which results when prices are kept below their equilibrium levels across the board, blocks trade, even if price ratios happen to be correct (Benassy, 1982), since the oversupplied currency cannot serve as an effective medium of exchange. Barter trade, endemic prior to the reform, similarly could not substitute for stable currency and free prices. Both Russian households and firms had accumulated large inventories of merchandise in the prereform period, and were therefore able to reap broad gains from trade in these stocks immediately after reform began. The blanket liberalization of imports contributed further to the same end.

Another source of efficiency gains was the elimination of wasteful nonmonetary equilibrating mechanisms. Price controls led to the expenditure of valuable resources other than money to ration limited supplies of goods. Most frequently this resource was time—spent in lines, in search of goods in short supply, or in attempts to make connections with those having access to goods. Price liberalization rendered these nonproductive expenditures unnecessary, and thus increased aggregate consumer welfare.

Although the distribution of these gains was frequently inequitable, it was sufficiently dispersed to provide the majority of the population with some offsetting relief to the many-fold increase in the consumer price index. According to household surveys, in the first few months after the blanket decontrol of prices, the population was satisfied by and large with the available level of consumption (Gorin, 1995). The reformers were also able to rely for a limited time on a "credit" of broad social support, based in part on widespread expectations of improving social and economic conditions, and in part on disarray among the potential opponents to reform (Balcerowicz, 1994). The fact that Russian reform initially met little resistance and that protests and signs of discontent were few and far between allowed monetary policy to be kept under tight control, thereby preventing the one-time dramatic price increase from triggering an ongoing inflation.

It should be stressed, however, that this initial success was accomplished within what was essentially a simple exchange economy, where institutional lacunae and deficiencies were less damaging than they would be in a full-scale trading economy with production and distribution based on market mechanisms. It was when the gains from trade in initially held endowments and inventories had been exhausted, and it was time to produce new commodities, earn returns on the contributed factors of production, secure ownership over these factors, and arrange for their reallocation to meet market demand that Russian reform ran into trouble. "Exchange in modern economies consisting of many variable attributes extending over long periods of time necessitates institutional reliability, which has only gradually emerged in Western economies" (North, 1990:34). This desideratum was—and largely remains—absent in Russia. As a result, the Russian economy developed an acute imbalance between its capital stock and technological potential, on the one hand, and the available institutional environment on the other (Rapaczynski, 1996).

## STRUCTURAL DISTORTIONS AND SUPPRESSED INPUT MARKETS

All the post-communist economies were characterized by profound structural distortions at the beginning of their reform processes. Since allocation decisions under central planning were based largely on the political preferences of the ruling communist elites, cost structures, output mixes, and intersectoral proportions were divorced from market demand, rendering them unsustainable in the new economic environment.

Few analysts were surprised that institutional restructuring featured prominently on reform agendas across the former Soviet Bloc. What was not always properly appreciated, however, was the degree of variation in the depth of these structural distortions from one country to another. While structural (dis)proportions are usually listed among the relevant "initial conditions" affecting the progress of reform (see, e.g., Balcerowicz, 1994), macroeconomic indicators, such as monetary and fiscal imbalances and foreign debt, received most of the attention in cross-country comparative studies. It was not generally recognized that policies (or the lack thereof) targeted at the micro level of the economy, particularly those designed to reallocate economic resources in order to compensate for or correct inherited mismatches, would underpin the success or provoke the failure of macroeconomic stabilization, and thereby the entire reform effort.

The extent and nature of prereform structural distortions in the post-communist countries depended on a number of factors, including the duration of centralized control over the economy, the political and economic role of the country in the former Soviet Bloc, and the scope of the tolerated nonstate sector. In Poland, agriculture and many services remained private throughout the period of communist control, and the economic system remained relatively less centralized than those of its neighbors. A substantial degree of decentralization was also characteristic of the Hungarian economy, which had been drifting away from communist economic orthodoxy and experimenting with reform for 20 years. The Czech Republic entered its period of communist rule with an advanced industrialized economy, shaped by market forces, already in place. The industrial structure of that economy displayed a great deal of inertia and was more or less preserved under the facade of central planning.

It is also important to recognize that within the framework of Comecon, all three of these countries specialized in the production of consumer goods. This meant that although none of the three completely escaped the structural "birthmarks" of central planning (e.g., an outsized heavy industrial sector, an overconcentration of production in a few regions, the maintenance of large stocks of redundant labor), the inherited distortions were not as dramatic as they were in other former Eastern Bloc members. As a direct result, the scope of restructuring was much less daunting.

Others suffered from far more severe "birth defects." Romania, for example, had to cope with the legacy of Ceausescu's drive for economic autarky, predicated on the hyperdevelopment of heavy industry. As a result, it faces much more formidable problems in attempting to implement structural corrections than did any of Central Europe's reform front-runners, and not surprisingly ranks far behind them on any scale measuring reform success. Slovakia, the disproportionately agrarian sector of the former Czechoslovakia, experienced the impact of Soviet-style industrialization to a much greater extent than did the neighboring Czech Republic, and consequently took longer to embark on a path of economic growth.

Russia found itself in a particularly disadvantageous position at the start of its reform effort. The country's economic profile had been shaped for over seven decades by political leaders seeking global dominance and strategic superiority. Even more perniciously, the backbone of the Soviet Union's, and the entire Soviet Bloc's, military-industrial complex was located on Russian territory. This "division of labor" meant that heavy industry, and military industry in particular, experienced hypertropic development in Russia at the direct expense of industries producing for consumer needs.

Russia also suffered distortions in other critical areas. The share of the labor force employed in industry in Russia was double that in Western industrialized economies, while employment in services was, proportionately, less than 50 percent of Western levels. Russian firms frequently consumed several times the quantity of inputs characteristic of similar enterprises in market-driven economies. Almost every enterprise featured formidable levels of overemployment.

The endemic "value subtraction" that was a salient characteristic of production in the Soviet-era Russian economy made restructuring not just one of the highest priorities of reform, but a necessary precondition for the successful introduction of a market economy. Unless market returns could be gained from the utilization of the nation's factors of production—particularly labor—continued stagnation and decline were inevitable. But market returns were impossible unless restructuring freed factors of production to move among firms, industries, and regions on an unprecedented scale. Unfortunately, the embryonic state of the input markets, particularly the labor market, meant that such movement was scarcely possible.

While input markets in all the reforming economies were characterized by serious deficiencies, the barriers to the movement of factors of production in Russia were particularly high. Although geography played a role, this was primarily the result of institutional deficiencies and lacunae. Unfortunately, the urgent need to correct the endemic misallocation of factors of production coincided in Russia with particularly dire conditions in input markets.

The development of a vitally necessary Russia-wide labor market was stifled by the deep territorial segmentation of real estate markets, the persistence of administrative barriers to population movement, and the absence of a universally available safety net and publicly provided services.

As the central government has abdicated its role as the provider of a safety net and basic social services, industrial firms and, to a lesser extent, regional authorities have emerged as their almost exclusive source (see, e.g., Gorin, 1995). The nonwage benefits traditionally provided by employers have become vital lifelines supporting workers and their families through the throes of transition. This "lifeline," however, compels workers to remain with their current employers despite nonpayment of wages and regardless of market conditions. Paltry and poorly administered unemployment benefits, as well as the loss of employer-provided housing, child care, and health benefits, make the decision to quit a job an extremely hazardous endeavor. As a result, "workers [are] retaining state jobs, where feasible, as basic insurance" (Commander et al., 1995:163).

Whatever labor mobility does occur is largely within the confines of particular cities and metropolitan areas. While some of the obstacles to interregional migration are the result of policies imposed by local authorities, the deep differentiation in the cost of housing plays a greater and more pervasive role. With mortgages practically unavailable until recently (because of inflation) and without established standards for secured lending, housing costs must be paid in full and in advance. Not only do these costs vary widely across the country, but they are also positively correlated with economic opportunities. This makes it almost impossible for workers from depressed regions to move to areas with better labor market conditions. As a result, the spatial disproportions of population and labor created by decades of decisions based on nonmarket principles continue to be sustained during the transition. In short, "the Russian labor market remains characterized by low interregional labor mobility, significant inefficiencies in labor allocation, and a large employment overhang" (Commander et al., 1995:148).

To assess fully the opportunity costs imposed by these barriers to labor mobility, one must first recognize that, as a result of Soviet policies imposing unified standards on education and broad aspects of social and economic life, Russian society is characterized by unusually high levels of social homogeneity, and hence "potentially high professional and territorial mobility. . . [that would allow for] prompt economic adjustment" (Naishul, 1996:4). Regrettably, these potentially advantageous social prerequisites for rapid restructuring are foreclosed by the institutional roadblocks discussed above.

The Russian capital market remains underdeveloped and heavily depressed for a number of reasons, including inadequate protection of property rights, poor enforcement of contracts, profoundly asymmetric information, low liquidity constraints on up-and-coming entrepreneurs, and overall political and economic instability. In addition, corporate governance is dominated by insiders, and, for reasons discussed below, the market for corporate control fails to function properly.

Most of the structural change that has taken place to date in the Russian economy has occurred through attrition. Loss-generating firms and industries have withered away (in terms of output, if not yet in terms of labor stocks), but the major investments needed to ensure that new businesses will take their place are not being made (see *Kommersant*, 1995). In addition, the link between the financial and "real" sectors of the Russian economy has been undermined, first by high inflation, and later, after inflation was brought under some measure of control, by political instability and the failure of the government to provide adequate safeguards for property rights and enforcement of contracts. As a result, the fairly substantial pool of private savings that does exist in Russia is prevented from being transformed into investment capital.

Blocked channels for the reallocation of economic resources, in combination with the deep structural distortions that pervade the Russian economy, have produced vast efficiency losses and, perhaps even more critically, had a profoundly distorting impact on the patterns of economic behavior emerging in transitional Russia. In addition, some of the main benefits of a market economy—as a source of efficiency-enhancing incentives and information—have been missed, and "when some markets are missing . . . markets need not clear in equilibrium, prices do not uniquely summarize opportunity costs and can even misinform, externalities result from most individual actions, information is often asymmetric, market power is ubiquitous, and 'rents' abound" (Przeworski, in this volume).

## MARKET REALLOCATION VERSUS EXTRA-MARKET REDISTRIBUTION

Production in modern economies requires that human resources, such as labor, entrepreneurship, and human capital, be properly combined with complementary factors of production (e.g., physical and financial capital, workplaces, land). Because prereform structural distortions did not provide for such combinations, there is a need for massive reallocation of factors of production through the input markets—in other words, for broad restructuring.

However, if the markets for production inputs, and in particular for labor and capital, are not functional, such restructuring is forestalled. As a result, human resources are not properly matched with complementary inputs and earn poor market returns. In this case, extra-market redistribution, where economic resources are spent for the appropriation of what has been produced by others, rather than for market production proper, presents an attractive alternative. Extra-market redistribution also demands far fewer complementary inputs than does production, enabling it to provide an income stream whether other factors of production are available or not.

Whether a rational individual seeks economic gains by productive or nonproductive means will depend less on his/her innate preferences or merits than on prevailing institutions, available opportunities, and anticipated payoffs (see, e.g., Buchanan, 1980). The inability to utilize complementary inputs effectively makes socially inefficient and/or nonproductive activities preferable to market production by rational agents. Therefore, as I have argued elsewhere (Polishchuk, 1996), sustained structural distortions promote widespread redistributional activities and subsistence production at the expense of the productive use of human resources.

A substantial body of empirical evidence, including household surveys, corroborates these conclusions. Gorin (1995) notes that once the gains from trade in previously stockpiled commodities had been exhausted, human resources sought a different extra-market cushion against the shocks of economic liberalization rather than shifting into productive channels. Government subsidies, channeled through industrial enterprises, were used to "open up umbrellas of social protection" (Gorin, 1995). As was also anticipated above, human resources continued to be engaged in harvesting small private plots of land, almost entirely for consumption within the household.

Nonfunctional input markets inflict three kinds of damage on an economy. First, there are the direct efficiency losses due to the persistent misallocation of factors of production, and it should be recognized that this harm goes well beyond simple mismatches between inelastically supplied human resources and other production inputs. Second, there is the diminishing aggregate supply of human resources available for productive use, as these resources are broadly absorbed in nonproductive and subsistence activities. Third, even those who have access to the required combinations of human resources and complementary inputs confront reduced incentives to produce. This follows from the threats of extra-market expropriation of facilities and output (by governments, corrupt competitors, or theft), as well as the pressure to join the redistributional "rat race." Many are vigorously involved in redistributional activities for what they foresee as the limited transition period. Since these lucrative opportunities will be lost once the uncertainties of the transition period are past, a "make hay while the sun shines" mentality is in the ascendant.

Because input markets remain undeveloped or dysfunctional, the lion's share of the country's GDP is being produced by a few export-oriented industries, concentrated in the extraction of natural resources and frequently utilizing environmentally hazardous technologies (*Kommersant*, 1995). Apart from these industries, only trade, finance, and a few other services are doing well in Russia. As only a relatively small fraction of the country's population is employed by or otherwise directly benefits from these sectors, and there are few market channels to spread the earnings of these sectors throughout the rest of the economy, the social and economic benefits from these pockets of prosperity have been limited. Subsistence production, where available, is providing minimal levels of nourishment for many in the short term, but it is incapable of maintaining acceptable living standards in a post-industrial society. The resort to these extra-market mechanisms by a large contingent of the Russian labor force should be recognized not simply as a matter of rational choice based on a cost-benefit analysis of alternative activities, but as a requisite for economic survival.

To summarize the argument to this point, the institutional void in the Russian economy is responsible for the fact that massive *extra-market redistribution of the national product* is taking place instead of the badly needed *market reallocation of factors of production*.

This redistribution, or rent seeking, is typically accomplished in Russia by either criminal or political means, and the two are closely intertwined. The result has been widespread concern about "mafiyas" gaining control of the country. While many fear that a tidal wave of organized crime is flooding the Russian economy, criminal methods of obtaining extra-market redistributional gains remain secondary to, and often feed upon, political mechanisms. Ironically the state, which reformers anticipated would withdraw from the economy, and in particular would refrain from making allocative decisions to the maximum extent possible, has reasserted itself and become the hub of what Russians term the "bureaucratic market" (see, e.g., Leontiev, 1994). Russian state structures have taken on roles that directly contradict Posner's (1987:28) ideal: "the optimal government for economic growth [is] strong enough to maintain law and order, but too weak to . . . engage in extensive redistribution." State structures and agencies have emerged as the only alternative to spot market trading. Private long-term contracting, a fundamental requisite of economic growth, requires the impartial enforcement of contracts and property rights (Williamson, 1995; Hedlund and Sundström, 1995), an impossibility in conditions of an institutional vacuum.

The "currency" of the "bureaucratic market" is lobbying and corruption. Both were widespread in the prereform Soviet economy and hinged on informal bargaining arrangements between different units of the state and economic bureaucracies. Reform, however, has unexpectedly provided a major boost to lobbying activities. That came as a surprise to many, as common wisdom suggested the opposite: lifting administrative controls over the economy would make bargaining between private parties explicit, and would transfer the settlement of distributional conflicts from the government to the marketplace.

## MONETIZATION OF THE ECONOMY AND RENT SEEKING

The first significant bout of lobbying in postreform Russia occurred shortly after the initiation of the 1992 reform program, prompted by the monetization of the economy. While the government surrendered any role in directly allocating economic resources in kind, it was still available as a source of subsidies and cash bailouts. For several reasons (discussed below), the switch from distribution in kind to cash payments enhanced incentives for capturing redistributional gains, and at the same time made it much more difficult for the government to withstand pressure from the lobbies.

First, once the economy became monetized, endowments also acquired monetary values. Cash subsidies, however, produced inflation, which eroded the value of these endowments. In their competition for subsidies, economic agents were not simply attempting to capture part of the economic surplus, but to compensate for inflation-induced losses in the value of their endowments. This rendered rent seeking much more vigorous than it would have been if subsidies were dispensed in kind.

Second, in a monetized economy, lobbyists' claims are made in nominal terms, allowing the government to buy time by trading off today's political pressure for tomorrow's inflation. As both parties to the exchange recognize, the government always has the option of fulfilling monetary claims, either in part or in full, by running a budget deficit. When the government's "budget constraints" were hard, that is, determined by limited stocks of contested resources, so was its ability to appease the lobbyists. Given the short tenure of reformist governments and the several months' time lag between an increase in the money supply and the ensuing rise in inflation, this exchange may look particularly attractive to those in power. Until rent seekers develop rational expectations about the "real," i.e., inflation-discounted, value of the subsidies they are obtaining, they will continue to be under the monetary illusion that their lobbying efforts are obtaining greater rewards in the monetized economy than they did when subsidies were distributed in kind.

Third, in the prereform, administratively controlled economy, the lobbyists' primary goal was to increase the amount of resources allocated to the firm. In so doing, lobbyists competed directly for access to scarce commodities. As a result, the contested rent was often dissipated, and the resources invested in rent seeking were partly absorbed within the community of lobbyists, with little impact on the government. When the Russian economy was monetized, however, rent seeking, while still to some extent retaining the characteristics of a competitive activity, developed features of collective action. This meant that all lobbyists were in effect pursuing a common goal: derailing the government's policy of financial austerity.

Given the large number of actors and the well-known difficulties of collective action involving many agents, analysts would expect such collusion to be difficult to achieve (Olson, 1965). However, two factors eased the problem of collective action for Russian firms seeking government subsidies. First, these firms historically were organized into sectoral groups (formerly controlled by branch ministries), and it is usually these groups, rather than individual producers, that are represented by lobbies. Second, and most important, in the absence of conventional corporate control and functional input markets, the Russian economy has spontaneously switched to an alternative institutional arrangement, one that promotes collusion rather than competition. This institutional arrangement is based on mutual nonpayment.

## NONPAYMENT AS A SPONTANEOUSLY DEVELOPED INSTITUTION

Apart from achieving price stability, one of the main rationales for introducing tight monetary policy was to eliminate the notoriously "soft" budget constraints faced by Russian firms, thereby compelling them to become cost conscious and profit oriented. "Hard" budget constraints would make producers sensitive to market signals and thus promote restructuring. This restructuring could take the form of shedding redundant labor, reducing nonlabor production costs, replacing obsolete equipment, switching to new product lines, or—should none of these options prove viable—going out of business through bankruptcy and liquidation.

As was detailed above, the inadequacy of input markets greatly impeded restructuring, but at least as important a role was played by the lack of a clearly defined and enforceable ownership structure for productive assets. With de jure property rights in limbo and de facto under the control of the firms' prereform management and labor representatives, there was little internal pressure on firms to engage in bona fide restructuring. Instead, faced with dwindling cash flows and unable to devise alternative strategies for securing income either through the market or (initially) through the government, firms resorted to the next available option: they ceased paying each other's bills.

When nonpayment became a universal modus operandi, insolvency was no longer an unequivocal indicator that a firm was nonviable. It could just as easily be an innocent victim of its nonpaying customers. The impossibility of assessing the economic health of enterprises on the basis of their books further undermined the prospects for restructuring in general. As a result, the economic signals required to guide the correction of inherited structural distortions were absent (Ickes and Ryterman, 1993), along with the input markets needed to reallocate the factors of production and economic agents with incentives to engage in such reallocation.

This snowballing of obstacles to restructuring indicates that when there is a gap in the standard set of institutions of a market economy, it will not necessarily be filled spontaneously by the missing component. On the contrary, an institutional gap may cause the economy to move further away from the desired set of interdependent institutions, causing it to slide toward a "bad" equilibrium. In this new equilibrium setting, additional sources of efficiency losses will emerge from the grass roots. In other words, the second-best dictum has both static and dynamic aspects: an incomplete set of market institutions will not only stimulate counterproductive behavior on the part of individual agents, but also give rise to alternative institutional arrangements of a collective nature that further undermine economic efficiency. Mutual arrears are an example of such an arrangement: they have become institutionalized as a stable convention, so that "the members of the community come to treat this rule as the appropriate and just form of behavior" (Knight, 1992:6)—in short, as an institution. Four years after its emergence, this institution not only shows no sign of withering away, but in fact has become "the most urgent problem of today's Russian economy" (*Segodnia*, February 28, 1995).

Nonpayment should also be viewed as a form of collective action on the part of the participating firms, based on their mutually held expectation of mass bailouts through either the resumption of subsidies or the cancellation of arrears. This expectation proved to be self-fulfilling. For the reasons stated above, the government was unable to distinguish the firms that should have been eliminated from those that were the victims of others' nonpayment. It also recognized that any attempt to enforce payments would have brought the entire economy to a standstill. In Russia, it took less than 6 months for the government to yield to this collective pressure, and as a result, financial stabilization gave way to an unprecedented inflation that brought the country to the brink of hyperinflation.

Since then, each attempt to restore financial stability has invariably been followed by a new surge of nonpayments and a financial crisis, although of gradually diminishing magnitude. While fiscal and monetary discipline was expected to reduce the scope of rent seeking by raising the transaction cost of bargaining with the government (Shleifer and Vishny, 1994), in fact it provoked a powerful response among rent seekers, who joined ranks de facto to offset this threat to their interests.

Nonpayment has become so deeply entrenched an economic convention that the government itself, in its struggle to gain control over the budget, has had recourse to the same mechanism. When the government routinely defaults on its obligations, firms quite naturally reciprocate, and overdue taxes currently dominate the payment arrears. Inadequate tax collections, in their turn, have produced an acute fiscal crisis (*Segodnia*, February 28, 1995).

## EVOLVING PATTERNS OF RENT SEEKING

Despite strong opposition, the government has not renounced its pursuit of financial stabilization. In an attempt to ensure fiscal discipline, a "double key" system was instituted: if a motion to increase spending is initiated by the President's office, it must be endorsed by the Cabinet, and vice versa. Thus the division of power is being used to create a credible commitment to budgetary austerity, and, if nothing else, to increase the cost of seeking subsidies and handouts.

As the tendency toward reduced inflation became clear, direct financial subsidies began to lose some of their attraction for rent seekers, both as too costly and as unsustainable in the long run. At the same time, the government intensified its efforts to develop the legal and regulatory framework that had been missing during the earlier stages of reform.

Since opportunities to do well in the marketplace remain heavily suppressed, these changes have not restrained the growth of extra-market redistributional activities. With extra-market redistribution continuing to offer greater rewards than productive activities, the main factor promoting the vigorous pursuit of rents remains intact. The nature of rent seeking, however, has evolved, reflecting shifts in government policy.

Responding to these changes, lobbyists have focused their efforts on the legislative and regulatory processes. The government's new emphasis on the rule of law and secure property rights has presented the managers of firms with opportunities to occupy and maintain advantageous economic niches and to gain control over streams of rent with potentially high capitalized value, not just to obtain one-time handouts. Preferential tax regimes, access to regulated activities, de jure control over resources, and advantages in privatization have become the targets of choice.

On the one hand, this is undoubtedly an encouraging sign, as it indicates that Russia's economic agents expect the rule of law to prevail ultimately in the Russian economy and society. On the other hand, it shows that Russia's various interest groups have discovered new incentives and opportunities for lobbying and that their competition has further intensified. To secure influence over public policymaking, the lobbies are no longer approaching the government as supplicants, requesting favors. Rather, they are attempting to gain direct representation within the government. In the opinion of one well-informed observer, Russia has a "unique quasi-state, all the elements and components of which are pursuing only private or group interests" (Leontiev, 1994:159). In such a "quasi-state," private and group interests become intertwined, and the well-being of each will depend on the political maneuvering and the leverage of their patrons in the government (Glinski, 1996).

In their attempts to secure a foothold within the institutions of the state, the lobbies are exploiting various natural divides—between different ministries in the cabinet, between the executive and legislative branches, and between federal and regional authorities. This process, which is known in Russia as the "privatization" of the government, goes well beyond developing close relationships with existing segments of the state apparatus. Those who have come late to the game are trying to establish new structural components within the bureaucracy or to expand existing agencies beyond their narrowly defined functional roles to create greater access.

The same factors help explain the excessive fragmentation of the Russian political scene and the proliferation of liberal and conservative political groupings, incapable of creating stable alliances despite shared platforms and values. Ideological differences are frequently of secondary importance, since the main reason for creating a new political movement is yet another interest group's perceived need to gain direct access to public policymaking.

## "THE B-o LAW"

Evidence from various sources indicates a strong correlation between the propensity to seek redistributional gains and an inability to function effectively in the marketplace. "One can formulate a statistically proven 'B-o Law' [the abbreviated name of a Russian political entrepreneur who allegedly exemplifies the phenomenon], according to which high political activity correlates with low liquidity" (Leontiev, 1995:2). Thus, a group's lack of productive assets with real market value may prove advantageous when it competes for political benefits, since it is less likely to be splitting its energies and resources between market production and extra-market redistributive activities and is fully investing in the latter (Glaziev, 1995).

The same logic explains the strong priority Russian managers place on preserving their firms' labor teams. According to various surveys and polls (e.g., Belianova, 1995), this task dominates managers' agendas, usually ranking higher than profit maximization. While this phenomenon is certainly symptomatic of a lack of corporate control, the incentives motivating labor teams, as well as managers, require further explanation.

As was mentioned above, workers view their continuing employment as a vital substitute for an otherwise unavailable safety net and therefore are willing to stay on despite meager wages, part-time employment, involuntary leaves without pay, chronic delays in salary payment, and other features typical of suppressed unemployment (see, e.g., Commander et al., 1995). But for exactly the same reasons, workers wield very limited bargaining power. "Managers appear to have high discretionary powers with respect to wages and employment, but they evidently choose *not* to exert them to enforce large employment separation or restructuring" (Commander et al., 1995:178). The fact that managers are not engaged in large-scale labor shedding, despite the weakness of labor's bargaining position, indicates that their self-interest is somehow served by retaining a large, though currently unproductive, labor force.

Managers' incentives to retain large labor stocks apparently have strong political underpinnings. While excessive labor is a liability in the market domain, it represents a valuable asset in the political marketplace, where managers can claim to represent sizable and politically vocal constituencies. When economic losses are weighed against political gains, the latter clearly prevail. This provides additional empirical evidence for our argument that actors gain higher payoffs from redistributional activities than from productive ones. The foregone profit can also be viewed as a political investment that is expected to render rewards in the future.

These examples and arguments confirm the view that productive assets in post-communist economies have both political and economic values, and that these values are negatively correlated (Frydman and Rapaczynski, 1994). A large, unrestructurable firm that is the single employer for an entire community may have a low market value, but it will have strong political clout with the government. As a result it will be well positioned to participate in extra-market redistribution. Another firm with modern technologies and a market for its products may do well in the marketplace, but it will have both weaker incentives and narrower opportunities to participate in rent seeking.

The primary distinction between these two firms is the extent to which labor is properly matched with other factors of production. Where there are widespread and profound structural distortions, a large portion of the labor force will be employed by firms with the "wrong" production assets. This will create powerful motivations for rent seeking, capable of destabilizing not only the economy, but the country's political life as well. "In effect, as long as the capital stock contains too much that is economically worthless, so that its improvement involves serious social costs, the government is always subject to being held up for ransom by the holders of economically worthless assets. Only when the winnowing out of the bad assets is a marginal, rather than the normal, economic problem, can the political system effectively resist pressures for large-scale redistribution" (Leontiev, 1994:193).

## CONCLUSION

The analysis and evidence presented above suggest that Russian economic reform is trapped in the following vicious circle. Restructuring requires publicly provided and maintained institutions that support the creation and effective functioning of input markets, corporate control, and social safety nets. The absence of these institutions during the early stages of the reform both forestalled restructuring and promoted broad redistributional activities based on extra-market means and the creation of socially counterproductive surrogates for missing institutions. Widespread rent seeking spawned interest groups, provided them with the means to pursue their antisocial interests by political means, and opened new opportunities for corruption within the government. As a result, the government has been incapacitated and is incapable of filling the institutional void in a positive way. This places further obstacles in the path of restructuring and continues to produce incentives for counterproductive activities.

These arguments explain why Russian reform has slid into a trap. Both "good" and "bad" institutional frameworks can provide stable equilibria. While the first is based on a full set of competitive markets and effective enforcement of contracts and property rights, in the second the necessary markets are underdeveloped, and property rights are poorly protected—a situation that stimulates broad extra-market redistribution. Both equilibria are based on a numerical externality (presented in different versions in Murphy et al., 1993; Sachs, 1995; and Acemoglu, 1995), which can be summarized as follows. Where "good" (productive, law-abiding) behavior predominates, the structure of social incentives favors such behavior, productive efforts are institutionally feasible, and the benefits that accrue from such efforts are properly secured. In addition, any opportunistic deviations can reliably be expected to be punished by a government that has both the necessary resources and public support "to enforce [the law] effectively and relatively cheaply against the few individuals who break it" (Rapaczynski, 1996:88). On the other hand, where "bad" (counterproductive, opportunistic) behavior is widespread, the structure of incentives is such that rational individuals are encouraged to join the majority and engage in such behavior, particularly since productive alternatives are few and far between and unprotected against rampant redistribution.

The stability of these equilibria over time indicates that they have a "gravitational zone," capable of capturing and trapping the processes of institutional change. This means initial conditions will be highly important. Where structural distortions in a yet-to-be-reformed post-communist economy are modest, rent seeking should be relatively contained and subject to being overridden, if not suppressed, by emerging market-based interests. In such a case the government usually will not meet much resistance in implementing its reform program. If, however, the initial distortions are pervasive and deeply seated, market interests will be overridden and suppressed by rent seeking, and the government will be confronted with entrenched antireform opposition.

As one might expect, the more distorted the prereform economy, the more difficult it will be to accomplish the required restructuring. What may not be anticipated, however, is that such an economy is also less capable of developing the institutions required for the task. A similar conclusion is reached by

Acemoglu (1995:27): "reversing the adverse effects of misallocation is difficult because such a misallocation also leads to an unfavorable . . . reward structure" (see also Hedlund and Sundström, 1995). While Acemoglu focuses on the misallocation of human resources and does not endogenize the selection of a "bad" equilibrium (except for references to unspecified initial conditions and nonpecuniary rewards), our analysis ascribes the nonproductive use of human resources to the initial misallocation of complementary productive inputs. The causal links adduced above also explain why misallocation is sustained. According to this analysis, countries like Russia are in double jeopardy: not only is the scope of the necessary structural corrections extraordinarily broad, but precisely because it is so broad, it will be all the more difficult to create the tools required to bridge the gap.

The same argument, applied in reverse, serves to explain the success stories of economic reform. Where the initial structural distortion was limited, the amount of resources directed to rent seeking will be relatively modest, and the process of institution building will not be delayed by the actions of self-aggrandizing lobbies. Once the new, or reformed, institutions are in place, restructuring and growth follow promptly.

Politics is revealed as the linchpin of this process, and it should come as no surprise that opportunistic politicians and faulty policy measures are widely cited as the prime culprits for the failures of Russian reform. While our analysis corroborates this conclusion, it goes further by making the propensity for "bad" politics endogenous to the system, and by relating it to the unfavorable conditions extant at the initiation of the reform process.

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# 4

# Fuzzy Property: Rights, Power, and Identity in Transylvania's Decollectivization

*Katherine Verdery*

## INTRODUCTION

An especially challenging aspect of transformation in the post-communist states—challenging for both social policy and social theory—concerns the (re)creation of private property rights from the collective property of communism. It is not only in post-communist contexts that property rights are changing, but these contexts differ profoundly from others. In no Western country undergoing the privatization of socialized assets has social production existed on anything like the scale of that in the communist states. Moreover, public enterprise in the latter instances operated in political, economic, and jural systems governed by totally different rules from those of liberal capitalism, making the creation of post-communist private property rights a wholly different proposition from the divestiture of public property in countries such as Britain, France, or the United States.

For these reasons, the process amply deserves the rapidly growing corpus of literature devoted to it. This literature treats such questions as the theoretical relationship among private property, markets, and democratic politics (e.g., Comisso, 1991), the process of transforming public property into private and its consequences for economic development and state power (e.g., Frydman and Rapaczynski, 1994; Frydman et al., 1993; Kiss, 1994; Staniszkis, 1991; Stark, 1992), the justifying ideologies of transformed property rights and their social effects (e.g., Appel, 1995; Verdery, 1994), and the nature of the new rights being exercised (e.g., Comisso, 1991; Cornea, 1993; Hann, 1993; Stark,

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1996). Reports to date on emerging property forms speak not of a wholesale shift from public to private ownership,[1] but of mixes of these: different social actors hold different bundles of rights, and the definitions of the status of property are blurred and ambiguous.[2]

Among the tasks these investigations facilitate is a deeper inquiry into the very concept of property itself—what it means, and how property regimes are socially produced. Such an inquiry should also explore the ideological aspect of privatization as a centerpiece of the transition, for the neoliberal project of transforming public into private property has more than a practical aim (ostensibly easing the creation of markets, not to mention the interface with global capital); it has great ideological significance as well. This significance goes beyond the mere fact of constantly pressing for private property. If we see the transition as a project of cultural engineering in which fundamental social ideas are resignified—including not only democracy, markets, and private property, but also ideas about entitlement, accountability, and responsibility—then the (re)creation of private property is evidently a critical locus for this cultural project. The reason is that neoliberal property notions so often emphasize rights (entitlement) and obligations (accountability), whose subjects are normatively individuals (physical or jural) exercising exclusive rights. From this vantage point, all other arrangements look fuzzy.

The purpose of this chapter is twofold. First, I suggest that to understand property in post-communist contexts, one must go beyond defining it in terms of rights and obligations that assume individualized property subjects. I prefer instead a property analysis that invokes the total system of social, cultural, and political relations and inquires into, rather than assuming, the nature of property conceptions (Hann, 1993; Ghani, 1996). That is, I seek to broaden the way we study the property aspect of post-communism. Second, the chapter chronicles a specific moment in which a specific set of property conceptions was taking shape, which favored not individual but collective property rights based in collective labor. By investigating this moment, I hope to show the social processes through which a new property regime is produced. My data come from Aurel Vlaicu, a Transylvanian village undergoing decollectivization. The breakup of its collective farm has resulted in a complex array of property forms and claims, antithetical to what I believe the neoliberal architects of privatization had in mind; hence I label the outcome "fuzzy property."

[1]It is common in much social science writing today to put scare-quotes around words whose customary meanings we want to question. The standard style for this volume precludes such usage; nonetheless, I ask readers to be aware that many terms appearing in this chapter are used in a way that questions their standard referents.

[2]Opinions vary as to whether these mixed, ambiguous forms are a good or a bad thing. For Staniszkis (1991), they are the route to a Polish capitalism; for Cornea (1993), they are a ticket to economic stagnation and communist restoration; and for Stark (1996), they are flexible forms that are likely to prove adaptive in the shift to market economies.

The chapter begins by describing some of the overlapping rights and claims to land that prevailed in this community as of 1996, and argues that these have meaning only in a larger enabling context. It then describes an episode in which collective property forms with overlapping rights were strengthened at the expense of exclusive individual ownership. Using ethnographic methods, I seek to document transitional dynamics that might otherwise remain invisible—though not in their long-term effects. In this episode we see the intersection of interests and dispositions that served to maintain complex property rights at a moment when these might have been simplified. We see as well how these rights are bound up with power relations, with social identities and notions of self, and with embeddedness in social networks. Both parts of the discussion explore different reasons why emerging property forms seem "fuzzy" from the vantage point of an idealized image of exclusive private property, and seek to show the processes and calculations generating this fuzziness.

I speak of "fuzzy property" partly to indicate that I view simplistic notions of private ownership ironically, and I leave the concept somewhat vague since property rights can appear indistinct for a variety of reasons. Different people may contest ownership of a single object, complicating the assessment of use rights, obligations, and claims to revenue. If property is a relationship between persons with respect to things, conflicting definitions of that relationship give the things in question ambiguous status. Property rights may also appear ambiguous because several different social actors enjoy overlapping claims to something. For example, the sovereign may have the right to allocate and recover use rights to certain lands, as well as have a claim on its fruits, while households actually exercise these use rights and perform all the labor, and lineage heads claim managerial rights and a share of the harvest. In such cases, the hierarchy of rights and obligations may in fact be quite *un*ambiguous, but from the point of view of privatization programs such as those being implemented in the post-communist states, the rights appear fuzzy because of their complex interrelations and the multiplicity of actors holding them. Yet other reasons for fuzziness appear if we define property (following Ghani, 1996) as a bundle of powers crystallized into practices of exclusion and inclusion within routinized rules.[3] Fuzziness, then, will lie precisely in the *lack* of routinized rules and crystallized practices around private property in the context of post-communism, as well as in the constraints on exercising bundles of

[3]Ghani's full definition is considerably longer: "Among stratified communities, property in land can be defined as a: (1) bundle of powers; (2) crystallized into marked forms of practice; (3) having routinized rules of the game; (4) regulating domains of rights of inclusion and exclusion; (5) in cultural traditions where persons, objects, rights and obligations are defined; (6) thereby setting forth fields of maneuver over control and access to land; (7) leading either to certain forms being sanctioned through power; (8) or to the reconstitution of the bundle of powers in new forms" (Ghani, 1996:3).

powers. The term "fuzzy property" covers all these forms of indistinct, ambiguous, and partial property rights.

## THE CONTEXTUALLY LIMITED EXERCISE OF PROPERTY RIGHTS

The chief social actors in the scenarios that follow are individual residents of the village of Aurel Vlaicu (county Hunedoara, Romania), where I conducted research during 1993-1994 and 1996;[4] the mayor and other officials of the commune in which Vlaicu is located; and a new organizational form, the Aurel Vlaicu Agricultural Association. This last requires explanation. Throughout Romania (and some other countries of the region as well), the return of land to its former owners entailed the liquidation of collective farms (known as CAPs), sometimes accompanied by the creation of new entities—associations.[5] The association is a kind of producers' cooperative whose raison d'être is that very few of the new proprietors owned the equipment necessary for cultivating their newly returned land, and many of them were too old to carry out the work of farming it. Moreover, in the Romanian case, many new landowners did not live in villages at all, for the restitution process permitted *all* heirs of former owners, even those living in distant cities, to claim family land. To ensure that newly private land would not go uncultivated, thus requiring massive food imports, the government encouraged people to form associations.

All members of the Aurel Vlaicu Agricultural Association signed over to it the land they received following passage of Romania's law on property restitution, known as the Law on Agricultural Land Resources or Law 18/1991. It was understood that the owners held and would retain ownership rights to the land placed in the association; they transferred managerial rights over cultivation in exchange for a payment from the harvest.

I see association property as fuzzy for a number of reasons, of which I will mention three. First, Law 18 established a number of fairly stringent constraints on an individual's private property rights by setting up a hierarchy of prior rights and claims. For instance, it constrained the land's use: owners of agricultural land did not have the right to leave it uncultivated, on penalty of a fine (Law 18/1991, articles 53-55), or to change the category of its use—say, from vineyard to pasture, or arable to houseplot—except under certain conditions and only by permission of the Ministry of Agriculture (articles 56, 57, and 69). There were limits on acquisition as well. No one could claim more than 10 hectares per family (articles 8 and 9) or thereafter acquire more than

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[4]The 1993-1994 research was supported by IREX; research in the summer of 1996 was funded by the National Science Foundation.

[5]For a description of this process see Verdery (1994).

100 hectares total (article 46). In addition, the law controlled the sale of agricultural land, making it contingent on the prior exercise of rights of preemption by an organization called the Agency for Rural Development and Planning (article 48), which as of mid-1996 did not yet exist. Such provisions suggest that the state held the most inclusive, prior rights over land disposal and use; in other words, it occupied the first rung in a "hierarchy of estates" of administration over land (cf. Gluckman, 1943).

Second, Law 18 biased the constitution of subsequent property rights in a collective rather than individual direction: it gave associations as jural entities the edge in acquiring property of moribund CAPs. A crucial clause reads as follows:

> Zootechnic constructions, workshops for small manufactures, machinery, equipment, and other such fixed means belonging to the disbanded CAP, as well as the land underneath these and the land necessary to using them, and also vineyards and orchards and animals all become the property of the members of associations of a private nature having the status of jural persons, if these are established (article 28).

In a word, CAPs would "morph" into associations; their social capital was assigned as shares to the members by an algorithm linking one's total land and labor contributions to the CAP. Only those villagers who chose not to belong to the association were to be separated out fully from the collective and paid in money or kind for their share of the fixed capital. Thus conceived, the law presented the transformation of CAPs into associations as the "default option"; their disaggregation into fully individual proprietorships required extra work. We see clearly in this a systemic bias toward quasicollective property arrangements.

Third, even once a person obtained undisputed title to a specific surface area of former CAP land, theoretically holding all the rights of use, enjoyment, and disposal not reserved for the state, that person faced serious contextual constraints on the exercise of these rights. Most people who received land did not own the implements needed to cultivate it, nor did interest rates on loans and credit permit them to buy that equipment. Hence, many signed their land over to associations, thus entering a realm of intricately overlapping rights and claims that seriously limited their ownership status (see Verdery, 1998, for further details). The association, for its part, acquired rights to manage and use the land and to take its fruits, but also the obligation to redistribute to members some of those fruits. Members held overlapping rights to the revenues, which they were obligated to share with other members. The association's duty to provide members with revenue often conflicted with rational cultivation strategies, thus constraining the exercise of managerial rights; these rights were further circumscribed by the highly fragmented state of the newly restored landholdings, as well as by the right of members to withdraw their land at will and their reluctance to provide labor for the association's labor-intensive tasks. Added to these impediments to associations' exercise of their managerial rights was their dependency on the state for mechanized inputs (their inheritance of the CAP's fixed capital was rarely adequate for efficient cultivation), credits, and prices. Problems with obtaining cheap credits to modernize their implements are probably the single most important limiting factor on what associations can do with the use-rights they enjoy.

In short, although Law 18 gave owners and managers certain rights and obligations, various systemic constraints obstructed their exercise. This shows how inadequate it is to consider property chiefly as a matter of rights and obligations. Exclusive individual ownership rights to land, which many in both Eastern Europe and the West see as the goal of decollectivization, are effectively constituted only within a total field of relations among institutions, policies, and social actors. These relations shape what actors are able to do with property, modifying the rights to which they may be entitled and the obligations to which they may be held. Fuzzy property in this context consists of complexly overlapping use and revenue rights lodged in external conditions that give the holders of these rights incomplete powers for exercising them. The emergence of something more closely approaching exclusive individual proprietorship would require not so much clearer legal specification of who has what rights—these rights are fairly clear already—but modifications in the surrounding economy, modifications that would permit individuals to acquire the means of cultivation affordably and to dispose profitably of their product while outcompeting quasicollective associational forms. Such modifications, in turn, depend on various parties' electoral fortunes, intergovernmental relations, decisions by international lending agencies, and other matters not usually included in discussions of property.

If property is more than just rights and obligations, it is also more than just the surrounding political economy; it entails complex meanings, often revolving around ideas about labor, persons, community, and kinship. These meanings are not necessarily those of Western privatization programs. Post-communist property regimes will gradually develop from repeated interactions between macrosystemic fields of force and the meanings, behaviors, and values of people caught up in them. The next section explores the dynamics of transition in Romania's property regime by examining a specific event that helps reveal more fully the meanings of "property." In this event, individual ownership rights were asserted and rejected in favor of persisting fuzzy property and collective rights. Behind this outcome lay not only a certain set of power relations, but also convictions about social justice and self-actualization. I offer considerable detail on this case to provide evidence of a sort rare in the literature on post-communism: the ethnography of cultural reproduction.

## THE TRIAL: INDIVIDUAL VERSUS COLLECTIVE CLAIMS

While in the office of the Vlaicu association one day in November 1993, I learned that its agronomist and accountant had wasted their morning in court. They told a complicated story about the liquidation of the collective farm, an irregular auction of a granary, a resulting lawsuit decided against the plaintiff—a villager I will call Ionescu—and an appeal aimed at annulling the auction. A few weeks later I ran into Ionescu on the street. He greeted me with much enthusiasm and invited me over to hear his side of the story, encouraging me as well to ask certain other people for their opinion. My curiosity piqued, I asked two of them about Ionescu's case.[6] One replied, with feeling, that the granary should belong to everyone, not just to Ionescu, adding, "He's boasted all over the village that he'll get the granary and will never have to work again, just live off renting it out. Shouldn't it belong to the village, rather than to just one person? The whole village built it, after all." The other disagreed, however, saying that Ionescu had been the victim of a breach of the law. Law 18 had special procedures for auctioning off the goods of collective farms, he said, procedures that had been closely followed until the officers of the prospective association had interfered with the auction unlawfully. Ionescu was right to sue them. Agreeing that it would of course be better to have the granary used by 100 people than by one, this man nonetheless felt that there were larger principles at stake: Do we or do we not respect the law, and do we or do we not give property to individuals who will take good care of it (as the association, he feels, does not)?

These four brief conversations—with the two association officers, with Ionescu, and with my two friends—set the coordinates of what became a village-wide controversy over privatization. Virtually all the significant issues appeared in these commentaries. I spent the next several months filling them out by attending the sessions of the court case; discussing it with the plaintiff and defendants, as well as with the presiding judge;[7] and asking many other villagers their opinion of it. Not having been present for the critical auction, I cannot say what happened there, but I am fairly confident of what was at issue in the case: a clash between procedural issues on the one hand and the "public good" on the other, and between the conditions promoting individual entrepreneurship as opposed to certain values of community. These conflicts lie at the heart of privatization all over Eastern Europe; they are also

[6]The two people in question were about 70 and 45 years of age at the time; Ionescu was about 55.

[7]By arrangement with the vice-president of the county court, I sat in this judge's courtroom three to four times a month and listened to cases, specifically attending to those about land. By the time the lawsuit against the association came up, I knew the judge reasonably well and had had a number of discussions with her. I was sent to this particular judge because many of the other judges had much less experience and therefore were less often assigned difficult cases pertaining to Law 18.

central to producing a new property regime, with specific conceptions of property, as well as specific conditions that either favor or impede autonomous individual action and ownership relations.

Before proceeding, I should emphasize a salient feature of this case: it is about the privatization of a good that, unlike land, had not been privately owned before. It thus resembles privatization of the industries that were built up during the communist period and were visibly the product of people's labor in that time, when collective labor produced collective products having no "owners." Land, by contrast, has prior owners; its privatization creates conflicts between those owners and others who feel themselves entitled to a share by virtue of their work in the collective (see Verdery, 1994:1105-6). With the Vlaicu granary, that sort of conflict was not present, and this brought the question of public good more cleanly into view.

As best I can determine, the events leading to the dispute went something like this. Law 18, providing for the liquidation of collective farms and the return of their land and animals to the former owners, unleashed chaotic activity because the terms within which everything was to be resolved were fairly short, and no one really knew how to do what they were supposed to be doing.[8] The law gave each CAP 15 days to constitute a so-called liquidation commission and each commission 9 months to dissolve the CAP (article 26). As already noted, the law foresaw the possibility of setting up associations—privileged recipients of the fixed capital of the old CAPs, which would otherwise be sold at auction and the proceeds distributed to members.

In Vlaicu—and presumably not there alone—it took a while to form an association. A few villagers began occupying and working their land singly; some of the personnel of the dissolving CAP began to think about forming an association, but were having trouble figuring out how. On July 5, 1991, then, when the association was still just an idea and not yet a jural entity, the village liquidation commission put in the newspaper the notice required by law, stating that every Thursday from 10:00-2:00 "until the patrimony [of the CAP] is liquidated," public auctions would be held for the sale or rental of buildings and the sale of equipment and other objects.[9] One aim was to obtain enough money finally to launch the association. Its first organizational meeting took place in March 1992, but its legal incorporation would occur only 5 months later, in August, after several items had already been put up for auction. These

[8]People had 30 days from the time the law went into effect to make their claims. Claims could be made on the basis of several possible kinds of evidence, which might in fact conflict and to which many villagers did not have ready access. Urbanites wanting to claim village lands had even more difficulty doing so if they lived any distance from their natal villages. The entire process of restoring ownership rights was to be completed within 90 days of the law's promulgation (article 10, paragraph 5).

[9]*Cuvîntul liber*, 5 July 1991. The term "patrimony" is widely used in Romania to indicate collective property. Space does not permit an exploration of this fascinating concept.

included three of the five cattle barns, some equipment, and the only available tractor.

By his own report, Ionescu showed up on Thursday, July 30, 1992,[10] to buy a CAP building. Also present were several representatives of the prospective leadership council of the embryonic Vlaicu association—I will call them the quasi-council. When this group outbid Ionescu for one building he wanted, he proposed bidding on the granary; the quasi-council made another bid, and Ionescu raised the offer. At this point one of the quasi-councilors asked that the bidding be stopped so the quasi-council could consult with association members as to how high they were willing to go. The president of the liquidation commission then suspended the bidding.

These events took place amid considerable confusion. As one of those running the meeting explained to me, "We had no idea how to do an auction, how to proceed with liquidating the CAP; my image of an auction was from American TV movies—standing in front of people and calling out numbers—but that's not how it was happening!" Although the liquidation commission had requested a legal aide from the county capital, none turned up. No one knew whether it was acceptable to suspend the bidding, but under the circumstances—in which people representing an embryonic association suddenly realized it could not function without a granary it did not yet have the resources to buy—that seemed the thing to do. The decision was not only logical but also possible precisely because most of the people on the liquidation commission were also on the quasi-council of the prospective association.

Deeply upset by what had happened, Ionescu complained to the mayor, who came on Saturday (August 1, 1992) and reopened the bidding. But Ionescu now refused to bid, saying that he had won the real auction held 2 days earlier, and Saturday was not a day listed for auctions. Overriding his objections, the association raised his earlier bid by a small margin and was awarded the granary. Ionescu got a lawyer, sued the liquidation commission, and lost. He filed an appeal to have the auction annulled for breaching the published terms that auctions were to be held on Thursdays only. By the time his appeal began (January 20, 1994), a year and a half had passed since that auction, and the association was a well established—indeed an essential—player in village life.

The appeal took place in two court sessions, which I attended. At the end of the second session, the lawyers for the two sides summed up their arguments as follows. The plaintiff's lawyer argued to annul the auction for procedural irregularity: (1) two persons who had bid on the granary for the association were also members of the liquidation commission; (2) the law requires publicity since sales are not for a limited number of people, but for all

[10]This auction thus took place well after the 9-month cutoff point at which all CAPs were to have been liquidated.

potential buyers, some of whom were unaware of the Saturday auction; and (3) it was impossible for the association as such to bid on the granary in July, for it acquired legal status only in August. Thus, the quasi-council could bid only as private individuals, which would mean they had no grounds for suspending the auction to consult with anyone else. The lawyer emphasized that the manner of the auction contravened the interests of the public and of the former CAP members since the lack of publicity kept potentially higher-bidding participants from attending, and this reduced the proceeds from the sale that could be distributed to villagers.

The defense lawyer rejected the suit, saying that (1) the plaintiff could have bid on Saturday (he had done so for earlier purchases), but did not; (2) as someone pursuing a private outcome, he was not legally qualified to sue in the public interest; and (3) because article 28 of Law 18 specifies that the fixed assets of CAPs automatically become the property of associations, the granary need never have been put up for auction at all. The lawyer called into question the very notion of "public good" used by the prosecution, asking whose interests were to be protected by wide publicity—those of people in cities and towns far from the place where things are being sold, who would have little reason to want a granary in a small village and might do antisocial things with it?

The summaries made it clear that completely different principles were at war in this case. One was that because article 28 of Law 18 privileged new collective forms, the auction need never have occurred, in which case all the other arguments were moot. Upholding the law in the broadest sense was thus compatible with ruling against the plaintiff. Alternatively, because Law 18 gave precise instructions about the conduct of auctions (and these had clearly, in my view, been breached), one could argue that it would be upholding the law to rule in the plaintiff's favor. There was also the matter of the association's legal status at the time of the auction, which might or might not be seen as adequate to qualify it for inclusion under article 28 of Law 18. Then there were questions about just what it means to defend the public good: How should one construe the "interested public" for purposes of selling off collective property, how broad should that public be, and who is qualified to defend its interest?

The question of the public good turned out to be decisive, as I learned from conversations with the presiding judge after she ruled against the plaintiff and dismissed the case. Her reasons, as she explained them to me, were these. First, given the provisions of Law 18, article 28, the whole auction was unnecessary. While acknowledging that she could have ruled against the association since it had no jural status at the time of the auction, she preferred to see the evidence that it was forming as sufficient grounds for applying article 28 and awarding it the CAP's fixed property. Behind this preference stood, second, her belief that the law should protect the interest of the greater number—the members of the association, rather than a single individual. In this case the plaintiff could not claim to be defending the social interest himself, for a larger social interest was represented by the defendants, and he could not sue for protection of his personal interest, since he had forfeited this by not bidding on Saturday when he had the chance.

Whatever the reasons for the judge's decision may have been,[11] the effect of her decision was to deny legal sanction to those who would have moved an object from an ambiguous status, subject to overlapping claims and rights on the part of individual owners and collectivity, into Ionescu's clearly defined, exclusive private ownership. By her decision, the granary remained the property of the association, belonging to all and managed by their representatives. It thus joined the larger patrimony of collective property in Romania that includes associations, state farms, and other state-owned enterprises. Each member had a claim on it—in fact multiple claims, motivated not only by their present share in the revenues that might help maintain it, but also by conceptions about the role of labor in property owning. Here the goals of the judge, local authorities, and association leaders that intersected in ruling the granary a collective good coincided with conceptions and values held by many villagers.

As I went on my rounds during these weeks, the trial was a prime topic of conversation, and the overwhelming opinion was that the association ought to win. Included in the file for the case was a full list of association members, over 70 of whom (65 percent) had signed a statement expressing the widespread view that the granary had been built with their labor, and they in no way agreed that it should become Ionescu's property. After the verdict, I heard repeatedly one or more elements of the following collective opinion: "It's very good that he lost the trial. He never worked in the CAP a day in his life. We all built that granary; it was hard work, and he didn't do any of it. There are many of us; we aren't a single person trying to become rich overnight! He's the kind of person who never really liked to work, was always looking for a way to get by easy—he even boasted he'd get this granary and never have to work again, just live off the interest! He's not even from here. Why should it go to a single individual, when it's the work of all of us and we need it? You can't give the wealth of everyone to a single person!"[12] Only 4 people (of the over 30 families from whom I noted an opinion) dissented from such views, and each had good reason. About half the villagers who expressed an opinion against Ionescu were members of the association; most of the others had received some land and were farming it themselves. A small number were inmigrants (like Ionescu) who had received no land, had little

[11]Some candidates are genuine conviction, a bribe from the defendants, and orders from county authorities.

[12]Kim Scheppele (personal communication) has found similar popular sentiments in the petitions from villagers to the constitutional court in Hungary.

possibility of benefiting from the granary, and thus might have sided with him. But even among these people, many saw the granary as a public good, usable (for a fee) not just by the association and its members, but by anyone.

The widespread opposition to Ionescu's suit, then, did not rest chiefly on the prospect of benefiting from the granary if he lost, even though the structure's utility was clearly significant to people. Nor was it a simple question of locals against inmigrants, although this division did play a role. Rather, I believe, it was a reaction against certain aspects of the construction of capitalist individualism that Ionescu unfortunately represented, as well as against the associated notion of private property. Implicated in both are deeply held values concerning community and the definition of self in relation to work. To explain this, and to show why Ionescu's suit catalyzed so vigorous a reaction among his fellow villagers, I should say a further word on his personal characteristics.

Ionescu is not a native-born Vlaicean; he comes from a neighboring village, whence he married into Vlaicu in the 1960s. His in-laws likewise are not natives of Vlaicu, but moved there from a hill village; by local status conceptions, they are "strangers" [*străini*], "inmovers" [*veniţi* or *venituri*] of relatively poor hillbilly origin, held in some contempt by the locals. Having no land, the family gave nothing to the collective farm at its formation and were not regular members of it. Ionescu himself had served as the village bus driver during the 1970s and had gained a certain sympathy; this was easily reversed, however, following his 1980 visit to a brother in the United States, from which he returned full of "American" ideas about how to get rich without working hard. From then on, he conformed to the stereotype of capitalist enrichment that was central to Communist Party propaganda. Vlaicenii had been laughing for years behind his back at his plans for one or another venture in which other people would put in the effort and he would "contribute the brains" and get the profits.

Why are these details significant? They illuminate the system of self-conceptions and social boundaries within which Vlaicenii constructed the public good and the public property that would serve it. The core of the village's reaction to Ionescu's case (echoing language used by the judge in her conversations with me) was that the granary is a public good and should not be monopolized by a single person. It is a public good not because it was part of the collective farm, but because it embodies the labor of those who lived in the village when the collective was formed in 1959. Those villagers built the buildings of the CAP in their "free" time, through "voluntary" labor, with coercive work norms to urge their voluntarism along. In a certain sense, these buildings embody the common suffering of all those who lost land to the collective: the structures were the result of everyone's combined labor, but alongside their sweat were blood and tears. Anyone (such as Ionescu) who did not participate in that experience but wants to appropriate its results finds himself facing the community from the outside.

This notion that the structures of the CAP in some sense represent villagers' personal substance appeared in the comment of a local functionary who observed, concerning the looting of the CAP buildings in many settlements throughout Romania, "The buildings of the CAP weren't *communist*, they were *people's work*!" The same notion appears even more starkly in the procedure by which villagers in Noul Român (in southern Romania) decided to dismantle their CAP buildings: they marked off with a tape measure separate sections for each family, the area corresponding precisely to the amount of work each family had given to the collective; each family then took the building materials from its section.[13] Similar procedures occurred elsewhere.

The same connection between owning and working appears in villagers' opposition to Ionescu as "lazy," as "not liking to work." People drew a contrast between we who work and he who is lazy. More to the point: he wants to be lazy *at our expense*. Vlaicenii could get positively apoplectic at the rumor that Ionescu would buy the granary and then rent it back to people to store their grain; thus, they would sweat in the fields, and he would sit with his feet up, profiting from their efforts in the present as well as in the past. Community property would thus be used to exploit community members. One woman put the problem thus: "The whole village is saying, 'Why should he get the results of our work?'" In short, private appropriation from the fruits of collective labor is wrong. The rumor about Ionescu's intentions fueled his difficulties, then, because the villagers so strongly associate possession with work.[14] From among numerous comments supportive of this point I cite one woman's succinct summary in telling me why a certain piece of land should belong to her: "It's mine because I worked it" [*e al meu căeu l-am slujit*]. We can only conclude that John Locke is alive and well in Transylvania.

Public reaction against Ionescu therefore rested on property conceptions involving notions of "community" and "person" and how self is formed in relation to these. Central to both were concepts of kinship and labor: Ionescu was placed outside the boundaries of community because he acted (or was suspected of acting) individualistically, like someone with no kin, and because he was seen as not valuing labor and the things built up from it; nor was his labor embodied in the public goods he wished to appropriate. Also at issue, I believe, was the larger—and very painful—process of seeking meaning for ruined lives. All the villagers and especially the elderly, who lived through the devastating experience of collectivization that many felt as a live amputation, are struggling to recast and revalorize the past 40 years. For these purposes, ideas about work, possession, social embeddedness, and community are vital.

[13] I have this report from Prof. Aurel Răduţiu of Cluj.

[14] For further detail on this point, see Verdery (1994:1105-1106) and Lampland (1995:100-103).

After the judge's decision, feeling subsided except among Ionescu and his few allies, who protested that the judge was a "communist" and the legal process in Romania a farce. One of them complained that the so-called collective interest should not overwhelm respect for correct procedure. Others summed up the collective-vs.-individual issue by observing that Ionescu had erred in thinking he could take on the whole village. More unnerving was the word that spread from those opposed to Ionescu's plans. Several villagers had sworn, it was said, that had he won the trial, they would have burned down the granary rather than have it become his. From this we see clearly the depth of the passions the case aroused over matters of owning, public vs. private, destruction, and appropriated work.

The above discussion has shown that many of the villagers preferred to maintain a situation of ambiguous and overlapping property rights rather than promote their disaggregation: instead of entering the exclusive private ownership of any one person, the granary remained "ours," with pieces of our work embedded in it. The reasons for this preference, I have argued, relate in part to the benefits villagers saw in having a collectively owned structure they could use in the absence of proper storage facilities of their own; that is, the lack of a storage and distribution infrastructure directly affected their interest in the building. At least as important, however, were people's sentiments about work, self, and the acceptable appropriation of the fruits of their labor—sentiments marshaled in revalorizing fractured lives and recreating meaning. It was not villagers' preferences and strivings, of course, but those of the judge that determined the trial's outcome. And although her reasons emphasized defense of the public good—which she did not see as resting in individual private property relations—more than ideas about self and work, "property" for both her and the villagers emerges with a distinctively collective coloring.

Because judge's and villagers' preferences intersected in the judge's decision, most villagers had the sense that justice was done. For them, the trial built credibility for the legal system and the larger political order behind it, legitimating certain communal values over those of exclusive individual ownership and gain. These values were reinforced not because of a corrupt, captive, or Stalinist judiciary, but because the trial mobilized deeply held senses of self and valued notions about community.

## CONCLUSION

What does the discussion in this chapter suggest about ownership, about the relations we think of as property, and about the transition? First, it underscores the truth, easily forgotten, that property is about social relations, relations among persons rather than between persons and things. It shows that one cannot set things off as wholly separate from the persons who exercise property rights, for property is also about self and definitions of selfhood: it is about relative investments of activity and of self in things, and about the sense of worth entailed in these investments. Property is therefore about the boundaries between self and nonself—and, as this discussion has shown, such "self" is not necessarily individual, but can also be collective. Property understood collectively lacks the clear edges of an ideologized notion of exclusive private ownership; it is, in this sense, fuzzy.

Second, the discussion suggests that post-communist ownership patterns generate these kinds of fuzziness because of the complexly overlapping rights, obligations, and claims that emerge from communist property relations. These rights and claims have just begun to crystallize into routines and practices, and what should be "bundles of powers" are still far from empowering. In part, property remains fuzzy because people prefer arrangements that obscure individual liability and separate obligations from assets in conditions of general economic uncertainty (Stark, 1996:1019-1021). We might express the point in a metaphor: just as the crystallization of a snowflake depends on the ambient temperature, the crystallization of exclusive private ownership depends on the ambient conditions and the relations among actors in an overall field of power; thus, to see the snowflake itself as representing property is inapt (we might say it is just the tip of the iceberg). This point and the preceding one together suggest that to understand post-communist property, we must look beyond both things and the rights claimed to them, focusing instead on meanings, relations, and powers.

Finally, this discussion shows the transition as a process in which new constellations of possibility and constraint work on notions of value, both inherited and emergent, to produce post-communist property regimes with only a messy relationship to their Western blueprint. The changes inaugurated in 1989 created new fields of action in which communism's legacies—such as forms of collectivism—are not simply reproduced; they are revalorized within the struggles that mobilize them. Before Ionescu's trial, if a different kind of person with a different project had bid on the Vlaicu granary, it is quite possible that the villagers would not have defended collective rights with such vigor. After the trial, however, I believe that definition of rights became more robust. Here is where ethnography—ethnography not just *of* but *in* the transition—is unparalleled as a path into histories of the future.

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# 5

# Rule Evasion in Transitional Russia

*James Leitzel*

The world is not thy friend, nor the world's law;
The world affords no law to make thee rich;
Then be not poor, but break it and take this.

Shakespeare, *Romeo and Juliet*

## INTRODUCTION

Policy reforms change the official rules. If people obeyed the rules, in both letter and spirit, reform would be a conceptually simple task. People, however, are quite ready to violate or circumvent rules, as a few minutes observing the behavior of drivers will make clear. Such evasive behavior would present little difficulty for reformers if the extent and direction of rule evasion or avoidance could be determined in advance. In practice, however, the ingenuity shown by individuals pursuing their own best interests cannot be anticipated by dispassionate (or even passionate) policy analysts. As a result, the potential for rules to be evaded clouds the relationship between policy changes and economic outcomes. The problem is exacerbated during a systemic reform in which countless rules are changing simultaneously, and the degree of enforcement of the new rules has not been established.

Rule evasion complicates policymaking in a second way. To the extent that evasion is illegal and punishment is a possibility, individuals will want to conceal their evasive activity. Thus, measures of economic activity often fail to account for evasive or underground behavior. Policymakers, then, may misunderstand the prereform conditions and choose inappropriate reforms. The problem is reproduced in assessing the impact of reforms, both because the starting point is misunderstood and because postreform evasive behavior may be uncounted. It cannot be assumed that unrecorded activity remains constant: systemic reform often changes the extent and character of hidden behavior.

Not all rules, of course, are created equal. A gross oversimplification is that laws that seek to prohibit voluntary exchanges (in the absence of negative third-party effects) are socially inefficient, while laws that prohibit or regulate coercive relations are good rules (see Epstein, 1995). Somewhere in between are rules that seek to tax or regulate, rather than to prohibit, voluntary exchanges. Breaking a bad law can result in a Pareto improvement. Breaking a good law probably makes society worse off.

While evasive behavior complicates the analysis of policies, it simultaneously can promote reform. Evidence of widespread evasion often will prompt a policy change. Wide-scale evasion of good rules, such as those against violent crime, will tend to be met with stricter enforcement or harsher punishment. Inefficient rules that are violated with abandon, however, will be more likely to be altered, or to become effectively dead letters through a lack of enforcement.

The transition from central planning to a "normal market economy" in Russia highlights the various roles played by the circumvention of rules in reform. The prereform economy included extensive second-economy dealing, very little of it captured in the official statistics.[1] One paradox of reform is that despite significant liberalization, subterranean economic activity apparently has increased during the reform era. Tax evasion is rampant. Crime, including organized crime, is a serious problem. The circumvention of government rules is so pervasive that some commentators question the efficacy of any policy change.

The purpose of this chapter is to examine more closely Russian economic reform and evasive behavior. The next section reviews the prereform situation, while the section that follows investigates those aspects of rule circumvention that have become important during the transition. The final section is devoted to the specific conditions of Russia and the role evasion might play in future reforms.

## RULE EVASION DURING THE SOVIET ERA

> After 60 years of experience with a Socialist economy run by government agencies, nearly everyone seems to have devised ingenious ways to turn its shortcomings to his individual advantage (Schroeder, 1979:340).

[1]Grossman (1977) defines the second economy as any activity conducted for private gain or performed in knowing, nontrivial contravention of the law. A large part of the Soviet second economy thus consisted of the legal collective farm markets.

Rules governing economic activity were pervasive in the Soviet Union. The annual plan was a major source of rules, guiding the allocation of goods within the state sector. Prices and wages within the state sector also were centrally determined. Furthermore, the state sector was itself very large as a result of rules that prohibited most forms of private economic activity.

The prevalence of rules within the Soviet economy was matched by evasion of the rules. The rigidities of central planning virtually required informal or illegal activity, even for state-owned enterprises, to meet the plan. Many goods were allocated illegally outside the plan. Price controls were evaded by bribes, whether monetary or in kind. Private economic activity flourished underground. Theft of state property was common enough that it became an accepted practice, almost a standard component of compensation.[2] Leonid Brezhnev was reported to have said, "No one lives on wages alone. I remember in my youth we earned money by unloading freight cars. So, what did we do? Three crates or bags unloaded and one for ourselves. That is how everybody lives. . . ."[3] Indeed, the second economy probably helped bolster the planning system by compensating for planning errors or shortcomings and by contributing to higher living standards. That some forms of economic crime in the prereform system were accepted and perhaps even socially beneficial is highlighted by the lack of social opprobrium attached to them.[4]

Almost from the beginning of Soviet power there was significant evasion of the economic rules.[5] But it was only during the Brezhnev era that the second economy began to expand noticeably (Millar, 1988; Treml and Alexeev, 1993). Sixty years was enough time for people to devise "ingenious"—and generally illegal—methods of making the most of central planning.

Early Gorbachev-era reforms attempted to legalize some of the existing activity and encouraged more private enterprise. The consequence was a

[2]Gaddy (1991) finds a negative correlation between official wages and the potential for informal earnings through the workplace, suggesting that in effect planners offered lower official wage rates in those occupations with good opportunities for theft or bribe income.

[3]From F. Burlatskiy, *Literaturnaya Gazeta,* as quoted by Treml (1990:2). The fact that Brezhnev apparently engaged in theft represents a slight increase in the amount of theft since czarist times, or an increase in the amount of honest confession. Nicholas I told his son, "I believe you and I are the only people in Russia who don't steal" (Chalidze [1977:28], citing Yakushkin, *Obychnoye pravo* ([Customary Law], Introduction to Volume 1).

[4]In particular, theft from the state received little social sanction, despite higher official penalties for theft of socialist property than for theft of private property (see, e.g., Grossman [1977:29] and Shlapentokh [1989:90-91]).

[5]Shmelev and Popov (1989) note that even during the period of War Communism, when private trade in grain could be punished by death, more than half of the grain that reached urban areas did so through private traders. Berliner (1952) documents the extensive informal operations within Soviet enterprises during the Stalin era.

whole new set of loopholes for various forms of spontaneous privatization. The possibility for state-owned enterprises to deal with private cooperatives broke down the wall separating cash and "noncash" rubles—the latter being accounting rubles employed in state-sector trade. As noncash rubles were quasilegally monetized, control over the money supply was loosened, which in turn led to higher inflation. With price controls in the state sector, inflation enlarged the gap between official prices and prices in the parallel markets. A self-reinforcing mechanism was thereby established: the larger price gap further increased the incentive to evade restrictions and spontaneously privatize; more and more goods were diverted out of the state sector in ways that led to money creation; there was more inflation, followed by an increased gap between fixed and free prices; and so on. Eventually, price controls and central planning were jettisoned, after they already had lost a good deal of their significance (see Leitzel, 1996/1997).

Wide-scale evasion of the economic restrictions of the Soviet economy thus paved the way for market reform. Nevertheless, as suggested above, the smaller-scale evasion that occurred throughout the Soviet era probably helped maintain the system. Why did pre-Gorbachev evasion serve as a substitute for reform, while the later wide-scale evasion promoted economic liberalization?[6] Two factors would seem to be important in determining the extent to which evasion leads to liberalization: the net social benefits of liberalization and the distribution of the benefits. Massive reforms will tend to be enacted when they offer significant net social benefits and when relatively few are harmed by them—a notion formalized in the "political cost-benefit ratio" of Rodrik (1991).[7] Wide-scale evasion, however, by generating a de facto, informal reform, improves the political cost-benefit ratio for liberalization. Legalization of the existing market activity can then proceed with diminished distributional consequences, while still offering social benefits by removing the need to conduct economic activity with stealth.

In essence, if an economy has, by and large, become marketized, it will be better if the markets are legal; alternatively, if the existing informal marketization is not too extensive, liberalization will result in significant redistributions. The tendency for large reforms to be postponed until large-scale evasion has already produced an informal transition can be detected in a wide variety of circumstances. Monetary reforms, for instance, often follow massive flight from the domestic currency.

More generally, the tendency for widespread evasion to lead to better policies, as opposed to simply different ones, is likely to be greater in systems

[6]A more general version of this question is examined by Leitzel (1996/1997).

[7]The relative political power of those who gain and lose from the reform also is a determinant of the likelihood of reform, as is the extent to which corruption lessens the interest of government officials in taking socially beneficial actions.

where the policy process is responsive to individual preferences. With a reasonably responsive political system, wide-scale evasion is a force that promotes the efficiency of policies. Evasion of "good" rules (such as those against violent crimes) will be met with tighter enforcement, whereas the political cost-benefit ratio favors the abandonment (or massive reform) of socially inefficient policies.

A further consideration in the relationship between rule evasion and reform is the extent to which evasion is visible or understood by policymakers. While individual acts of evasion tend to be hidden, the existence of widespread evasion often becomes common knowledge—as was the understanding of the informal economic system in the Soviet Union. Widespread evasion of rules, then, is likely to come to the attention of policymakers. There is thus a two-stage process through which wide-scale evasion contributes to better policies.[8] First, widely evaded policies are likely to be disproportionally represented among those policies that come under reconsideration; second, political economy considerations are likely to favor socially desirable changes—either stricter enforcement of good rules or a change or liberalization of bad policies.

In the case of the Soviet Union, high levels of evasion also served to erode the communist regime's ideological underpinnings. The departure from Marxist-Leninist principles was so severe that it could not help but be noticed. It "had all gone rotten," as Shevardnadze said to an agreeing Gorbachev in 1984, and thanks to their privileged positions, they may have been among the last to know.[9]

The history of lawbreaking in the Soviet Union is not a promising legacy for a country interested in developing respect for its new rules. The credibility of reforms requires a belief not only that new policies will be sustained, but also that they will be enforced. The toleration of widespread evasion in the prereform period could lead to a general distrust in the government's commitment to any proposed rule change. Both the desire and the capability of the government to implement reform may be called into question.

## EVASION IN TRANSITION

> The criminality and corruption of the former regime has already become standard operating procedure in the new (Handelman, 1995:8).

Liberalization during the Russian transition has resulted in substantially loosened controls on private economic behavior. Forms of rule breaking that were prevalent in the prereform system, such as circumvention of price con-

[8] This discussion echoes Rubin's (1977) analysis of the pressure toward efficiency in common law.

[9] The "beach walk" of Shevardnadze and Gorbachev is recounted in Goldman (1992:83-84).

trols or "speculation," are, for the most part, no longer against the rules.[10] Nevertheless, there remains a good deal of corruption, illegality, and underground activity. Why?

First, the rule changes during the reform era do not represent a simple legalization of preexisting activity. The more-or-less general prohibition against private economic activity has been replaced by a host of new regulations and taxes at different levels of government. The liberalization has been far from complete, and private activity officially remains much more tightly controlled than in the United States, for example.

## Legal Uncertainty

Besides generating a large change in the rules, the transition also has brought increased uncertainty as to what the rules really are. Laws are murky, changing, and contradictory. Even high-level constitutional questions remain unresolved. The "division of powers and responsibilities [among Russian Federation members] is as clear as an old-fashioned London fog" (Hanson, 1995:28). In the Russian legal environment, a well-intentioned entrepreneur would have a difficult time knowing the relevant rules.

In some instances, de facto rules are informal, reflecting the powers of government authorities. Consider the case of local price controls. Most localities in Russia officially control the prices of only a handful of goods—though often these controls apply to the most important household goods and services, particularly apartment rents, utilities, basic foodstuffs, and local transport fares. But informal restrictions can be much more severe. Threats by a government official to make life difficult for those who fail to hold to informal strictures are all that is required. The director of a local antimonopoly committee noted that he had the power to imprison for up to 3 years any enterprise manager who ignored his edict, and because he had this power, he had not had to use it, as no one had ignored him. In the same locality, the owner of a private bread store indicated that his biggest problem was the "state racket" and the need to keep on the good side of local officials.[11] Local control of commercial real estate provides one important source of official leverage over private businesses. The continuing practice of selling identical goods to different customers at different prices—with the traditional state-sector customers receiving the lowest prices—is another indication that some elements of the planning system have outlived the system's formal apparatus.

Taxes provide a fertile area for evasion even in a developed market economy, so it should be no surprise that they offer significant potential for evasion in a transitional economy. Russian tax rules are complex, murky, and

[10]Alexeev et al. (1995) discuss the changing nature of crime in transitional Russia.
[11]These conversations took place in June 1995.

frequently evaded. Here is what awaits the foreign investor in Russia with respect to taxes:

> The incoherent and ever-changing tax codes which characterize the current system mean that foreign firms are often unable to calculate even their present tax bills, despite employing large amounts of resources and paying consultants to identify precisely what they owe and where responsibility for taking a decision about tax liabilities ultimately lies. In the event, tax bills are often calculated on a the basis of prolonged negotiation with officials from a variety of governmental departments (Halligan and Teplukhin, 1995:124).

When all relevant taxes are included, rates have been quite high, providing the incentive for underground operation or other forms of evasion—and simultaneously improving the soil for the growth of organized crime. In May 1995, the chairman of Goskomstat estimated that output hidden for purposes of tax evasion accounted for 20 to 22 percent of gross domestic product (GDP), though even this could be a substantial understatement.[12] The Tax Police uncovered 9,000 cases of large-scale tax evasion during the first 9 months of 1995 (OMRI Daily Digest, No. 104, Part 1, 30 May 1995).

Growth of organized crime has been one of the most visible results of the Russian transition. Mafia protection offers its clients the benefit of decreased uncertainty.[13] One set of rules—those involving the enforcement of private contracts, debt collection, and relations with government officials—becomes more standardized, at the cost of increased violence and strong-arm tactics. Those who are caught up in this system would probably prefer a world of government-supplied, inexpensive protection and legal stability, but there is little they can do about it individually. (Another frequently employed substitute for public protection, however, is to deal only with those with whom one has strong personal connections.) In this sense they are in a similar position to that of prereform enterprise managers who were required to deal on black markets.[14] A survey of Western firms that have invested in Russia indicates that the largest obstacle to foreign direct investment is the legal uncertainty; fear of crime or the mafia is a relatively minor concern.[15] For many Russian businesses, as for most Western firms, security and protection are a standard business expense.

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[12]Such a figure reinforces the point made earlier that wide-scale evasive activity can lead to significant misunderstandings of actual economic conditions.

[13]Other benefits of organized crime are recounted by Leitzel et al. (1995).

[14]"The individual, in fact, may have little choice but to fall in with the system of extralegal gain" (Grossman, 1977:30). Simis (1982) also documents the extent to which illegal behavior was necessary for the smooth functioning of state-sector enterprises. See especially his discussion of Food Shop Number Five (pp. 218-221).

[15]See Halligan and Teplukhin (1995:119-121). As noted, this survey involved firms that had already invested. Fears of crime or the mafia might be more important in preventing initial investments.

Increased uncertainty about the future during transition tends to reduce effective time horizons. To the extent that breaking the rules entails some risk of a future punishment, including a loss of reputation, individuals will be more willing to run such risks in less stable settings. Similarly, the punishment that accompanies some forms of rule breaking has been undermined during the transition. Corruption, for example, is generally punished by the loss of one's official position. As the private sector grows, however, dismissed state officials have less to lose from corrupt behavior. This assessment seems most applicable to street-level police officers. Police have relatively high-paying alternatives as private security guards, and their marketability in the private sector cannot be diminished greatly by previous bribe taking.

## Evasion and Reform

As suggested earlier, the benefits of evasive activity depend on the quality of the rules being evaded. Evasion of the economic restrictions of the planned economy often was socially beneficial, and in many instances even promoted plan fulfillment.[16] In a liberal market economy, however, widespread evasion can be quite detrimental.[17] Present-day Russia has neither a planned economy nor a liberal market economy. Whether evasion currently is offering positive net benefits is impossible to know. Evasion of continuing price controls and excessive government regulation probably improves the economy. Simultaneously, tax evasion can contribute to higher inflation (if there is monetization of the increased budget deficit) and increased uncertainty, and violent criminal activity has a chilling effect on some would-be entrepreneurs. Further, an environment of widespread illegality can be unfair, and certainly contributes to a perception of unfairness. Individuals who do well in such circumstances often are those with the fewest scruples about breaking rules.

Evasion of rules in one area tends to induce responses in other areas. For example, the possibility for policemen to earn money through bribes lowers their official salaries. And while firms are evading their legal obligations to the state in tax payments, the state is evading its legal obligations to firms in terms of payments for goods, which in turn is partly responsible for delayed or nonpayment of wages and further tax evasion, and so on.

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[16]Montias and Rose-Ackerman (1981) distinguish corruption that promotes the goals of the official organization ("organizational corruption") from corruption undertaken for private benefit ("individual corruption"). Whether plan fulfillment actually promoted the welfare of Soviet society is another matter.

[17]Even "good" rules, however, benefit from some evasion. Policies are not complete, in the sense that they do not prescribe precise actions for every individual in all possible circumstances. Rather, rules tend to be quite coarse and are unresponsive to detailed individual preferences or conditions. Occasional avoidance or evasion offers an opportunity for improved actions based on more complete information (see Leitzel, 1996/1997).

Widespread evasion of rules in a transitional economy can still provide an impetus toward efficient policies. The significantly increased responsiveness of the Russian government that has come about with democratization would seem to augment this effect. The rules themselves, however, are not nearly so inefficient to begin with, so the marginal social gains from evasion-induced rule changes presumably are reduced relative to the prereform situation. Nonetheless, the ability to evade rules during transition helps prevent increased government regulation, and in the case of tax evasion is leading to simplification and rate reduction in the tax code. In other areas as well, the potential for corruption serves to limit the amount of discretion available to governmental officials.

## FURTHER SPECULATIONS

> . . . in several very important respects the development of a backward country may, by the very nature of its backwardness, tend to differ fundamentally from that of an advanced country (Gerchenkron, 1952)

It is always tempting to judge events in Russia by the standards of developed market economies. Nevertheless, the application of Western standards frequently is misleading, as I have argued elsewhere with respect to barter, monopoly power, and organized crime (see, for example, Leitzel, 1995:41-45, 100-108, 127-130). The economic outcomes that we see in the United States represent the aftermath of a long (and continuing) evolutionary process of rule making, individual responses, amended rules, new responses, and so on. Policy changes in such near-equilibrium settings then take on the character of, in Schroeder's (1979) famous phrase, a "treadmill of reform." Policymakers respond in marginal ways as problems become apparent. Over time, tremendous changes can occur, but primarily they are the result of a relatively slow, evolutionary policymaking process.

The massive reform that Russia has undergone, however, has not shared that character. Rather, the public policy changes, and individual responses, have been far from marginal, even as the initial post-Soviet conditions have continued to exert enormous influence over the Russian economic and political environment. The system of public finance and the social safety net, both of which were largely implicit in the planning system, have had to be overhauled completely. Commercial banking and its regulation have developed from ground zero. Private farming, which was permitted in the form of small private and garden plots in the old system, has expanded enormously. By mid-1993, there were already more than 250,000 full-scale private farms; individual garden plots were estimated to be responsible for 70 percent of Russian vegetable output and 90 percent of the potato crop in 1996 (Wegren, 1995:48; on individual garden plots, see Gurushina, 1996). Legal private business in general has mushroomed: there were more than 900,000 private enterprises in

Russia by the end of 1995, including more than 120,000 that had been privatized (see Blasi et al., 1997:Table 1, 189).

With such large changes across a wide spectrum of policy areas in such a short period of time, it is not surprising that there have been opportunities to evade the new rules. Privatization offered a very significant, one-time opportunity for evasive activities that included, besides insider machinations to retain control of enterprises, bogus voucher investment funds and counterfeiting of vouchers.[18] In many cases the enforcement of the new policies (such as the value added tax) had to start from ground zero. The development of a financial market also presented entirely new types of crimes that Russia had no experiencing with policing. Nevertheless, the policy situation, like the macroeconomic environment, appears to be becoming more stable. Strengthened resolve with respect to macroeconomic stabilization has decreased access to legal "loopholes" in tax laws and limited the subsidies through which localities can sustain price controls. Many severe violent crimes showed downward trends in 1995; in 1996, murder and attempted murder again decreased, as did recorded crime overall.[19]

The current situation in Russia, however, remains far from a U.S.-style market economy. Here is a description of the reforming Russian economy, circa October 1995, from former acting prime minister Yegor Gaidar (1995):

> . . . the main problem of present-day capitalism that has formed in Russia is as follows. It is the problem of the utmost intertwining of property and power. If we look at the operation of the Russian enterprises, the work of government agencies, in Moscow, in the regions, we will see constantly the closest intertwining of business and bureaucracy. In the majority of cases the success of an enterprise depends not on the ability of the director or the owner to organize normal production, but on his ability to correctly give bribes, on whether he has sufficiently high patrons, his ability in this connection to secure for himself a set of individual benefits and exceptions from the rule, his ability to get cheap money out of the budget, and so on.

The continued entanglement of the government in the economy is quite stifling and shows little signs of diminishing. This entanglement is the most important source of the uncertainty over what the laws actually are—the de facto law essentially remains at the discretion of local officials, upon whom the local judiciary also is dependent.

[18]The alternative to official privatization, however, was not the pristine regulation of state-controlled enterprises. Rather, spontaneous privatization that was quasilegal at best was putting enterprise assets or their associated profit streams in the hands of managers (see Johnson and Kroll, 1991).

[19]Through the first 11 months of 1995, recorded crime increased 5.6 percent over the same period in 1994 (Morvant, 1996a). Murder and attempted murder, grievous bodily harm, and rape fell between 1994 and 1995, however (Morvant, 1996b). For the reported declines in 1996, see Morvant (1997).

Relative to the Soviet system, however, the current situation seems to be an improvement. Certainly there has been a massive increase in private economic activity, despite the barriers of state and mafia extortion. And the legal norms governing state-private interaction in the United States are inappropriate in the Russian context (see Posner, 1995; Rapaczynski, 1996). Of surveyed Russians, 70 percent do not expect fair treatment from the state; 45 percent do not expect fair treatment from grocery stores, either (Rose, 1995:39). In such circumstances, high levels of corruption that allow citizens to buy services from government officials for a bribe in the same way they can buy bread at the grocers may not be such a bad outcome.[20] There is some evidence that the analogy is not far-fetched: ". . . Moscow newspapers list the going rates for whatever ostensibly free government service you may need" (Germani, 1995:2A).

The transition period in Russia has been marked by radical changes in the official rules and by significant individual responses to the new rules—including widespread evasion. A return to a normal policy regime—a treadmill of reforms—might be quite welcome after the momentous changes of the past few years. With small policy changes and time, state involvement in the economy can "wither away" to levels more consistent with long-term growth.

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[20]Rose (1995) characterizes Russia as an "hour-glass society," where the top half of the hourglass is political and social life, and the bottom half contains informal networks of friends and relatives. He characterizes a "significant portion of the electorate" as "actively wanting to protect their well-being by keeping the center of the hour-glass as narrow as possible in order to limit what the state can do to them" (p. 41).

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# III

# Transforming Management, Labor, and Production

# Restructuring Production Without Market Infrastructure

*Judith Thornton*

The aim of economic reform is to provide a framework of laws and institutions that will further freedom and prosperity. In pursuit of this aim, the reforming economies have attempted to privatize firms, liberalize markets, deregulate access to markets, and redirect the role of the government to the provision of economic and social infrastructure and the securing of individual rights. Several of the Eastern European and Baltic countries are succeeding in building a healthy private sector and reorienting economic activity to the world market. However, although Russia and many of the republics of the former Soviet Union have pursued privatization with no less vigor, a successful restructuring of production continues to elude them. In 1996, official data set the level of real gross domestic product in the Commonwealth of Independent States at only 52 percent of that in 1989 (European Bank for Reconstruction and Development, 1996:112). This essay examines the key elements of economic reform and their application in the context of the transition economies of the former Soviet Union.

Why have some economies succeeded in rekindling growth while others have failed? The difference lies in the extent to which these economies have succeeded in putting in place the institutional infrastructure needed to support competitive production and investment, rather than rent seeking, subsidy seeking, or influence activities. The economies differ in the extent to which they have provided the legal, financial, and administrative infrastructure required to support a competitive nonstate market sector.

## CREATION OF MARKETS

What does economic reform mean? Creation of markets is a crucial first step. Central planning relied on administrative direction and sanctions to direct resources to centrally determined tasks. The widespread emergence of black or gray markets for goods signaled the costs these systems faced from the absence of legal alternatives to planned allocations.

After economic reform, as the structure of domestic production adjusts to consumer preferences and world market opportunities, competitive product and factor markets must play the central role in directing resources to higher-value activities. In the absence of institutions supporting open markets, producers may construct alternatives, such as networks of closed relationships, privately enforced, but such arrangements are likely to stunt economic growth.

### Emergence of Private Producers

Reform implies the emergence of nonstate producers who face hard budget constraints and competition. Private producers will bear risks, reap the benefits and costs of their activities, and thus have incentives to move resources to higher-value uses. In the reform economies, a population of competitive producers can emerge from the privatization of existing state producers, from the entry of new firms, and from an inflow of foreign capital and management. An opening of domestic markets to international trade will bring the discipline of market competition as well.

Creation of a nonstate sector implies an end to the state's monopoly on ownership of productive resources and the emergence of private owners with the incentive to use resources productively. But establishment of private property rights requires legal, financial, and administrative infrastructure to define and enforce ownership rights. It implies a significant redefinition of the role of the state, which is no longer the owner and allocator of resources and capital, but is rather the means for providing social infrastructure and public goods.

### Redefinition of the Role of the State

Thus, most importantly, reform implies the creation of a separate tax-based state with the capacity to supply social infrastructure and public goods. A separation of government revenue from ownership of capital provides greater transparency in both the capital market and the public sector. Government taxes and subsidies become explicit in the government budget, rather than implicit in government prices and allocations. If the central functions of the administrative state were ownership and control, then the central functions of the market-oriented state are provision of institutional infrastructure, social insurance, and public goods.

It follows that the role of the state is very different in the planned and market economies. In the prereform era, state controls supplanted much of the institutional infrastructure of a market economy, overriding contract law with administrative practice. Thus, elimination of state control involves rebuilding the rule of law and the capacity to enforce a framework of rules of the game. It involves rebuilding a capacity to manage the macro economy by means of monetary and financial policies, to establish independent financial institutions, and to provide public goods and a social safety net. Restructuring of government will involve building local governments with the capacity to provide local public goods and agencies at all levels that will provide more public services and less regulation.

## Structural Change, Investment, and Growth

Initial reform policies—liberalization, stabilization, and privatization—have set some of the Eastern European transition economies well on the road to integration with Europe. But successful implementation of each of these policies assumes the existence of supporting institutions and minimum levels of governmental administrative capacity. Where such infrastructure is lacking—notably in the republics of the former Soviet Union—the desired policy results have been more difficult to achieve.

The second stage of economic reform involves a still more difficult process, the reallocation of labor, capital, and management from subsidized state sectors to expanding export and consumer-oriented sectors. Eastern Europe has had considerable success in mobilizing domestic saving and attracting foreign investment, while Russia and the Commonwealth of Independent States continue to suffer capital flight.

## Initial Conditions and State Dependence

The task of restructuring production is hampered by initial conditions. The Soviet Union shared with Eastern Europe a bureaucratic power structure controlled by a communist party and oriented toward the maintenance of political power. Yet the legacy of the Soviet system serves as a more serious impediment to restructuring in Russia than in Poland, Hungary, Czechoslovakia, or even Estonia.

The classical Soviet system was a highly centralized bureaucratic hierarchy that produced distorted incentives, biased information, and high levels of lobbying. Its structure protected bureaucratic monopolies and allowed party leaders to pursue political objectives at the expense of economic performance. Ericson (1991) depicts a system that lacked rudimentary incentive-compatibility or market-based flexibility. This system had the following characteristics:

- A hierarchical structure of authority
- Rigid centralized planning
- A commitment to maximal tautness
- Widespread rationing of goods and services
- Exhaustive price control
- A lack of flexibility, and in particular the lack of a true money
- The lack of legal alternatives to central plans
- Absolute and arbitrary control by superiors of plan assignments, performance evaluation, and rewards
- Plan-oriented incentives that ignored the economic consequences of decisions

Many features of postreform Russia still reflect this Soviet legacy: the long bureaucratic channels between local and central levels, the largely uneconomic dispersal of production, a heavy military burden, and the burden of implicit subsidies provided by policymakers during the first years of reform.

The poor information features of Soviet bureaucracy were particularly harmful. Good decisionmaking requires accurate information about the options available and the likely consequences of each choice—information that is best obtained directly from people on the spot who can seek out alternatives, gather evidence, and forecast consequences. But opening a decision process to participation by individuals with a stake in the outcome increases the resources devoted to lobbying, and these lobbying costs are greatest when a decision redistributes a large amount of wealth. Thus lobbying costs must be balanced against the increased information lobbying provides (see Milgrom, 1988; Milgrom and Roberts, 1990).

One way to reduce rent seeking is to limit the distributional implications of decisions, a step that may also sharply reduce the bureaucracy's capacity to adjust to changed circumstances. Another is to limit communication by denying individuals in the hierarchy access to the information they would need to politic effectively, a step that reduces the accountability of top-level decision makers and reduces the information on which central decisions are based.

The sheer size of the Soviet economy meant that the resources at stake in government decisions were enormous, creating significant incentives for individuals in the decision-making hierarchy to lobby and to distort the information on which decisions would be based. Local interests took advantage of long bureaucratic channels and local control of information to supply biased reports.

Decentralization, attempted by Khrushchev and Gorbachev, limits influence activities by eliminating the central authority altogether, but decentralization when there are no markets leaves decentralized actors without effective means of coordination. The informal economy is a product of this need for horizontal links.

Moreover, allowing decentralization without establishing a legal framework for private ownership is likely to give managers access to rents, leading to a drain of resources from the state-controlled sector of the economy to the informal or illegal sector. Poznanski (1997: 276-277) refers to this process as "creeping capitalism":

> From the very beginning, a total shift of control to the centre proved to be impractical, this because of lack of information. . . . With time these informal spheres of free action have gained ground, this process, to a degree, being helped by official reforms. Those communist-era systemic reforms that delegated authority down the decision-pyramid, even if short-lived, were conducive to such expansion. Any reversals in the reform course were helpful because they brought in an element of confusion that served lower-level agents to hide their activities. Personal incentives to work outside of official directives—the central plan—increased further with a decline in the level of coercion. With the practice of subverting the system for personal gain reaching all layers of the system, including the center, interest in applying coercion has subsided. And when in use, coercion was increasingly applied for extracting personal gains as well.

As the government began issuing trading concessions and production permits to members of the political elite, argues Poznanski, a system of what he calls "political capitalism" emerged in Poland. In this system, political power was used by party bosses, state officials, and the police to acquire and safeguard private wealth. The alternative to political capitalism is legal private property.

## The Socialist Firm

The institutional features of the socialist firm were similarly perverse. The exercise of state ownership of productive assets left property rights poorly defined, difficult to measure, costly to enforce, and difficult to transfer. Control rights to assets were vested in the political elite that exercised control through an administrative bureaucracy. Cash-flow rights were assigned to the citizens, since they would bear the benefits and costs of decisions in the level of their standard of living. Officially, returns to capital and resources were supposed to be centralized in the treasury in the form of profits, taxes, and charges for resources, but in practice, administrators who enjoyed control rights could assign subsidies and impose costs by the policies they pursued.

Although the institutions of the command system denied individuals legal ownership rights to most physical assets (tenancy rights to housing were allowed), they afforded the elite control rights over the vast rents generated by administrative allocation. Thus, corruption was commonplace. Sometimes, corruption can serve to circumvent bureaucratic obstacles. However, while corruption allows an allocator to "sell" market access at a shadow price reflected in the market for bribes, there is no legal way to enforce a bribe contract, so property rights remain insecure. Moreover, since control of access rights is a potential source of power and wealth, corruption creates incentives to increased regulation, resulting in a proliferation of regulators, each attempting to hold the producer hostage on a different margin.

Governance of enterprises within the ministerial hierarchy raised agency problems on every margin. The enterprise manager, an agent, faced multiple principals (such as the party, the ministerial authorities, the treasury, and local authorities) whose incentives were likely to negate each other. These principals claimed enterprise surpluses and bailed out losses, taking on much of the risk the enterprise faced. While in theory the enterprise manager had few control rights over resources, in practice his control over information and his ability to trade off unmeasured dimensions of performance against measured performance indicators gave him substantial benefits of ownership. On the other hand, as central authority deteriorated in the 1980s and as nominal price controls created increasing excess demand, managers more and more frequently had to bribe allocators to gain access to supplies (Shleifer and Vishny, 1994; Boycko et al., 1995).

In spite of extremely high levels of monitoring, the enterprise overstated costs, concealed true capacity, diverted resources to local purposes, and avoided innovation. Changing institutional arrangements to improve incentives and increase flexibility in the Soviet system was a daunting task.

### Restructuring of the Socialist Firm

If the centralized Soviet Ministry was a feudal barony, then the enterprise subordinate to it was a principality. Kotkin's (1991:1) depiction of the Magnitogorsk Works in *Steeltown, USSR*, is instructive:

> Forty-three kilometers around, the Magnitogorsk Works, a dense mass of smokestacks, pipes, cranes, and railroad track, consists of 130 shops, many of which are as large as whole factories. "Steel plant" would be an inadequate description of the complex formed by an ore-crushing and ore-enriching plant, a coke and chemical by-products plant, 10 gigantic blast furnaces, 34 open-hearth ovens, and dozens of rolling and finishing mills. The Magnitogorsk Works produces more steel each year than Canada or Czechoslovakia and almost as much as Great Britain.
>
> The metallurgical complex dominates city life in every way. The works owns apartment buildings in the city housing two hundred thousand people, eighty-five children's institutions, several hospitals, a number of nearby resort complexes, and an entire agricultural system of state farms and greenhouses in the surrounding countryside.

Ivan Romazan, the director of the Magnitogorsk Works, oversaw not only production, but also the political administration of almost all social life in the city. Through his influence in the Moscow Ministry, he was responsible for ensuring delivery of the centrally allocated resources to everyone from the mayor to the plant managers. Through his role in the Communist Party *nomenklatura*, he selected these managers in a system where one's position in the bureaucracy constituted one's primary wealth.

A restructuring of the Magnitogorsk Works involves more than privatizing a firm that employs 60,000 workers. It means creating an institutional framework for civil society in a city of 440,000 people. Moreover, it means creating the labor and housing markets needed to allow a considerable part of the population to leave "the largest assemblage of obsolete equipment in the country" for a city with better prospects.

## THE ROLE OF INSTITUTIONS

What are the institutions whose absence impedes adjustment? First and foremost, they are property rights and markets, but the provision of property rights requires rule of law as a foundation. Institutions are sets of formal and informal rules that constrain behavior in society. According to North (1991:3): "Institutions reduce uncertainty by providing a structure to everyday life." Institutions provide a framework within which individuals seek to coordinate their separate activities and insure against risk. They structure incentives and constraints, define procedures for changing the rules, and delimit membership.

The institutional framework of society includes both the formal and informal "rules of the game" and the resulting organizations people create and within which they interact to reach their individual and collective goals. Formal rules, such as laws and contracts, define the rules of the game and give people the rights and mechanisms to enforce the rules. Informal rules of the game depict individuals' expectations about the uncertain consequences of actions and events. They take into account the real-world costs of negotiating agreements, monitoring compliance, and enforcing sanctions.

When the formal rules of the game provide incentives that are consistent with individual self-interest, actual behavior will generally conform to formal rules. But when the formal rules of the game conflict with individual self-interest, individuals will have incentives to evade the rules and, if there are penalties for evasion, to conceal their actions. The vast gulf between the formal rules and the de facto practice of the command system tells us that the perceived benefits of violating the rules were sufficiently large to outweigh significant penalties, which were enforced with high levels of monitoring.

How does an economy's institutional framework influence the forms of governance of organizations? In a market system, there are few legal constraints on the form organizations adopt. Individuals will attempt to choose arrangements that reduce the costs of governance in order to minimize the sum of production and transaction costs. They will trade off agency costs against the resource costs of preventing agency problems.

In an administrative bureaucracy, where bureaucrats receive a small share of the benefits and costs of their decisions, the state will impose regulatory constraints on decisions and monitor results in order to prevent deviation from centrally set goals.

In the Russian bureaucracy, both principals and agents have incentives to seek arrangements that give them control of information influencing the division of income. For example, low-cost producers will seek to conceal their true profits in order to retain a larger share, while government principals may seek to hide the true value of centralized resource rents from both enterprises and regional authorities who enjoy some de facto control rights to local resources. Since agents have incentives to divert resources from joint activities to their separate benefit, the authorities will attempt to create strong restrictions to local initiative.

Moreover, if the political elite, as principals, gain security by their ability to monitor decision makers at lower levels in the hierarchy to prevent challenges to their authority, the state system will not necessarily have incentives to reduce monitoring costs, either. With collusion, there will also be costs of monitoring the monitors. So in sum, state-owned institutions burden citizens with an inefficient partitioning of property rights and deny them governance mechanisms that would allow them to contract around inefficiencies.

## The Role of Property Rights

The success of an economic system depends on how its institutions structure the incentives to produce wealth, to capture wealth, and to protect wealth. Property rights are a key institution in this process. Property rights are rules of the game that may be defined by formal laws or administrative practices or may be codified in informal custom. They define the forms competition for resources may take in society.

Consider two individuals, A (with an endowment of wine) and B (with an endowment of cheese). What institutional arrangements would allow both individuals to consume both commodities? The form of the transfers from one party to another will depend, in part, on whether each individual respects the other's property rights. If property rights were not protected, A could steal B's cheese, transferring ownership without compensation. If B has to incur high costs to protect herself from theft, then the value of her property will be much reduced. Alternatively, A could threaten B with violence. In this case, A would have transferred property rights to B's person, but he would allow B to purchase the rights back with an appropriate amount of cheese. Voluntary market exchange will occur only if each individual recognizes the other's property rights. (For systems with private protection and private capture, see Hirshleifer, 1995, and Grossman and Kim, 1995.)

Private property rights create incentives to produce wealth by internalizing the benefits and costs of the owner's actions with the owner. Private ownership means that an owner can control the use of an asset and exclude others from using it, that one has the right to enjoy benefit or income and the right to transfer. Ownership also implies the responsibility to bear the costs of one's actions. Gaining these rights of ownership, individuals have incentives to create and maintain productive assets.

When property rights to valuable income streams are not defined and enforced, individuals have an incentive to spend real resources to capture such rights. Such a competition will tend to dissipate (or, with uncertainty, more than dissipate) the value of ownership. If the private protection of property is costly, individual incentives to produce and maintain resources will be reduced. Further, some of the resources available for productive use will be diverted to attempts to capture wealth or prevent such capture.

Property rights not only define the individual's rights to capital, but also define people's rights to their own skills and abilities. That is, liberty implies the right to direct oneself and to own the fruits of one's effort. The link between property rights and civil rights is demonstrated in the case of China. In prereform China, political authorities held the right to direct individuals to a place of work and to define the conditions of their employment. These control rights over labor were enforced by a rationing system that gave individuals access to rations of basic commodities at their place of employment. But as soon as agricultural reforms created a free market in food, it became much easier for workers to move from place to place in search of better work opportunities, giving them greater de facto property rights over their own human capital. As is true of all institutions, it is de facto and not de jure property rights that will determine people's incentives to act and will shape the organizations they establish.

### The Supply and Demand for Institutional Change

Private owners who receive the gains from moving resources to higher-value uses will have incentives to create institutional arrangements supporting such transactions. Thus, resource owners have incentives to create market institutions that define and enforce property rights at lower cost.

Moreover, differences in initial endowments and tastes for risk and incentives to enjoy specialization and economies of scale will lead individuals to establish institutional arrangements that allow them to partition property rights in a variety of different ways. If the institutional framework allows, an owner may choose to farm her land herself or to hire a tenant. She may lease her fields to the tenant in exchange for a fixed payment, leaving him free to select crops and choose his own level of effort, or she may share the control rights and the returns in a multiplicity of different contractual arrangements. Just as competitive markets force out inefficient producers, the freedom to enter into a wide variety of contractual arrangements allows individuals to select among contractual forms in order to reduce the sum of production and transactions costs within the existing institutional framework.

In a market system, the process of changing formal institutions is defined by the rule-making and rule-enforcing powers of executive, legislative, and judicial branches of government. The formal rules influence the costs of enforcing agreements and contracts between individuals and organizations. When the domestic institutional framework is faulty or incomplete, individuals may have access to the institutions of the international market.

In the socialist system, bottom-up processes of formal rule making were blocked. In its formal constitution and laws, the Soviet state was similar to other modern states, with a legislature, a state administration responsible for applying the laws, and a judiciary. But in its de facto practice, rule making and enforcement were under the control of a closely entwined bureaucracy that united Communist Party monopoly of power with centralized state administration. Legislators were nominated by the bureaucracy and subordinate to it. In the courts, the state *procurator*, or prosecuting attorney, was also the judge.

Communist Party members were subject not to formal legal sanctions, but to party discipline. In the Stalin era, the party's arbitrary political authority overruled even the most basic legal norms. In the post-Stalin era, party members and bureaucratic authorities were under obligation to put party resolutions and instructions into practice. Infringement of state discipline could result in sanctions ranging from censure to a prison sentence or execution. Nevertheless, bureaucratic authorities were not subordinate to the legal system; rather, laws, regulations implementing the laws, and the security apparatus enforcing the laws were all subordinate to the bureaucracy.

Large discrepancies between the formal rules of the game and informal norms of behavior should signal that there are large potential payoffs to influencing the rules and their enforcement. Either the central authorities would choose to increase monitoring and penalties for noncompliance with their desired laws, or they would eliminate "bad" laws that constrained productive activity without negative third-party consequences. But the formal institutional arrangement of the Soviet system created a gulf between formal rules and actual practice, maximizing the incentives for corruption and illegal activity, while centralization of regulatory authority left rule making in the hands of authorities who profited from the discrepancy.

Authorities who controlled access to valuable rights gained power and benefits. They could transfer benefits to their subordinates by giving them regulatory power. If corruption or "illegal private enterprise" emerged as a way of getting around regulations, subordinates were guilty of breaking the formal laws, and thus were more vulnerable to political control or blackmail.

Thus, a successful transformation of a socialist economy from bureaucratic discretion to market regulation requires more than nominal privatization of firms. It requires that market performance, not government regulation, taxation, or subsidization, become the primary determinant of a producer's success. Not only must new laws be written and enforced, but old regulations must be eliminated. New, independent courts must be developed as old political bureaucracies are dismantled. Today, Russia's state authorities are still in a position to assign the rights to rents through taxation, regulation, and ownership of natural resources and land, while private entrepreneurs continue to find influence activities more profitable than innovation. Will the institutional change now under way—privatization and opening to the world market—create an effective demand for complementary governmental institutions? The evidence is contradictory.

## Privatization of State-Owned Enterprises

Official privatization of state-owned enterprises proceeded nowhere more rapidly than in Russia. The pace of privatization was forced by the rapid unofficial privatization of assets that emerged after the 1990 Russian Law on Enterprises and Entrepreneurial Activity.

Small-scale privatization began in 1992, as municipal authorities sold retail shops, cafes, and service facilities in cash auctions and in commercial tenders.

Subsequently, mass privatization, extending from December 1992 through July 1994, saw 15,000 medium and large-scale enterprises privatized through distribution of shares to enterprise employees and through voucher auctions. In the process, firms accounting for two-thirds of the Russian industrial labor force were privatized, and over 50 million Russians became shareholders in either privatized enterprises or the investment funds that held equities.

The privatization legislation was a vital first step in codifying property rights in productive assets. However, privatization alone could not render sprawling former state-owned giants efficient. The division of individual ministries into firms and the boundaries of individual firms were determined by political negotiations between Moscow and the regions, rather than by considerations of economic efficiency. All large facilities of the electric power network were incorporated in a single monopoly, as were the production and distribution assets of Gasprom. The oil industry was reconstituted into 11 vertically integrated holding companies. On the other hand, municipal telephone companies and local railroad warehouses were privatized separately, although the links connecting them remained state owned.

Large enterprises and production units were privatized directly from Moscow, while enterprise managers and regional authorities bargained for the right to separate local plants from national conglomerates by setting up holding companies and offering ministry elites blocks of shares in them.

To minimize outside control, regional elites used regional banks to purchase and hold regional assets and acquired shares in other regional firms. The resulting pattern of ownership was hybrid, with equity divided among enterprise workers and management, regional elites, institutional investors—usually banks and investment companies—other enterprises and holding companies, foreign investors, and state agencies.

At the end of the first stage of mass privatization, insiders—managers and workers—owned 65 percent of privatized firms. Management, separately, accounted for 25 percent of the ownership share; outsiders—citizens, firms, investment funds, holding companies, and banks—accounted for 21 percent; and the state held 13 percent (Blasi et al., 1997).

In the 2 years following mass privatization, further shifts in ownership occurred. Top managers together retained about 18 percent of their firms. Workers retained about 40 percent. The share of outsiders—commercial firms, investment funds, and citizens—rose to 32 percent, on average, but majority outsider ownership was concentrated in a small number of large firms, many of these export oriented (Blasi et al., 1997). In fact, de facto control by top managers is considerably greater than these statistics indicate.

During 1995, the Russian government attempted to sell 136 large companies in a round of cash sales, but desire to retain domestic control of the shares eventually led to a loans-for-shares agreement between the government and several Russian banks. Banks were allowed to organize auctions themselves and participate in them as both bidders and depositors for bids. In the end, stocks in 12 firms were sold, including LUKoil, Surgutneftegas, and Norilsk Nickel.

A further privatization of government shares in several large companies and utilities is to continue in 1997. At the end of 1996, then, employees of privatized state-owned firms, about 10-15 percent of the population, owned some 58 percent of their firms. Several million additional Russians had acquired property in small-scale privatization, and about 12 million Russians had acquired ownership of their housing. On the one hand, privatization created a constituency favoring property rights in small-scale assets, but the unequal distribution of wealth created another political constituency opposing private ownership of large firms and land.

## Restructuring of Existing Firms

Will privatization lead existing Russian firms to restructure themselves? Whether firms restructure depends on who exercises control rights and what the incentives are for productive investment versus rent seeking and subsidization.

The state-owned Russian firm produced its output in response to government demands, serving a multiplicity of goals other than profit making. Managers enjoyed considerable leverage as a result of their superior knowledge of the firm's true capability, and exercised that leverage by diverting resources in directions that served their separate interests. The main skill of a successful general director was his ability to pry scarce supplies out of the center, not knowledge of production, marketing, or finance. The legal rights of residual claimancy belonged to the state. In most markets, existing firms began reform with redundant labor, outmoded technology, and production processes selected in a protectionist environment—that is, in response to the wrong prices.

Successful restructuring of the firm, then, means bringing control and cash-flow rights together through privatization. It also means eliminating political capitalism as the primary determinant of enterprise success. In the case of firms with many owners, the goal of bringing control and cash-flow rights together implies creating institutions for corporate governance and providing the legal infrastructure to support governance. The weaker is corporate governance; the more concentrated must be ownership. In practice, ownership rights in larger Russian firms are split among several groups, and the legal and financial infrastructure needed to support governance is just beginning to emerge.

Restructuring of firms is inseparable from creation of input and output markets. Price liberalization and an opening of the economy to the world market present producers with new customers, domestic and foreign, and with new sources of competition. In consequence, firms face rapid changes in relative prices and in market demands. Berkowitz and DeJong (in this volume) find evidence that an integration of consumer markets is, indeed, under way, indicated by comovement of prices across Russian cities.

Market integration brings changes, as well, in the relative profitability of various economic activities and in the valuation of assets used for production. Many former directions of production are unprofitable and cannot compete, but there are windfall gains and unfilled market niches elsewhere, and, in the short-run, opportunities for arbitrage between domestic and foreign markets.

What must a firm do to survive in a competitive market economy? It will have to produce in response to private, rather than government, demand, supplying products that can be sold in competition with new domestic and established foreign competitors. Especially in neglected consumer sectors, opening to the foreign market brings in cheaper, better-quality foreign products, so domestic producers will need a rapid infusion of know-how and technology if they are to survive.

Those firms that adapt will have managed to separate out a few productive pieces from a former industrial complex such as Magnitogorsk, shortening hierarchies and bringing information and decision making closer. They will have to sell off unneeded facilities and housing and transfer social over-head capital to private firms and the municipal government. They will employ a substantially smaller labor force than they used in the past and be producing a new mix of products. Only when such a substantial restructuring appears probable will outside investors be willing to risk capital in the privatized firm to accomplish the necessary renovation.

These changes, again, require market-supporting infrastructure and a market-oriented state. Only when the institutional base supporting property rights is stronger will inside managers be willing to direct profits to long-run investment.

Major restructuring is likely to require the replacement of the Soviet-era general director and his deputies with new managers who have a radically different mix of skills and face different incentives, including the long-run incentives of ownership. Kuznetsov (in this volume), says the new managers must be turn-around specialists who can chart new directions and introduce new technologies. They are unlikely to succeed without links to the world market.

However, in Russia, there are information problems in both the market for management and the market for equity that may raise the search costs of finding a new manager. Brown (1997) captures key features of the Russian market for managers. With poor disclosure of the financial condition of firms, firms do not receive a signal of the ability of outside managers. Firms can eliminate the adverse selection problem by offering managers a performance-based contract that screens out low-ability managers, but managers require a large risk premium for a performance-based contract since they, in turn, do not know the true financial condition of the firm offering the contract.

Stronger incentives and better managers are complementary changes. Johnson et al. (in this volume) suggest they might be so strongly complementary that neither change would yield results alone. Case studies of enterprise restructuring in Poland indicate that an infusion of new management skills is crucial to restructuring (Johnson and Loveman, 1995). Blasi et al. (1997) report that 33 percent of large and mid-sized firms in their sample had replaced their general director between 1992 and 1995. They observe that the larger was the share of outside ownership, the higher was the probability that a firm would have replaced its top manager.

Many firms will not survive. Some may continue to produce in the short run if they cover variable costs, but their owners will not reinvest net revenues. In an environment with high political and economic risk, it may be in the interest of some asset holders to strip the existing firm of its assets, to harvest its resource stocks rapidly, and to move the portfolio offshore to an environment with lower risk and more secure property rights. Until legal and financial infrastructure are in place, a conservative portfolio manager may well wait to exercise an option to invest in the Russian economy.

## The Demand for Financial Institutions

The underdevelopment of the Russian financial market is a major constraint on the restructuring of existing firms and on the emergence of a new private sector. Private lenders provide vital discipline in Western financial markets, where banks, lenders, and trade creditors have the ability to monitor performance, establish restrictions on the policies of borrowers, and, ultimately, obtain control of the assets of an insolvent borrower. But in Russia, the legal and administrative foundations for well-functioning financial markets are still incomplete. Private property rights to land are missing or incomplete, it is difficult to use property as collateral for lending, bankruptcy laws are in their infancy, and the legal infrastructure for enforcing contracts is weak and subject to political influence. There are major information problems in assessing the performance of firms and banks. As a result of these shortcomings, savers lack confidence in domestic financial institutions, and financial institutions, such as banks and stock markets, play a limited role in mediating between savers and investors. With more than 60 stock exchanges and over 2,500 banks, 90 percent of stock trading is done over the counter and settled offshore.

A well-functioning financial system is essential to the process of restructuring. Trade liberalization leads to the collapse of noncompetitive activities, but without an infusion of management know-how, new investment, and new technology, new competitive sectors are slow to emerge. A well-functioning financial system would mobilize savings and direct investment to activities with the best prospects for profitability.

In the past 8 years, in spite of weak infrastructure, Russia has seen the rapid appearance of financial institutions, some of which have quickly developed the capacity to become participants in Western-style financial markets. These include more than 2,500 commercial banks, over 600 investment funds, over 1,000 licensed insurance companies, and more than 60 stock exchanges (down from 109 in 1993).

In contrast to the privatization program, which was initiated from the center, the development of capital markets was initiated by private actors. After the first commercial banks were established in late 1988, other financial institutions appeared rapidly. In December 1989, the Soviet Ministry of Finance issued its first treasury bills, and the USSR Bank of Industry and Construction introduced promissory notes, *vekselya*, opening a market in government debt.

In 1990, when the Russian government gave state-owned firms the right to sell over-contract production privately, networks of trading companies and commodity markets sprang up. The first of these was the Russian Commodity and Raw Materials Exchange, founded in 1990 by Konstantin Borovoi. Numerous stock and currency exchanges and brokerages were formed in 1991, sometimes as branches of existing commodity exchanges. In July 1991, the Russian Republic legalized investment funds and provided for their regulation. At the same time, foreign investors were granted the right to buy Russian equities. Liberalization of prices in January 1992 eliminated the need for most commodity exchanges, so many of these exchanges moved into voucher trading. As privatization accelerated in 1993, most began to make markets in the shares of privatized enterprises. Along with the exchanges, numerous brokerages and voucher investment funds were established.

Although exchanges have proliferated, to date there has been little self-regulation of exchanges, and popular mistrust of many exchanges is widespread. In consequence, the exchanges account for a small share of trade in equities. Most trades are conducted through the over-the-counter market.

An interregional system of currency exchanges with branches in Moscow, Novosibirsk, Rostov, St. Petersburg, Ekaterinburg, and Vladivostok, established with support from the Russian Central Bank, plays the largest role in interbank trading of government securities, bank securities, municipal bonds, and corporate securities. About one-third of the daily trades of equity take place through the Russian Trading System, an electronic system that is expanding to link more than 20 regions. Most trades in that system involve a core group of large conglomerates, the "Russia 100" companies. These represent a few sectors of the economy—oil and gas, 43 percent; electric utilities, 21 percent; metals, 13 percent; telecommunications, 11 percent; and others, 12 percent (Blasi et al., 1997). Another two-thirds of trades take place over the counter.

However, much remains to be done before Russia's stock markets will bring borrowers and investors together in a transparent and orderly process. First, legal infrastructure must allow property rights to be defined clearly, enforced at reasonable cost, and transferable. This requires that market participants agree to a set of rules guiding procedures for reporting of price, trading, clearing, and settlement in order to reduce the risk of fraud and of insider trading. Clearance and settlement procedures must be established to minimize the risk of default and provide timely transfer of funds. Procedures for issuance, listing, and pricing of additional shares should be agreed upon. Most important, the compliance of market participants with the rules must be monitored by a trustworthy coalition of market representatives and government authorities and enforced by the courts. The changes necessary to support an equity market are under way, but Russian apprehension about foreign participation in the domestic financial market restricts the role of international firms.

Governance remains a problem. The low prices at which Russian assets trade reflects the apprehension of outside owners that inside managers are in a position to transfer most of the benefits of production to insiders. Russian capital markets have little or no transparency. This lack of transparency reflects the economic interest of market participants, inside managers, and outside stockholders who are competing for control of enterprise assets. After privatization, most share activity was characterized by a one-way transfer of shares from initial small holders to managers and other closely related insiders. During the post-privatization period, not only managers of firms, but also large outside investors and financial intermediaries themselves have entered the market to acquire small stock holdings at advantageous prices. Where a control battle between insiders and outsiders was likely, secrecy was also important to stock buyers.

In a recent World Bank report, Morgenstern (1995:89-101) characterizes the Russian securities markets as a "one-way control market" where the brokers' principal customers, and often the brokers themselves, have little economic interest in transparency and liquidity. Since there is little two-way trading that would benefit from self-regulation and institutional support, brokers see control of the economic environment as a higher priority than liquidity. Brokers often view their principal customers as the issuers, not the investors. In the wake of privatization, stock exchanges functioned like a vacuum cleaner, vacuuming up securities from workers on behalf of inside mangers and strategic investors.

While much remains to be done to create genuine two-way trading in a stock market, a bank-centered closed market for ownership has emerged instead. Large outside blockholders are gradually consolidating control of a core group of large enterprises, initiating market-oriented changes, but the high degree of centralization of Russia's top-tier banks and their dependence on political relationships makes it uncertain whether they will be able to provide bank-based enterprise governance that is oriented to long-run efficiency.

## Banks and Financial Industrial Groupings

A study of bank privatization by Abarbanell and Meyendorff (in press) shows that an emerging demand for financial institutions led to the commercialization and privatization of state-owned banks more rapidly and irreversibly than in other reforming economies. Over half of all Russian banks operating today originated in the private sector, with over 75 percent of banking assets under the control of private investors. During the past 8 years, the Russian banking sector has undergone an impressive change. A top tier of about a dozen banks has emerged that provides a wide variety of corporate and personal banking services. The top ten banks in this group account for more than half of total assets in the banking sector. While the Russian state still has majority ownership in the two largest banks, six of the top ten banks are new commercial firms, and they tend to dominate the market for new services.

Outside of the top tier of banks, there is a large pool of small regional banks that emerged early in reform, many of these established on the basis of regional branches of state banks. Often these banks served to direct regional savings into local investment and to channel central bank credits to regional enterprises. They have familiarity with local clients and rely on a relationship system to enforce contracts, but they are frequently undercapitalized and lacking in the professional skills needed to compete with larger centralized banks in the long run.

Can the privatization of a top tier of strong banks provide the institutional framework for bank-led governance of Russian industrial firms in the style of Germany or the Japanese *keiretsu*? The evidence is ambiguous. Looking at the case of one successful bank, Abarbanell and Meyendorff (in press) find that rapid bank privatization contributed to elimination of the government's role in the corporate governance of Mosbusinessbank. Effective as the Russian approach was in privatization, it was ineffective in the transfer of genuine control rights to the nominal owners of the bank. Inadequate governance, monitoring, and voting rights mechanisms lead to a passive, diffuse ownership structure that perpetuates managerial control and agency problems.

An incumbent management that enjoyed strong relationships with prospective stakeholders of the bank gave Mosbusinessbank an initial franchise value, the maintenance of which provided incentives to direct credit in efficient directions. "On the other hand, the tendency for these managers to engage in non-market driven transactions, to respond slowly to new opportunities, and to make restructuring decisions on the basis of criteria other than profit maximization suggests that the franchise value of the bank will continue to decline in an increasingly competitive market" (Abarbanell and Meyendorff, in press). The authors also observe that intense competition by new domestically owned private banks brings product market discipline to the credit market, motivating improvement in preexisting banks.

In the case of bank credit, Abarbanell and Meyendorff observe that the initial franchise value of Mosbusinessbank was based on the strength of management's relations with ministries and local government officials, and find a large number of cross-holdings and cross-governance relationships in the bank's ownership structure and investment portfolio. Profitable bank operations in the period 1992-1995 were at least partly linked to the federal government's policy of funneling directed credits to troubled enterprises through the banks, using central bank loans for leverage. Initially, government-directed loans were profitable for the banks, but recently, government delayed payments have imposed losses on banks.

The emergence of large conglomerates with extensive cross-holding among banks and enterprises and the consolidation of these relationships into more than 30 financial-industrial groups (FIGs) provides evidence that infrastructure for open financial markets is still missing and that "political capitalism" continues to be an important source of wealth. However, these FIGs could provide an alternative governance structure in which long-term relationships and implicit contracts sustain cooperative behavior.

FIGs are large, diversified conglomerates that can play the role of a blockholder in restructuring the enterprises they control. Freinkman (1995:57) writes:

> In general, the characteristic feature of many existing FIGs is extreme diversification and confusion of their internal structure, in which, as a rule, a great number of small and auxiliary subsidiaries are created. These subsidiaries have a very complicated cross ownership structure and stable high volume of mutual payments. This results from the aim of maximizing accounting confusion and minimizing tax payments on this basis, as well as evading state regulation requirements, including limits on investment activity.

Blasi et al. (1997:155-157) see FIGs as an attempt to create a kind of closed capital market in which enterprise managers can deal with people they know rather than with the anonymous market. They differentiate "capitalist politburo" FIGs, attempting to reestablish old management systems, and merchant bank FIGs that function as a concentrated shareholder:

> The merchant bank does not have to worry about stock market, share registries, struggles with managers, or halfhearted commitment to restructuring plans. . . . This conglomerate is performing all the functions of a concentrated blockholder while skirting many of the barriers smaller blockholders confront.

In sum, banks, investment trusts, and brokers have designed successful strategies for operating in a market with missing institutions, but their ability to function as a source of market-led discipline will depend on continued improvement in financial market infrastructure. Russia's merchant banks are undercapitalized themselves and need to establish credibility in the international market. The participation of foreign banks in the Russian market is limited. Rapid institutional innovation in financial markets could either support an active open capital market or serve the closed capital market of Russian financial industrial groups.

## Product Market Discipline

To date, a competitive product market provides a stronger source of market discipline in Russia than does a competitive financial market. Rapid domestic price liberalization and more gradual trade liberalization force firms to compete with both import and export alternatives. However, most large and medium-sized firms are spin-offs from former state organizations. Genuine new market entrants are small and have little access to the capital market. Blasi et al. (1997:189) report that of 917,937 firms privatized between 1991 and 1995, over 900,000 were small firms; of these, 794,889 were small startups.

The size of the informal economy suggests that official statistics understate the entry of private entrepreneurs into trade, services, and construction. But in the product market, as well as in the financial market, missing institutional infrastructure impedes the ability of small private firms to compete. Small private firms are vulnerable to extortion from racketeers and to arbitrary and changing tax liabilities from all levels of government. In consequence, many small businesses contrive to operate in the cash economy without a fixed place of business. Firms that come to the attention of a local "mafiya" frequently close down, sometimes reopening inconspicuously in a different location at a later date.

New entrants are extremely important to the restructuring of Russia's markets. They fill market niches that were underserved in the planned economy, supply food and consumer goods, provide employment, and mobilize saving. Their success generates information for prospective future entrants to the market. McMillan (1995) points out that entry of new firms reduces the control of bureaucrats over the economy. Because it reduces the profits of former state firms, it can force those firms to improve their performance as well.

## Operating with Weak Legal Infrastructure

In the absence of a legal framework to structure relationships, resolve disputes, and enforce contracts, Russian enterprises seek strategies for operating without using law and legal institutions. Hendley et al. (1997) find that Russian enterprises make little use of law and legal institutions in structuring their relationships. Some of the firms' business strategies, such as requiring prepayment for goods, implied relatively little ability to develop substitutes for legal enforcement of contracts, while other strategies, such as extensive, multilateral barter, indicated that the firms were able to develop informal relationship institutions in place of laws.

In August 1995, Kevin Block, General Director of the Pacific Law Center in Vladivostok, met with business researchers from the University of Washington to discuss how firms there use Russian law in structuring business practice. Block said Western investors misunderstood Russian legal institutions. Some assumed Russian law creates a binding framework of rules to which all parties must adhere and provides penalties and sanctions if they do not. Others assumed Russian law was "telephone law"—all problems could be resolved by telephone calls to a friendly official. But in his experience, the truth lay somewhere between these two views: "Russia doesn't have rule of law, but there are a multitude of laws and there are consequences for breaking them."

Block said businesses found themselves operating in three separate spheres of law: relationship law, substantive law, and bureaucratic law. Russia is still a relationship society, where whom you know is more important than what the rules say. The term "relationship law" refers to the fact that it is generally so costly for a contracting party to enforce the content of a contract that the rules set forth in agreements should merely be viewed as a statement of the parties' intent to work together to achieve a common goal.

The sphere of "substantive law" refers to the new body of Western-style laws that are being written to support market reforms. Modern commercial codes, laws on foreign investment, and tax laws are examples. These laws are clear, rational, available, and subject to interpretation, not unlike legal norms in the United States. But to support a rule-of-law society, laws must be enforced by "mechanisms that work and sanctions that hurt." In Block's view, tax and customs laws could be considered substantive; others were not as yet.

Finally, said Block, the largest sphere of law was "bureaucratic." Russian bureaucracy is like bureaucracy elsewhere. Its primary mission is to regulate. For business, bureaucratic law has some unique features. One is its sheer volume and intrusiveness. Second, it is produced by people with no interest in business and "often contradicts sound business practice." Third, regulations are enforced arbitrarily, corruptly, or not at all. Fourth, regulations often contradict the law they are supposed to implement. Fifth, it is difficult to find out about regulations, especially at the local level, because they are not published in a consistent manner. In this environment, said Block, businesses use law mainly to structure arrangements to avoid future problems. Contracts between parties are set up to provide some counterleverage at each step in a relationship.

Another recent study of business strategy in an environment with missing infrastructure finds that Russian firms set up links with foreign firms in order to gain access to the institutional infrastructure of the world market (Thornton and Mikheeva, in press). The authors find that Russian firms rely on their Western partners to supply investment and credit or to borrow and post collateral on the world market. They use a foreign partner or subsidiary to collect receipts and disperse payments. A Western partner with a reputation for strict monitoring of quality may vouch for the quality of a Russian firm's performance, allowing it to gain access to the world market before its track record is known.

Within the Russian economy, Russian enterprises make use of familiar relationship and reputation mechanisms to enforce agreements within business networks. They attempt to design self-enforcing arrangements to support agreements in the absence of third-party enforcement and to reduce the incentives to engage in short-run opportunistic behavior. A high franchise value of business opportunities within the relationship system and private enforcement of contracts together provide positive and negative incentives to live up to agreements.

## CONCLUSIONS

The aim of economic reform is to provide a framework of laws and institutions that can channel investment and production in competitive directions and support economic growth. Liberalization of markets, stabilization of the macro economy, and privatization of firms in Russia are vital steps in providing the incentives, information, and market discipline needed for improved economic performance. But until Russia extends property rights in land and acquires the administrative capacity to provide essential market-supporting institutions, newly privatized firms will not have the incentive to provide greater transparency or face the discipline of competitive markets.

Investment, structural change, and renewed economic growth will emerge if self-interested owners and investors are able to design self-enforcing institutions of corporate governance, build the legal institutions required to enforce contracts, and provide secure and transparent capital markets. The experience of Eastern European countries shows that a major redefinition of the role of the state and a minimum level of state capacity (to provide market infrastructure) are necessary to support market reform.

Alternatively, in the absence of market-supporting infrastructure, the Russian state itself could be "privatized" as the major source of economic rent. In this case, future Russian economic growth could be based on an interlocking network of large, well-connected conglomerates at the center and an insecure and rapidly changing periphery of small service firms. The resulting inequality of ownership and access would generate social discord and a high level of political uncertainty. Thus, if the state is unable to provide market-supporting legal, financial, and administrative infrastructure, the economic result is likely to become not market competition, but a system of "political capitalism."

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# 6

# Learning in Networks: Enterprise Behavior in the Former Soviet Union and Contemporary Russia

*Yevgeny Kuznetsov*

## INTRODUCTION

This chapter examines enterprise behavior and enterprise learning in the former Soviet Union and contemporary Russia. Enterprise learning can be understood as a process of experimentation and repetition that enables tasks to be performed better and new production opportunities to be identified. In an economy with rudimentary—or missing—markets, enterprise learning will require significant start-up costs. First, quasi-market institutions must be created to take the place of the underdeveloped or missing markets required for adjustment. Only after these are in place can enterprises begin to adjust to them.

Institutions are defined broadly as any long-term explicit or implicit agreements about patterns of social behavior; that is, they constitute formal or informal social contracts. For example, in the absence of both firms that provide long-term leases and laws that would regulate this activity, enterprises must create quasi-leasing institutions themselves, inventing sophisticated barter schemes and ingenious forms of enforcement. The absence of market institutions necessitates the investment of already accumulated competencies (in managerial time and financial resources) to create an institution that will serve as a substitute for court-enforced leasing. Enterprise adjustment in a transitional economy is therefore somewhat similar to the complex of processes that firms in economies with antiquated physical infrastructure or pervasive government regulation must undergo. In all these cases, an entrepreneur incurs a number of start-up costs:

• Capital must be invested to establish at least part of the required infrastructure.

• Time and financial resources must be devoted to complying with the tangle of regulations involved in setting up a firm.

• Intangible capital and financial resources must be marshaled in the effort to secure general adoption of the new institution.

This chapter examines post-socialist transformation in terms of the emergence of new institutions, with their accompanying start-up costs, and suggests policies that would encourage firm-level investment in enterprise learning. The formation of market institutions is generally viewed in the current literature from one of two mutually exclusive points of view. In advanced market and semi-industrialized economies, it is viewed as a gradual process, with emphasis on continuity and path dependence (North, 1990). In contrast, the debate on post-socialist transformation stresses discontinuity and shocks, assuming that market institutions are created from scratch (Blanchard et al., 1994). This chapter reveals the importance of path dependence and continuity in institutional formation during transition through an examination of enterprise behavior in periods of drastic economic liberalization in both the former Soviet Union and contemporary Russia. It shows that both pervasive hierarchy failure (in the Soviet Union in the 1970s and 1980s) and market failure (post-socialist Russia) resulted in the formation of formal and informal networks sharing intangible capital, such as personal trust, reputation, and information that is tacit and difficult to transfer.

The next section describes the theoretical framework for the analysis. On the basis of empirical studies of real-life planning, interviews with enterprise managers, and recently published memoirs of top planning officials, the chapter then proceeds to develop a model of Soviet planning in the 1980s as a continuing balancing of implicit obligations within producer-consumer networks. The section that follows examines the low-level equilibrium trap in which the Soviet economy foundered. The next two sections introduce and illustrate, respectively, the portfolio principle in learning. The final section presents conclusions.

First, since the chapter presents relatively new evidence concerning the functioning of the economies of both the former Soviet Union and Russia, it is worth describing the source of that evidence. The conclusions presented here are based on a series of in-depth interviews with the top management of 24 enterprises in the Russian military-industrial sector, conducted between September 1993 and May 1994, with funding provided by the MacArthur foundation. We examined a broad set of issues, past and present, focusing on the manager's behavior, incentives, and priorities. It should be noted that this sample is biased, since, to maximize candor, we concentrated our efforts on firms whose top management were recommended to us as trustworthy. Annex 6-1 summarizes the sources of sample bias and describes the sample.

To test the quality of the information obtained through the above surveys, we performed an experiment at the beginning of the project. Two teams were sent to the same enterprise: one used a formal, closed-ended questionnaire to collect information on standard economic indicators such as profit, output level, and the like; the other included enterprise insiders who were authorized to pursue whatever avenue of inquiry they deemed interesting. In most cases, the first team labeled the enterprise in question a failure, while the second defined it as a qualified success, with real long-run economic potential. The difference is accounted for not only by pervasive underreporting,[1] but also by the more fundamental difficulty of defining the boundaries of the firm. Because of the broad array of disequilibrium processes inherent in transition, including privatization and firm-level decentralization, the firm is currently best described as a fluid constellation of personal networks with constantly changing boundaries. Given both the difficulty in working with such a fluid definition and the available micro-level information, one must be prepared for certain stylized facts presented in this chapter to be somewhat speculative. Finally, it should be noted that the chapter reflects the evolutionary perspective on post-socialist transformation pioneered by Murrell (1992, 1993) and Stark (1992, 1994, 1996). In the Russian case this perspective has received extensive empirical corroboration in the surveys of Russian industries lead by Ickes and Ryterman (1994).

## THEORETICAL FRAMEWORK

The value of a law firm is related only marginally to the book value of its assets; what matters is its reputation and its personal network of clients. Similarly, an important share of a bank's capital—including information about customers, customer and organizational networks, reputation, technical and organizational know-how, the culture of the organization, and its ability to change—is intangible.[2] This capital is also tacit and difficult to transfer. The more uncertain the environment, the more substantial is the role played by intangible capital. For organizations operating in emerging and transitional markets, and in particular those involved in intertemporal trade, intangible capital will be of paramount importance.

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[1]The more entrepreneurial the manager, the less reliable the economic indicators she/he produces. For example, no intelligent manager would display any profit (since it tends to be taxed away), and to avoid excess wage tax, the manager would hire labor "on paper" (indicating that actual employment would be much higher than that reported).

[2]In the case of the bankruptcy of a bank, this information capital is not easily sold or otherwise transferred to other firms, which is precisely why such a failure imposes high social costs.

Institutional venture capital funds provide a good example. Since personal knowledge is critical in this area, one would expect to see the emergence of an informal venture capital market where successful business owners would reinvest their wealth in promising young companies. Even in advanced market economies, one can observe the coexistence of informal and formal venture capital markets.[3] This example of stable equilibrium in which informal and formal capital markets coexist is important because informal institutions are usually perceived as a spontaneous response to the failure of formal markets. Yet as this example demonstrates, informal networks and formal institutions not only coexist, but are mutually supportive. Informal investors provide financing at the initial, "embryonic" stage of a project, and as it matures into the "infant" stage, hand it over to the formal capital market. This concept of the life cycle of an institution with various stages is useful in the analysis of economies with rudimentary formal markets.

Imagine an economy in which intangible capital is embedded in personal networks.[4] These networks may also include or overlap with formal institutions, such as banks and other financial institutions. A relevant example is the *grupos economicos* in Latin America—these are extremely diversified entities that often comprise assets without any apparent synergy, but that are united by a network of extended family ownership. Imagine that an economy characterized by such entities undergoes a combined institutional and demand shock, which is typical in countries that can no longer afford gradual macroeconomic stabilization and structural adjustment. What will happen with existing networks? More specifically, what will be the after-shock allocation of the intangible capital embedded in these networks? Which new institutions will arise? Because of the assumption of a shock, North's (1990) scheme of gradual marginal evolution of institutions appears not to be applicable. The following theoretical framework combines insights of Schumpeter (1934) and Kindleberger (1978).

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[3] William Wetzel, who heads the Center for Venture Research at the University of New Hampshire (Meeks and Bohner Lewis, 1995), estimates that in the United States there are as many as 250,000 informal investors who, relying on "neighborhood networks," in 1994 invested $10-20 billion in more than 30,000 companies in their own back yards. To put this informal activity into perspective, in 1994 $4.2 billion in institutional venture capital funds was raised and invested in fewer than 4,000 companies. Another 181 companies raised $1.1 billion in deals of $10 million or less in the initial public offering market (Meeks and Bohner Lewis, 1995). In the United States, the country with the most advanced formal venture capital market, the informal market is at least as significant as the formal one.

[4] From the perspective of public choice theory, a network is defined as a club good that is only partially excludable. In general, a club is a voluntary group deriving mutual benefit from sharing one or more of the following: production costs, the members' characteristics, and/or a good characterized by excludable benefits (Cornes and Sandler, 1986). We focus here on the following club goods: personal trust, reputation, and agreement to enforce each other's obligations.

A shock (displacement) provides new opportunities that may involve high risk. This particular blend of opportunities and uncertainties is likely to bring forward an entrepreneur who simultaneously does the following:

- Reaps the opportunity by undertaking a nonmarginal amount of learning in adapting existing institutions to the new situation.
- Reduces uncertainty by carving out new networks from existing ones, thus realigning personal trust and reputation inherited from previous periods.

The following characteristics of this carving-out process are important:

- Enterprise learning—a process involving investment in the accumulation of new skills and the formation of new networks. Because of the fixed costs involved, learning is subject to increasing returns.
- As a result of increasing returns, there is a multiplicity of after-shock equilibrium institutional configurations.
- The entrepreneur has a choice with regard to the magnitude of the initial investment in learning. This choice largely determines which equilibrium institutional configuration will emerge. In turn, the entrepreneur's choice depends largely on his/her planning horizon: the longer the planning horizon, the larger the investments in organizational learning will be.
- The particular blend of formal and informal institutions depends on the government's legal framework. If this framework provides low transaction costs for doing business, informal networks will have an incentive to register as legal entities and become subject to government supervision and regulation. (This applies to firms of various sorts, including alliances such as joint ventures and coproduction agreements, and lobbying organizations.) If transaction costs are high, informal economic activity that takes place outside the government taxation and regulation systems will flourish. In this case, networks will perform functions the government is unable to perform.

To summarize, enterprise learning includes the processes of acquiring competencies and accumulating social capital, as well as forming the social networks that will enable firms to put both capital and competencies to productive use. During the post-socialist transformation, the interaction among these various facets of enterprise learning has created an unusually rich and diverse set of transformation options.

## THE SOVIET ECONOMY AND ENTERPRISE NETWORKS

This section summarizes and reinterprets as a set of stylized facts the results of a number of empirical studies of Soviet planning conducted at the end of the 1970s and during the 1980s. As is customary in macroeconomics, we distinguish between the short-run (related to working capital turnover), and long-run (related to investment allocation) consequences of these planning activities.

### Short-Run Planning as a Policy Surprise

In studying the process of real-life, short-term (yearly) planning, Medvedev (1982) finds no significant correlation between planned and actual increments in output (i.e., the difference between the current- and previous-year levels).[5] Rather, he finds that plans change on a daily basis, and that no one expects them to be fulfilled. He concludes that it is not planning that directs enterprise behavior, but rather "informal interaction between enterprises,"[6] the scope of which goes far beyond Kornai's (1980) vegetative system of control. If the plan is a trajectory rather than a point, how can one define good planning? In other words, how does the planner set out to achieve the plan's objectives? Medvedev (1982) provides abundant evidence that a good planner creates small and unpredictable oscillations in the plan's trajectory. This may or may not create imbalances in plan implementation, but these oscillations will capture various slacks (X-inefficiencies) in enterprise production. The deliberate creation of (small) imbalances thus becomes the planner's major tool for checking the opportunistic behavior of his agent, the enterprise manager.[7]

### "Change of Regime" Through Organizational Innovation as a Means to Secure a Planner's Impact

A plan can best be understood as an initial agreement that shapes and constrains subsequent network interaction. Thus one might hypothesize that there may be situations in which it is worthwhile for an enterprise to obtain an initially taut plan, if doing so enhances its future bargaining position. An analysis of Soviet economic realities in the 1980s shows that such a situation became more the rule than the exception. In the construction sector, where the problem of breaches of contracts (plans) among planners, construction agencies, and production ministries—consumers of the construction services—became pervasive, every party involved tried to secure a taut initial plan. For

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[5]If one looks at absolute levels, there is bound to be a large correlation between plan and actuality. The quality of planning is then best described in terms of increments, since it is change rather than the status quo that interests a planner.

[6]The notion of a plan being an outcome of horizontal bargaining with the planner as a broker is systematically explored by Hungarian economists such as Laky (1985), Antal (1985), and Kornai (1980).

[7]Evidence that a plan is a trajectory and planning is a continuing interaction in a network of planners and producers makes the well-known hypothesis of planning "from the achieved level" trivial. If opportunistic behavior is so pervasive and the level of uncertainty/complexity is so high that every transactor involved in "planning" expects mutually agreed-upon action (the plan) to be violated on a daily basis, it is perfectly rational for the process coordinator (the planner) to make the first approximation of such an agreement solely on the basis of his/her former knowledge.

the producer, a taut plan meant more resources for its implementation. For the consumer, it increased the probability that construction would start. For the planner, it implied more leverage over the producer (threatening a penalty in case of failure to implement the plan).

Over time, a planning regime of this type becomes destabilizing: plans increasingly become the result of signaling and bargaining games among relevant economic actors, and lose any relation to and sometimes even influence on the real sphere of action. To restore his/her influence, the planner may resort to a change in the planning regime—changing the expectations of all parties involved through changes in planning and accounting procedures, through mergers and/or redivisions of ministries, and most important, through personnel changes within ministries and enterprises. Starting in the mid-1970s, the Soviet economy became notorious for organizational innovations of this kind. These changes are usually interpreted as merely a bureaucratic imitation of activity. However, I would stress that organizational changes, and even organizational shocks, were a vital part of the regime changes necessary for central planners to maintain any degree of control over the economy.

### Exchange Relations Within Relevant Networks

If a planner is powerless to enforce plans (except for a brief period of time following a change of regime), what determines actual economic outcomes? Empirical research by Naishul (1992), Shironin and Aven (1987), and Lavrovski (1988) produced evidence that the Soviet economy was governed not in a hierarchical fashion (in which the behavior of subordinates is administratively restricted), but in a network fashion (in which relatively autonomous agents operate on the basis of mutually agreed obligations that restrict their behavior). This research paints a picture of an economy in which everything—power, status, physical goods, money in enterprise bank accounts—becomes the object of trade and exchange. It also means there are relatively stable, “virtual” prices for all these goods that can be derived from the routine transactions in which they are exchanged.

The view of the Soviet system as one of exchange rather than hierarchy[8] calls into question its standard division into a shadow sector, operating outside the plan, and the formal sector, based on the plan. Once the plan is understood as the outcome of horizontal bargaining among various parties, the planner is revealed as merely a broker, and the line between the shadow and formal economies becomes blurred indeed.

[8]It is difficult to summarize the evidence provided by the cited authors. An illuminating example is an explanation of the 1991 coup failure provided by Naishul (1992). He aptly notes that the coup plotters were under the false impression that they were living in a command economy, and thus all their orders would promptly be implemented, whereas they should have known that even in the army one must provide some benefit in order to accomplish anything.

### Investment Allocation

In the 1980s, Soviet economic analysts tended to portray the investment allocation process as determined by bargaining among various industrial interest groups and ministerial hierarchies. The central planner, who was allegedly responsible for the elaboration and implementation of the nation's investment strategy, was seen as having been effectively "captured" (see Gaidar, 1990; Glaziev, 1990; Rassokhin, 1985). Thus there was no such thing as a centrally devised and implemented industrial or development strategy. Gaidar (1990) argues that there is little evidence for Kornai's hypothesis that investments will be allocated to alleviate bottlenecks and shortages. Instead, investment allocation is a function of interest group bargaining and the monopoly power of the relevant hierarchy, neither of which is directly linked to the shortage of goods or services provided.[9]

Gaidar (1990) gives an illuminating account of the interaction among actors during the process of investment plan formation, which explains why the "normal level of shortage" of some goods is not the only, and may not even be the primary, variable in the allocation of the relevant investment. The key factor is obtaining the support of all parties on whom completion of the investment process is dependent: the construction agencies, the ministries providing equipment and other necessary inputs, and the local authorities where the project will be physically located. Withdrawal of support by any participant will bring the investment project to a halt, no matter what the central planner's intentions. To avoid this situation, the primary beneficiary of the investment project must buy the support of all of the other parties involved—usually by guaranteeing a mutually agreed-upon amount of the project's future output to each of them. Failure to allocate sufficient resources to ensure of the investment plan results in a long construction cycle precisely because any relevant party may choose to withdraw its obligations.

### Drastic Regime Changes and Credibility

Because of the inertia of customary law in the Soviet Union, the best enterprises (in the productive efficiency sense) had to elaborate quite sophisticated signaling and bargaining games to secure the desired capital allocations. A simple strategy of this kind will illustrate. Suppose that 2 or 3 years in advance of the desired capital replacement, a signal is sent to the top authority saying that unless capital allocations are forthcoming, immediate deterioration in the performance of the plant in question will be unavoidable. Such signals usually have zero information value (since everyone sends them), but since the

[9]Civil construction aimed at soil improvement had a negative marginal social product, yet the relevant hierarchy was in the process of expanding rather than downsizing at the time of the regime's collapse

enterprise in question is the best of its kind, will be considered bluffing. The plant manager's next step is to make the enterprise perform substantially below its capacity for a year or two. This move will not be considered bluffing, simply because there is a risk involved for the manager: she/he could easily be sacked by the regional party authority. This move is intended to send a signal to the central authorities that the ministry to which the enterprise is subordinate is not able to manage its best enterprises—a signal that will substantially enhance the bargaining position of the enterprise. Eventually, to remedy an unfavorable impression in the eyes of the top authority, the ministry will allocate the required capital. Note that the strategy of the enterprise hinges on surprise, i.e., moves that are substantially different from expectations. In the next capital replacement cycle, the manager will have to play a somewhat different game.

Note that considerations of allocative efficiency are nowhere in sight: the interaction among the decision makers is entirely in terms of signals designed to maximize their bargaining positions vis-à-vis each other. As economic agents learn how to play these games, the economic environment becomes more complex. To implement a policy move that affects many powerful interests, the planner must design an organizational shock of increasing intensity. Given the sclerosis of the Soviet ruling elite during the period under discussion, this reveals the complete impotence of central planners to implement any development strategy. Suffice it to say that the need for strong policy moves to accomplish even minimal deviations from an equilibrium did not go unnoticed, and expectations of continual policy overshooting appear to have been very strong among Soviet enterprise managers. In other words, Soviet planners had to administer organizational shocks to ensure the credibility of policy moves—however minor.

Viewing the process of Soviet planning as a string of minor regime changes initiated to counteract the inertia of horizontal networks is important for understanding the enterprise sector's reaction to Gaidar's 1992 price liberalization. Among the salient features are the relative autonomy of enterprise decision making, enterprises' ability to deal with pervasive uncertainty, and the readiness of the enterprise sector to meet the central planner/reformer with institutional innovations that were bound to modify the impact of the original policy move. In this context we can interpret the behavioral response of the enterprise sector to the price liberalization as it emerges from our case studies. Among most enterprise managers, the Gaidar reform was interpreted as a relatively dramatic regime change, but one that still conformed to the style of the game they were accustomed to playing: the shift was simply from bargaining/signaling over real resources to bargaining over a single resource—money. Enterprise managers quickly recognized that they could be even more innovative in playing this game, simply because a shortage of money could be temporarily accommodated by institutional innovation—the creation of substitutes for liquidity, a trick hardly possible with real resources. Since the government provided no indication that enterprises would be penalized for any such efforts, a series of socially destructive institutional innovations rapidly followed. Most important, existing horizontal business networks were galvanized through mounting inter-enterprise arrears.

The view suggested here of real-life planning as a continual balancing of obligations within relevant networks through which members minimize transaction costs has important implications for the post-communist transformation. It demonstrates first that formal contractual obligations were prone to failure, and second that industrial managers had to develop an ability to "get things done" on their own even under the prereform Soviet system.

## A LOW-LEVEL TRAP IN LEARNING

Consider a persistent problem of Soviet railroads with the unloading of agricultural fertilizers, which in winter used to freeze solid during rail shipping (Kuznetsov, 1989, 1993). To unload such fertilizers, one must keep the car in a heated space for a number of days, and even after that it must be unloaded manually. The technical solution to the problem was well known: producers needed to switch to granulated fertilizers, which do not freeze. The mechanisms for inducing producers to make such a switch were far less obvious, however. Usually, coordination problems of this type were solved by the interested party's establishing an informal network of individuals, including representatives of the agency that could solve the problem (the producer), representatives of an agency interested in seeing a solution (the consumer), and planning officials who would help negotiate the solution and later make it legitimate through a decree of the Council of Ministers and/or the Central Committee of the Communist Party. To induce the producer to undertake the relevant change, the consumer had to offer some incentive, usually in the form of a transfer of a share of its investment funds, construction capacities, or other scarce resources or services. Thus to solve the problem, one had to establish an institution: *an informal network* capable of negotiating relevant exchange proportions (how much would be done and for what). This activity had to be based on personal trust for the agreement to endure. To establish such a network, one had to invest a tremendous amount of organizational talent and time; this explains why coordination among various branches of Soviet industry usually failed.

In the case of the fertilizers, no one was willing to incur the fixed costs of establishing such a network (although the problem was important, there were more pressing ones), and the solution was found along the lines of incremental learning. The railway agency asked the defense sector to invent a technical device that would enable thawing and unloading of fertilizers that freeze solid during shipping. This device—a cheap and effective one—was invented and produced by one of the defense plants. This example shows it is erroneous to assert that a Soviet-type system was innovation-averse. Rather, it catered to special imbalance-driven innovations that (more often than not) represented *allocatively inefficient* technical change. If this innovation had not appeared, it is likely that mounting pressures from both consumers and transporters of frozen fertilizers would eventually have induced the producer to switch to much more efficient granulated fertilizers that do not freeze. After the technical innovation appeared, however, these pressures abated, and a *low-level equilibrium trap,* in which a more efficient outcome became permanently locked out, was established. There are many facets of allocative inefficiency in Soviet-type economies, and technical change as a *handicap* rather than a promoter of socially efficient development is one of the most striking of these.

The need to incur fixed start-up costs to establish a network explains why low-level equilibrium traps were so widespread in the Soviet economy. Benefits from relevant innovation (or any change) typically did not justify these costs. The following sections show that the creation of networks (involving nontrivial start-up costs) that facilitate learning and enterprise adjustments remains a central feature of the Russian post-communist transformation.

## THE PORTFOLIO PRINCIPLE IN LEARNING

Learning to adjust can be viewed as the accumulation of competencies and a firm's intangible capital. The latter includes the firm's technical and organizational know-how; its reputation, as embodied, for example, in trademarks; organizational and customer networks; the culture of the firm (e.g., its ability to change); and trade secrets. The accumulation of such intangible capital may be incremental or, when a new institution is being created, involve an investment that implies fixed costs in terms of financial resources and/or the firm's competencies. For instance, firms wishing to attract foreign capital invariably find it necessary to switch to Western-style accounting systems. Doing so requires not only relevant investment in subcontracting with Western accounting firms, but also non-negligible learning on the part of the firm's employees to master the system. In the case of the transition to a new accounting system, the start-up cost of learning can be reduced by resorting to foreign expertise, though this option is not always available.

In Russia beginning in 1993, funds for defense procurement were allocated directly to the final producer of weapon systems. This was something entirely new to the Russian defense industry, in which the military-industrial commission routinely allocated funds to every enterprise irrespective of whether it was a subcontractor or final manufacturer. As with the switch to a new accounting system, the expenditure of organizational resources was necessary to make the procurement headed by final producers (rather than by a central authority) function smoothly. Why should the final producer pay on time? What would happen if it canceled the order after inputs had already been produced? Since such issues cannot be settled in court because in Russia there is no enforceable business code, an *organizational network* of subcontractors was created to deal with these issues.[10]

In a few cases, we observed the creation of institutions providing information about potential demand to customers of enterprises undergoing conversion. Thus a defense enterprise in St. Petersburg contributed space for the exhibition of civilian products manufactured in the defense sector. The exhibition has a database of specific outputs required by customers in the St. Petersburg area. It is open to everyone, but in order to join, an enterprise must include in the database the range of its output, along with relevant price and delivery data. The database has proven useful to the extent that a number of matches between customers and suppliers have been accomplished. What is noteworthy in this example is that the database and exhibition have emerged as a cooperative effort of defense enterprises frustrated by the wasteful way they were entering the civilian market,[11] rather than the creation of an entrepreneur who perceived and seized the opportunity. There were nonmarginal start-up costs in terms of managerial time for the organizers; as in every cooperative effort, benefits and responsibilities had to be negotiated.

New institutions are invariably created when a firm starts exporting. All relevant firms in the sample had to establish (with the help of Western consulting firms) agencies dealing with the preparation of export contracts, and had to set up service and customer networks abroad. Investment was involved, but it was investment in intangible capital rather than fixed assets.

The list of examples showing that serious adjustment involves the creation of a new institution requiring start-up costs can easily be extended. At this point it is important to note that, as in every situation involving increasing returns, there is a probability that innovation requiring fixed costs will fail to appear. As usual, there are two basic reasons for this. The first is lack of capital: because of capital market deficiencies, the firm is unable to raise the capital required to undertake the investment. The second is the deficiency of the revenue stream (because of a lack of demand, for instance) for recouping the fixed costs. Although we are concerned here with organizational innovations, these two basic reasons still apply. A lack of intangible capital (the

[10]Kuznetsov (1995) shows that such a network implies settlement of business disputes on the basis of personal reputation and the threat of expulsion in case of noncompliance. There are designated individuals within networks—modern equivalents of law merchants—who prepare settlements and make recommendations to top management of enterprises in the network.

[11]In the manufacturing of consumer durables, one can clearly observe the phenomenon of waves of excess competition emerging as a result of the lack of information about market demand. For instance, in 1993 the market for refrigerators became profitable, and no fewer than ten defense sector companies were unaware that other firms also doing this had entered the market. The database was created with the modest objective of avoiding such situations.

company's competencies) is even more serious than a shortage of financial capital, since intangible assets are tacit and difficult to transfer. That is why if a company's initial competencies are below a certain threshold, no amount of Western consulting will help it establish competitive marketing and service and customer networks abroad. Similarly, to recoup investment in the establishment of a new institution, the benefits should be sufficiently high, yet the revenue stream from the (more often than not) outdated fixed assets of Russian industry does not allow this. As a result, adjustment normally proceeds through incremental learning rather than the creation of the new institutions.

More accurately, one may envision *a portfolio of restructuring options* that vary by the amount of start-up costs. Rather than adopting a Western-style accounting system, one can reorganize company accounting by adopting a system of double or rather triple bookkeeping: one level for top management to understand what really happens in the enterprise, one as the standard system, and the third for tax authorities and other outside observers. Another option is to computerize an existing system, thus improving the flow of information. The option with the lowest start-up cost is the one usually chosen. An export orientation has the indirect benefits of a regime change in that options with negligible start-up costs are often not available (to be successful one must establish marketing and customer networks), and thus export-induced learning is necessarily quite intensive. Even if export attempts fail and the relevant fixed costs turn into sunken costs, the learning experience has been gained and can be applied later. Because of these learning-inducing externalities of export activity, there is a rationale for government support of export programs.

## LEARNING PATTERNS

Lessons managers learn in the process of adjustment are wide-ranging and often unexpected. The manager of a mechanical plant in Voronezh was visiting German firms for training in marketing and returned with a resolute belief that his company's intentions to start exporting were futile, that its expectations for exporting should be adjusted downward. Three and a half years after the beginning of adjustment, managers now have a more sober assessment of themselves, their companies, and the economic future. When contemplating diversification three years ago, managers tended to focus on high-tech output, while today the emphasis is on more mundane products that meet market demand. There is a growing awareness among both management and labor that without outside investment, all attempts to turn a company around will be futile, and outside investors are unlikely to appear unless the incumbent managers leave. In one case in the sample, the manager voluntarily stepped down to give way to a strategic investor. Table 6-1 summarizes the major dynamics involved in real adjustment, in the areas of both performance

TABLE 6-1 Enterprise Learning Dynamics, 1992-1995

| Strategies | Learning in the Incentive Sense (How well can I [the manager] perform a task? Should I start doing it?) | Learning by Doing |
| --- | --- | --- |
| Export orientation | Growing awareness of sunken costs related to entry into the export market. More pessimistic attitude toward export promotion. | Accumulation of expertise in preparing export contracts, making an enterprise more transparent for foreign partners. Foreign consultant firms are used extensively. |
| Diversification to meet internal demand | Growing attention to "mundane" output, including services and diversification into agriculture. | Ability to carve up viable parts of the enterprise and create wage differentials to induce the separation of unwanted labor. |
| Downsizing with the preservation of major production lines | Awareness that without an outside investor, such a strategy is often doomed. Readiness to step down from the top management position to clear the way for outside investors. | Marginal learning related to cooperation with banks and searching for inputs from new suppliers. |
| Downsizing on the way to closure; managing enterprise as a social protection unit (the most widespread strategy) | Result of repeated failures in the past. No matter what I do, I am going to fail because of the unfavorable economic environment. | Marginal learning related to private rent seeking (asset stripping) and traditional rent seeking (lobbying the government). |
| Splitting of the enterprise into different parts | More permissive attitude toward the spin-off because of the presumed ability to retain some control over the spin-offs. | Learning to create new organizational forms, such as business groups and other networks of firms. |

improvement (learning by doing) and learning in the incentive sense (How capable am I? Would I be able to respond to this or that challenge?).

In addition to these two facets of learning, there is another, often overlooked aspect—learning to deal with inherited personal and social networks. The personal networks of industrial managers were of vital importance in the times of extreme uncertainty following the shock of 1992. Network capital—one of the components of intangible capital discussed earlier—still facilitates input/output decisions, as well as contract enforcement. There is a growing realization, however, that many inherited personal and social networks are becoming increasingly unreliable and an impediment to adjustment. For instance, the general director of a large radio-electronic plant in St. Petersburg was skeptical that he could dramatically restructure the management structure of his company. "Because of implicit obligations to my deputies and to other staff, it is difficult for me. Someone from the outside must do it." The same manager allowed certain units of his enterprise to spin off while using the parent company's infrastructure and research and development capability. One of the spin-off companies had attractive assets, so the parent company management obtained a loan to acquire a controlling share of its stock during the share auction. There was an agreement—based on personal trust—that the spin-off company would not redistribute shares without consulting the parent enterprise. The spin-off company subsequently broke the agreement, and the management of the parent company lost control, as well as a share of its investment. Ex-post, this was probably an efficient outcome, but had the managers of the parent company predicted it, they would never have allowed it to happen in the first place. One of the functions of a network is the provision of information and the diffusion of learning experience. The failure of the "engineered spin-off" became known to other enterprises and formed their attitude toward similar actions.

Some enterprises with strong charismatic leaders are now choosing to separate themselves from any networks and to be free of the associated implicit and explicit obligations. The prevailing attitude, however, is to carve out new networks combining viable elements of the old ones and to seek closer associations with banks, trading companies, and other agents of the nascent private sector. Associations of graduates of elite Moscow colleges such as Moscow Physics-Technical Institute, University imeni Bayman, and the Aviation Institute play an active role in the process. Once the major source of human capital for the defense industry, these institutions have now become major suppliers of skilled labor for the banking and trade spheres. Graduate associations, some of which are quite active, provide a cross-fertilization of expertise between reform-oriented directors and the new banking elite. New networks are being formed, the major function of which is the provision and distribution of information. Through such networks, for instance, banks obtain information about which assets are potentially competitive and thus worth including in emerging business groups.

There is also a process that parallels the carving out of a restructuring-oriented network: the formation of rent-seeking networks, a phenomenon that is particularly pronounced at the regional level. Managers of defense enterprises, many of which are the only employers in their respective communities, have always been considered "shadow" local governments with an authority exceeding that of the real government. Faced with the imminent collapse of these enterprises and the need to maintain them as social protection units, local governments first resist any attempts to declare bankruptcy, then seek subsidies for the plants (which are actually subsidies for the plants' social infrastructure) through their own channels. To illustrate, the manager of a large tank plant in Siberia that had not been receiving any defense orders had been begging the federal government to close the plant. He obtained some personal rents from its assets and wanted a safe retirement. It was the local government which threatened that if the manager stopped "fulfilling his social obligations" (i.e., maintaining the social infrastructure), it would engineer a comprehensive audit of the plant, with the objective of revealing abuses of managerial authority. This is an example of *forced managerial entrenchment* that illustrates the rapidly forming rent-seeking alliance between local government and enterprise management that is unable to adjust.

At this point it is worth carrying a step further the argument of Krueger (1974), who emphasizes that rent-seeking activity does not emerge out of nowhere: in addition to the distortions imposed by rent seeking, there is associated deadweight loss.[12] Rent seeking is just one option in an enterprise's portfolio of adjustment responses. When performed outside the lobbying group/rent-seeking network, it is not even particularly efficient. Our case studies show that more learning-intensive options are often preferred. Once chosen, each adjustment often goes through a process of being perfected and improved and becomes self-reinforcing. As the formation of rent-seeking networks advances, the switch to restructuring options becomes increasingly unattractive: rent seeking crowds out restructuring. On the other hand, once restructuring options have been mastered, rent seeking becomes unattractive: learning-intensive restructuring crowds out rent seeking. Because of the cumulative nature of learning, early choices determine long-term outcomes.

Two policy implications follow from this analysis. First, until substantial progress in learning-intensive restructuring is made,[13] the federal government should abstain from discretionary sectoral policies that are particularly prone to rent seeking. Such policies would encourage an early choice of restructuring options (which is likely to perpetuate itself) from a portfolio of adjustment responses. Second, the federal government should allot more specific and transparent subsidies to social infrastructure, thereby discouraging alliances between antireform enterprise managers and local authorities.

The distinction between rent-seeking and restructuring-oriented networks once again underlines the differences between rudimentary learning with little

[12]Anyone seeking rent will be willing to commit resources (which is a deadweight loss for society) up to the amount of the rent.

[13]One criterion of such maturity is the presence of competitive enterprises that became viable without government subsidies.

investment in the enterprise's intangible capital and the learning of new skills. One can also draw a distinction among (1) rudimentary learning; (2) fragile learning, when restructuring depends on the abilities of one (usually the top) manager; and (3) sustained learning, when a managerial team with extensive organizational capabilities is created to respond to and manage change. Mapping this three-pronged distinction to the network dimension of learning (either networks are active or they are not), one derives a taxonomy of learning patterns (Table 6-2). We were unable to fit all enterprises of the sample to this taxonomy. It is noteworthy that half of the enterprises that could be fit fell into the category of fragile adjustment driven by the top manager, who does not seek the benefits and obligations of network participation. This observation can be interpreted in three ways. First, we might say that reform-oriented managers prefer a competitive industrial structure with no room for enterprise alliances and associations. Second, we might say that mistrust of institutionalized (formally through a business group, or informally through implicit contracts) inter-enterprise obligations is a peculiar consequence of the Soviet type of planning in which such networks were typical of the manager's way of life. Having "tasted freedom," the manager maximizes decision-making authority, a propensity that will subside as time elapses. Third, we might say that the process of carving out old networks has just begun. In the future, reform-oriented networks are likely to become bank-led business groups, while rent-seeking networks will become corporate sectoral associations and lobbying groups. One should wait for the institutionalization of nascent tendencies.

TABLE 6-2 Learning Styles of Management

| Type of Network | Rudimentary Learning: Incremental Improvement of Rent-Seeking Skills | Individual Learning: Investment of Top Managers' Time and Company's Resources to Master Market Routines | Creation of Sustained Organizational Capabilities: Investment in Managerial Team |
|---|---|---|---|
| External networks are small | "Fly-by-night" manager (2) | Entrepreneur—a business loner (7) | Profit-oriented management (1) |
| Networks are extensive and growing | Lobbying group, cronyism (1) | Charismatic leader with established reputation and extensive informal networks (3) | Growth-oriented management, often acting as a catalyst for business group creation (2) |

NOTE: The number of enterprises from the sample of 24 firms belonging to the respective category is shown in parentheses.

## CONCLUSIONS

The burgeoning literature on incomplete contracts emphasizes the importance of trust and self-enforcement (enforcement by convention) of incomplete contracts. A contract is said to be highly incomplete if major contingencies remain outside its scope, leaving open the possibility of its breach or ex-post (after the contingency has occurred) bargaining. This chapter has examined the transition to a market economy in Russia as a learning-enhancing transformation of personal networks—which in the planned economy were minimizing transaction costs—to profit-oriented congealed personal networks. This perspective emphasizes the following features.

### Discontinuity vs. Path Dependency

The perspective expounded in this chapter suggests that the discontinuity of the transition from a planned to a market economy is not as large as is commonly believed. Personal trust inherited from the days of a planned economy provides strong path dependency in institutional formation. Trust inherited from past relationships and thus acting as a barrier to entry gradually evolves into an instrument for reducing barriers to entry. This is the most remarkable feature of the newly emerging mechanism of economic selection.

### Multiple Equilibria and Institutional Lock-in

This chapter has emphasized the role of individual and institutional learning in reducing the transaction costs of doing business in new and unfamiliar ways and with unknown economic agents. Since such learning involves increasing returns to scale (with the increase in the number of transactions, the marginal transaction cost decreases), the currently fluid Russian institutional structure may evolve into a number of (rather than just one) equilibrium institutional configurations. As the likely outcome, one can think of a society with a large informal economy and private (and extremely violent) contract enforcement (the Colombian trajectory), or of the industrial structure of most countries of South America and Southeast Asia, with a few highly diversified economic groups that are economic agents at the mezo rather than the micro level. Both outcomes represent a so-called institutional lock-in, in which a rather inefficient institutional structure based on networks perpetuating extensive entry barriers rather than contestable markets becomes the stable equilibrium.

### Social Construction of the Equilibrium Institutional Configuration

Even though the economic policy of the government is potentially capable of escaping the outcome of networks with high entry barriers, its freedom of action is constrained by common law—the implicit norms and beliefs established within existing networks. An exploration of the resilience of societal norms and beliefs in the face of repeated development failure appears to be a promising avenue of research. It could help us discern nonviolent cooperative solutions for the persistent challenges (such as poverty alleviation and correction of income inequality) of economic development.

## ANNEX 6-1
## THE SAMPLE

Although the sampled companies include enterprises from all branches of the defense sector and all major regions of Russia, the group is biased in at least three ways. First, half of the sample comprises the radio, communications, and electronics branch, which is less asset-specific compared with, for instance, tank manufacturing, and thus possesses more favorable conditions for conversion and diversification. Second, almost half of the sample is located in Moscow, St. Petersburg, or their metropolitan areas. Third, and most important, the sample represents a more active (but not necessarily more successful) adjustment than appears to be the case in industry as a whole. More energetic enterprises appear to be more amenable and open to study and provide more interesting and challenging information. In addition, many of the enterprises in the sample were selected as a result of a personal connection with their managers, who happened to be dynamic. Information on non-adjustment cases was collected through regional administrations. These interviews were less detailed and did not cover the range of issues included in the case studies.

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# 7

# Formal Employment and Survival Strategies After Communism

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## INTRODUCTION

The countries of Eastern Europe and the former Soviet Union have suffered large declines in output and, in most cases, employment since the collapse of their communist regimes. Most research on labor markets in these economies has focused on changes in formal employment status. Numerous studies, using techniques developed for Western market economies, have examined the flows into and out of formal jobs, particularly in Eastern Europe (see, for example, all the papers in Commander and Coricelli, 1995; Coricelli and Revenga, 1992).

The assumptions underlying this work are clearly presented in the leading labor market model for post-communist countries (see Aghion and Blanchard, 1994; Blanchard et al., 1995). According to this model, the beginning of economic reform means a jump downward in state-sector employment, followed by a steady decline. There is a net creation of jobs in the private sector, but not enough to absorb all the people who leave the state sector. The result is steadily increasing unemployment. People who remain employed or who find new jobs do relatively well, while those who are unemployed, particularly for a long time, do badly. In this conventional model, state enterprises either keep people employed or fire them. Individuals respond to being fired by either finding a new job or not. Some individuals may also quit and move directly to the private sector. The model is therefore a sequence of discrete, zero-one choices by both firms and individuals.

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For post-communist economies, this model is not appealing for three reasons. First, there is a great deal of anecdotal and survey evidence indicating that firms can vary greatly the intensity with which they use labor. Standing (1994) documents what he calls "hidden unemployment" in several forms. Hours worked can be reduced through closing the factory for some period, through sending people on forced vacation (paid or unpaid), and through offering extended maternity leave. A person can also be paid a lower wage, either relative to others or in absolute terms, with it being understood on both sides that this implies a lower level of time commitment to the firm. Second, individuals can also respond to changes in their formal employment by engaging in various "survival strategies," or alternative ways of earning income, primarily through informal self-employment. In principle, an individual can vary his or her intensity of work in these survival activities over an almost continuous scale. Third, it seems inappropriate to assume that firms make one formal employment decision per person, and each individual then decides how to respond. Rather, the interaction between most individuals and their original employer is repeated, with both sides taking into account both the previous and expected future actions of the other. For example, if the managers of a firm see an individual heavily engaged in survival strategies, they may consider cutting back on that individual's work in the firm, although not necessarily firing him or her. The individual may respond by putting more effort into other income-earning opportunities, but not necessarily quitting.

Our empirical work is guided by a theoretical framework that modifies the standard model to take these three considerations into account. We model the individual's decision as a stochastic dynamic supermodular optimization problem. This problem has two critical assumptions. First, we require that managers choose the intensity with which each individual works in the firm, while the individual chooses the intensity with which he or she works outside the firm. As the manager reduces the intensity of firm work, there is a higher payoff to the individual from increasing the intensity of outside work. The converse may also be true: if the individual works more outside the firm, the manager derives a higher payoff from reducing the intensity of work for this person. The second critical assumption is that larger adjustments are more costly than smaller ones for both firms and individuals. This slows down the optimal speed of adjustment on both sides and means that optimal intensities of work adjust over time (although the optimal speed can vary considerably across individuals).

These two assumptions describe a supermodular optimization problem. Static versions of supermodular problems can be analyzed using the tools provided by Milgrom and Roberts (1990), but this approach does not capture important aspects of transitional economies. Instead, we use the results established by Friedman and Johnson (1996), which show that in the presence of complementarities and convex-type adjustment costs, the dynamic adjustment path for the individual increases in parameters that change the overall economic environment. The appeal of this approach, as shown by Friedman and Johnson (1997), is that it allows us to generate robust testable hypotheses.[1]

These results provide a framework that is consistent with a variety of specific models about interactions between firms and individuals, and that encompasses important elements of established theory about Eastern European labor markets as a special case. This is an attractive feature because while there is no agreement on precisely how firms restructure and how individuals behave in the post-communist economies, aspects of most existing models can be formulated in terms of our supermodular framework.

Our evidence is drawn from a survey of 1828 current and former state enterprise workers, conducted during the summer of 1994 in Ukraine. The sample comprises people who were separated, people identified by management as working less than normal hours or earning unusually low wages, and people who were randomly selected from among the employed. The workers were previously or still employed at 26 organizations, drawn from a cross-section of sectors and based primarily in the heavy industrial region of eastern Ukraine, but including some research institutes and schools in addition to firms. With this evidence, we can assess the standard model of labor market adjustment.

We find evidence of much more general complementarities than are predicted by the conventional theory. Using both direct measures and estimates of earnings, we find evidence (from cross-tabulations) that people who worked less inside the firm worked more outside the firm, and vice versa. However, in simultaneous regression estimation, much stronger results are found for demographic variables. In effect, we find that while most people can offset poor formal employment outcomes through use of survival strategies, women and pensioners are less able to do so. These groups appear significantly less able to cope by earning income in the private sector. Another impressive result is the extent to which people across the board earn at least a survival level of income through informal or secondary activities. In our sample, 70 percent of the randomly selected employed people were engaged in a survival strategy of some kind. Remarkably, we find that people who remained employed were more likely to engage in survival strategies than were those who were unemployed; the proportions are 69 percent for the employed and 65 percent for all the unemployed (56 percent of the unemployed receiving assistance and 79 percent of the unemployed not receiving assistance).[2] Using the lowest plau-

[1]Friedman and Johnson (1997) show that for a wide range of dynamic optimization problems, supermodularity is both necessary and sufficient for monotone static results. In the present context, this implies that our supermodular model requires the minimum set of assumptions to obtain monotonicity in the optimal decision variables.

[2]The evidence presented here needs to be supplemented with information about inter- and intrafamily income transfers. This issue was addressed in a follow-up survey, but analysis of the results is not yet complete.

sible estimates of income from survival strategies, employed people earned an average of $15.9 per month in their primary formal employment and $29.3 per month through other activities. At that time, the cost of a minimum survival basket of food per adult was at least $20 per person.[3] Many people therefore appear to have responded to worse outcomes in their formal employment with various forms of survival strategies.

These results extend three literatures. The first is recent work by Western labor economists on a range of post-communist countries (Commander and Coricelli, 1995). Using an approach developed in the study of Western labor markets, this literature has focused on formal employment and the measurement of "true" unemployment. A major puzzle for this theory is that even though the employment decline has been of a similar order of magnitude, unemployment rates in the former Soviet Union are much lower than those typical in other areas of Eastern Europe. Registered unemployment in Eastern Europe is over 10 percent everywhere except in the Czech Republic, and up to 20 percent in some countries. In the countries of the former Soviet Union, it is generally less than 5 percent, and in Ukraine during 1994 it remained below 1 percent. Layard (1994) argues that Russia has had more labor market flexibility, including lower real wages, but he does not model secondary employment strategies.

While supporting the finding that there are problems for some of the unemployed in post-communist labor markets, our results are perhaps closer to the literature on the second economy during and particularly at the end of the Soviet period (see, for example, Alexeev and Treml, 1993). According to this work, the second economy was always strong, and economic reform brought to the surface activities that previously existed but had been hidden (Leitzel, 1995). Consistent with this argument, we show how people continue to use second-economy activities to survive after the collapse of communism.

Third, we also show how to estimate empirically a general model of strategic complements in labor market adjustment. The theoretical work of Milgrom and Roberts (1990, 1994) has not yet been used extensively in econometric work. Our results indicate that with the modifications provided by Friedman and Johnson (1996), this approach offers an extremely attractive general framework for testing rival hypotheses.

The next section summarizes the Ukrainian economic situation through the summer of 1994. We then develop our model of strategic complements between firm and individual decisions concerning formal employment and survival strategies. The following two sections, respectively, present tests based on directly measuring the intensity of work and use income as a proxy for intensity. Next we examine what determines whether a person is coping or not. The final section presents conclusions and policy implications. Annex 7-1 contains a detailed assessment of gross separations in our sample.

[3]The cost of this food basket is based on our own food price surveys, which are now used in Ukranian Ministry of Economics publications (e.g., Zienchuk, 1994-1995).

## THE UKRAINIAN ECONOMIC SITUATION[4]

By the summer of 1994, Ukraine was in a deep crisis. With the breakup of the Soviet Union, the country suffered a major deterioration in its terms of trade, particularly with Russia and Turkmenistan, which provide most of Ukraine's energy imports. Its share of gas and oil imports by value increased from 12 to over 50 percent of imports from the former Soviet Union between 1991 and 1993. This increase in the imported energy bill was met by compressing nonenergy imports—by about 35 percent a year in 1993 and 1994—and by increasingly running energy arrears to Russia and Turkmenistan. As the result of an overvaluation of the relevant exchange rate, exports fell by over 15 percent a year in both 1993 and 1994. From 1990 to 1994, official gross domestic product (GDP) fell by over 50 percent, and measured in dollar terms at the market exchange rate reached around $33 billion ($600 per capita). In purchasing-power terms, Ukrainian GDP was approximately $3500 (in 1994 dollars).

Inappropriate economic policies contributed significantly to this decline in economic activity. Throughout the postindependence period, the state maintained, and at times further tightened, administrative controls over economic activity, particularly the exchange rate, domestic and external trade, and prices. In addition, there were frequent changes in regulations. This regulatory environment hindered restructuring and the development of the private sector and induced many activities to become unofficial or go underground, thus eroding the tax base (Kaufmann, 1994).

Loose fiscal and monetary policies were largely responsible for the very high inflation Ukraine experienced after 1991 (Åslund et al., 1994). Monetary financing of the budget deficit was between 10 and 25 percent of GDP, while the average inflation rate climbed from 90 percent in 1991 to 1,210 percent in 1992 and to 5,000 percent in 1993. By the fall of 1993, inflation rates were approaching hyperinflation, with prices rising about 65 percent a month. Following a tightening of credit policies and a reinstatement of administrative controls (such as on energy and other prices), the rate of inflation fell in 1994, although it was still estimated to be about 800 percent for the year. The sharp decline in production and rapid increase in prices significantly eroded the standard of living of the population. There was a marked deterioration in schools, hospitals, and health care more generally. By the summer of 1994, almost all state enterprises had encountered serious financial problems and faced the need to cut employment or wages or both.

Realizing the extent of the crisis, the new president, Leonid Kuchma, who was elected in mid-1994, called for a break from previous economic policies.

[4]This section draws on various World Bank documents, particularly the Report on the Rehabilitation Loan, November 1994, as well as Kaufmann (1994), Johnson and Ustenko (1995), and Åslund et al. (1994).

A comprehensive program of macroeconomic stabilization and structural reforms was developed, and initial measures to stabilize, liberalize, and privatize the economy were initiated in late 1994. The results presented below have not been influenced by these new policy developments; instead our evidence reveals formal employment and survival strategies in the crisis months of the summer of 1994.

## THE MODEL

The two critical assumptions presented in the introduction concern the complementarities between the actions of firms and individuals and the nature of adjustment costs. Two actions are complementary if taking one does not preclude taking the other, and taking both together gives at least as much benefit as taking the two separately.[5] In the case of differentiable functions, complementary is identical to positive cross-partial derivatives. Intuitively, this means doing more of one activity increases the benefit from doing more of another activity.[6]

Here we model the potential complementarity between the intensity with which managers employ individual workers inside the firm and the intensity with which workers engage in income-earning activities outside the firm. The firm's employment strategy, $f_t^i$, is controlled by management and represents the intensity with which the firm employs this worker. If $f_t^i$ is higher, individual i is working less intensely inside the firm; that is, the degree of "underutilization" of this person has increased.[7] A higher value of $f_t^i$ means fewer hours worked, less salary paid, and in general less intense work for a particular person. Nothing in our model requires that $f_t^i$ or any other variables be continuous or differentiable. In fact, we would expect many of these variables—such as whether the worker is given a "forced" vacation—to be discrete in nature.

The individual chooses $i_t$, the intensity with which he or she works outside the firm. There is also an adjustment cost, which depends on the magnitude of the change in his or her action, $i_t$, between periods. This variable is

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[5]Formally, we require players' strategy sets to be compact sublattices. This represents the idea that individuals' activities can be ranked in an ascending order and that any combination of activity levels is feasible. Each activity is totally ordered, but when they are considered together, the resulting vector is only partially ordered. The lattice assumption does not require continuity or convexity in the activities, so discrete and continuous variables can be treated in the same way. Precise formal requirements are explained in Friedman and Johnson (1996).

[6]Our theory, and the work on supermodular functions more generally, assumes only weak complements; that is, the conditions are all satisfied if there is no cross-effect. The only requirement is that the cross-partial derivatives (or the appropriate analogy for nondifferentiable functions) be non-negative.

[7]We assume there is a single decision maker in each firm who controls all the elements of $f_t$, so we can use "firm," "manager," and "management" synonymously.

intended to capture the idea that it takes time for individuals to develop outside opportunities, so more rapid adjustment is more costly. Given these versions of our two critical assumptions for each individual's payoff function (b) and adjustment cost function (I), the overall objective function is also supermodular. (For formal proofs of these points, see Friedman and Johnson, 1996.)

The individual's objective function can be written as the present discounted value of payoffs minus adjustment costs:

$$E\{\Sigma_{t=1}[\beta(f_t^i,i_t;w) - I(i_t,i_{t+1})]\} \tag{1}$$

where $f_t^i$ is the firm's action and $i_t$ is the individual's action, and $w$ is a vector of parameters describing the individual from the individual's point of view (and taken as given by all decision makers). The single period payoff function is given by $\beta(f_t^i,i_t,w)$, while adjustment costs are $I(i_t,i_{t+1})$. We will test whether a lower intensity of work inside the firm is complementary to a higher intensity of work outside the firm, that is, whether working less inside the firm raises the payoff to working more outside the firm.

In this framework, a higher intensity of reform policy leads to a greater reduction in the intensity of work inside the firm and an increase in the intensity of work outside the firm (but not necessarily for all individuals). We can now formulate the two hypotheses to be tested. The first is as follows:

> *Hypothesis 1.* Controlling for individual characteristics, the intensities of inside and outside work are negatively correlated (i.e., a lower intensity of inside work implies a higher intensity of outside work, all other variables being held constant).

If this hypothesis is correct, the intensity of work inside the firm should be negatively correlated with the intensity of work outside the firm. For example, the individuals who work more intensely outside the firm (using what we call "survival strategies") should be those who work less inside the firm. Some of them may leave the firm altogether, as implied by the conventional theory, but our model also allows other forms of reduction of work intensity short of complete separation.

Note that nothing in our model requires that every person work at a reduced intensity inside the firm during or after the completion of reform. In fact, our empirical work in Russia and Ukraine indicates that some people continue to work at a high intensity while others are gradually pushed out of the firm.

We also assume that firms perceive differences among individual workers. Worker attributes are represented in the vector w, where a higher value means that the firm has a higher incentive to reduce that individual's intensity of inside work. This may be because that worker is currently paid more than his or her marginal product, or because the worker is a troublemaker, or because the manager feels he does not need to employ this kind of worker because she has excellent outside opportunities. Again, an important advantage of our framework is that all these specific explanations are consistent with our formal model.

> *Hypothesis 2.* Individuals' characteristics significantly affect the intensity of inside and outside work, even when we control for potential simultaneity.

Our empirical work therefore includes regression analysis with the intensity of inside and outside work on the left-hand side in a pair of simultaneous equations. Variables on the right-hand side will include demographic and firm-specific information.

We follow this analysis with a third testable hypothesis implied by, but not formally derived from, our theory:

> *Hypothesis 3.* People who do not earn a minimum survival level of income (i.e., who do not cope on their own) are those who work significantly less both inside and outside the firm.

## THE INTENSITY OF WORK

Testing our first two hypotheses requires an analysis of the intensity of work both inside and outside the firm. This section provides direct measures of intensity, while the next uses income earned as an indicator of intensity. The following section deals with the third hypothesis, about people who can and cannot cope.

### The Sample

Our sample contained 26 enterprises, of which 19 were from Dnepropetrovsk, 3 from Kiev, and 4 from Simferopol (in Crimea). Our goal was to cover a wide cross-section of the economy, and to this end we included 2 schools, 4 industrial institutes (which provide design and research support for manufacturing and construction), 5 machine-building enterprises, 2 equipment-building enterprises, 3 food-processing enterprises, 3 chemical enterprises, 4 enterprises producing construction materials, and 4 enterprises producing consumer goods. We wished to contact 75 people from each organization, 50 of whom were still employed and 25 of whom had separated.

In each organization, we obtained a list of workers from the personnel office. Because we were particularly interested in the behavior of low-income people, 25 of those still employed were to be people identified by the personnel office as being "unsuccessful," which our interviewers defined as meaning working fewer than normal hours, having taken a forced vacation, or receiving unusually low wages. Our intention was to have management identify some of the people who could be considered in some sense to be "hidden unemployed." The other 25 employed people were randomly selected from among the entire staff of the organization, with the interviewer being told to visit as many departments as possible. Note that our sample probably underrepresents upper-level managers.

We also wanted to examine differences between people who remained employed and those who had separated. We therefore obtained from management a list of people who had separated. We interviewed people on this list by telephone until we had responses from 25 people or until the list was exhausted.[8]

Our final sample comprises 1828 people, 30 percent of whom were randomly selected, 37 percent of whom were employed and on the list provided by management, 14 percent of whom were separated and employed, and 19 percent of whom were separated and unemployed. Our sample therefore represents the three groups we wanted to investigate in roughly equal proportions. Compared with the total population of people employed in these firms in 1991, of course, it overrepresents both those employed with fewer than normal hours and those who were separated.[9] Sampling in this way enabled us to draw interesting comparisons across employment categories, but it means one must be careful about using the sample to infer overall proportions in the total population.

For the most part, the same questions were asked of the separated and nonseparated. However, the separated were also asked some additional questions about what happened to them after separation (e.g., whether they received unemployment assistance).

## Use of Survival Strategies

Our survey asked whether a person was engaged in any of six types of survival strategy: "another job" (this was asked only of people we knew had at least one formal-sector job, i.e., who had not separated or who had separated and were reemployed), use of a dacha or other plot of land to grow food, work to some extent as a private taxi driver, renting out of one's apartment, business trips abroad, and renting out of a garage. With the exception of the rentals, all

[8] Cost considerations precluded us from interviewing separated people in person. However, we do not think the difference between phone and in-person interviews biases our results.

[9] About 6 percent of those still employed earned the minimum wage. However, estimates of "hidden unemployment" range as high as 34 percent. The specific size and nature of the "unsuccessful" group depends on the precise definition used.

the questions asked here related to informal employment (although answers about "another job" could refer to another formal job).[10]

For the dacha question there were four possible answers: "I don't have a dacha," and "I grow food for myself a little," ". . . for myself a lot," or ". . . to sell." We considered only the second and third of these answers to represent the "dacha survival strategy." Almost everyone we know in Ukraine who has a dacha grows some food for his or her family and always has. We therefore regard the response ". . . for myself, a little" as being a culturally determined income-supplementing activity that will probably always exist in Ukraine and should not be confused with survival strategies due to the difficult economic situation.

We also asked whether a person worked in any way "as a taxi driver." There is an established tradition in Ukraine of giving people rides for short distances (effectively hitchhiking in the city). Prices for this service are high compared with official state-sector wages—about $1 equivalent for a 10-minute ride in Kiev at a time when state-sector wages are $20 per month. There were three possible answers: no, part-time, and full-time. Anyone who gave either of the latter two answers was classified as using the taxi survival strategy.

We asked people further whether they rented out their apartment or shared in the income of another family member who rented his/her apartment (and as a result lived with the respondent). We were also interested in what foreign business trips people had taken in the last year. Specifically, we asked whether people had traveled to Russia, Poland, Turkey, China, or Western Europe.[11] Answers were classified as one to three, four to seven, or more than seven trips to each destination. Finally, we asked people whether they rented out their garages. Of the fully employed, 5 percent did so.

Table 7-1 shows a remarkably high use of survival strategies across the board. Of all the employed (nonseparated) people in our sample, 70 percent made some use of at least one strategy. People working fewer than 30 hours per week made as much use of the strategies as did the unemployed who did not receive assistance (which indicates some support for Hypothesis 1). However, even people working at least 40 hours a week were only slightly less likely to have a survival strategy.

Of the 493 people in our sample who had a car (34 percent of the total), 34 percent worked as private taxi drivers (4 percent said they worked full-time in this occupation). This survival strategy shows the biggest difference between the sexes, being cited by 19 percent of men, but only 2 percent of women.

[10]In this survey we did not ask about income transfers. The survival strategies here are therefore "active" ones, involving some work, but are only a subset of all strategies. Our follow-up survey deals with this issue in more depth.

[11]We did not ask about trips to the Baltic states or other former Soviet Union countries. The numbers here therefore understate the amount of foreign travel.

TABLE 7-1 Proportion of People Engaged in Various Survival Strategies (all numbers are percentages)

| | Dacha | Trips | Taxi | Rent | Second Job | ≥1 Strategy |
|---|---|---|---|---|---|---|
| Unemployed with assistance | 14 | 26 | 4 | 26 | n.a. | 56 |
| Unemployed without assistance | 40 | 40 | 8 | 26 | n.a. | 79 |
| Of nonseparated wage earners: | | | | | | |
| Less than 20 hours | 37 | 21 | 19 | 15 | 22 | 74 |
| 20 to less than 30 | 26 | 36 | 10 | 15 | 33 | 79 |
| 30 to less than 40 | 33 | 28 | 21 | 9 | 26 | 68 |
| 40 or more hours | 25 | 29 | 12 | 17 | 20 | 69 |
| All sample | 24 | 25 | 11 | 13 | 20 | 70[a] |

[a]This percentage refers to the employed only and not the whole sample.

This is obviously related to the fact that 78 percent of women, in comparison with 56 percent of men, said they did not have a car.

Of the 1828 respondents, a striking 503 (28 percent) had taken a trip of some kind. Most of these people (15 percent of the sample) had gone to Russia three or fewer times, while 5 percent had gone there more than three times; 81 (4 percent) had gone to Poland, 35 to Turkey, and 12 to China. The pattern is interesting. Older people, women, and the unemployed who were not receiving assistance were more likely to go to Russia and less likely to travel to non-Russian destinations.

At this informal level of analysis, we find some support for our first hypothesis. Cross-tabulations show survival strategies are used somewhat more by people who work less in formal jobs. We now test more formally for the effect of work intensity on the use of survival strategies.

## Regression Results

Table 7-2 shows regression results for the simultaneous equation system in which the inside and outside intensity of work are the left-hand-side variables. The inside intensity is measured as the number of hours per week the respondent reported working in the firm, while the outside intensity is an index measuring the extent to which an individual engaged in survival strategies. In this index, each basic use of a strategy is given 1 point, while each use above the minimum is given an additional point. The index is capped at 5 points.[12]

All regressions were estimated by three-stage least squares, using instrumental variables and taking into account the simultaneity. The instruments were

[12]It made no difference to our results when the index was capped at 8 points.

TABLE 7-2 Regression Results for Work Intensity

| | 1. Whole Sample | | 2. Nonseparated Only | |
|---|---|---|---|---|
| Left-Hand-Side Variable | Inside Intensity | Outside Intensity | Inside Intensity | Outside Intensity |
| Constant | 44.51* (7.04) | 2.11* (0.61) | 37.4* (3.5) | 3.40 (2.37) |
| 18-25 years old | 0.27 (2.01) | –0.64* (0.25) | 0.86 (1.02) | –0.16 (0.16) |
| 26-35 years old | –0.29 (1.31) | –0.17 (0.15) | –1.84* (0.74) | –0.08 (0.16) |
| 36-45 years old | 1.50 (1.17) | 0.21 (0.14) | 0.93 (0.72) | 0.059 (0.13) |
| Dummy for pension age | –0.06 (3.08) | –0.92* (0.32) | –1.95 (1.27) | –0.32 (0.20) |
| Female dummy | –3.84* (1.23) | –0.34* (0.10) | –3.02* (0.68) | –0.37 (0.19) |
| Dummy for specialized education | 0.11 (0.97) | –0.13 (0.11) | 0.197 (0.60) | –0.06 (0.09) |
| Dummy for higher education | 0.54 (1.26) | –0.18 (0.16) | –0.81 (0.73) | –0.06 (0.12) |
| Dummy for administrator | –2.09 (1.26) | 0.33 (0.18) | –1.04 (0.74) | –0.12 (0.12) |
| Years of tenure | 0.41* (0.09) | 0.022 (0.012) | 0.073 (0.069) | 0.025* (0.0075) |
| Dummy for at least one dependent | 3.58* (0.84) | n.u. | 0.85 (0.73) | n.u. |
| Dummy for no one else works | –0.36 (1.02) | n.u. | 1.04 (0.79) | n.u. |
| Net reduction 1991-92 | 0.02 (0.06) | n.u. | 0.06 (0.036) | n.u. |
| Net reduction 1991-93 | 0.004 (0.002) | n.u. | –0.0009 (0.001) | n.u. |
| Net reduction 1991-94 | –0.02 (0.06) | n.u. | –0.06 (0.036) | n.u. |
| Outside intensity | –9.48* (2.64) | n.u. | –1.24 (2.14) | n.u. |
| Number of dependents | n.u. | –0.0032 (0.002) | n.u. | 0.11* (0.030) |
| Number of children | n.u. | –0.21* (0.094) | n.u. | –0.03 (0.06) |
| Number of adults | n.u. | –0.044 (0.056) | n.u. | 0.07 (0.04) |
| Number of pensioners | n.u. | –0.057 (0.07) | n.u. | –0.006 (0.05) |
| Number of students | n.u. | –0.022 (0.097) | n.u. | –0.09 (0.07) |

TABLE 7-2 (Continued)

| | 1. Whole Sample | | 2. Nonseparated Only | |
|---|---|---|---|---|
| Left-Hand-Variable | Inside Intensity | Outside Intensity | Inside Intensity | Outside Intensity |
| Number who work | n.u. | 0.078 (0.064) | n.u. | 0.06 (0.046) |
| Inside intensity | n.u. | –0.019 (0.029) | n.u. | –0.06 (0.06) |
| Observations | 1,571 | 1,571 | 1,191 | 1,191 |

NOTES: Standard errors are in parentheses. Coefficients significant at the 5 percent level are indicated with an asterisk (*). "n.u." denotes that this variable was not used.

measures of individual attributes and firm-level performance that were already on the right-hand side of the regressions.[13] In the regression for the whole sample, outside intensity is significant when put on the right-hand side. This result is obviously influenced by the presence of both the unemployed (with zero inside intensity and varying outside intensity) and the separated and reemployed (with zero inside intensity and outside intensity assumed at the maximum level.) We therefore ran the regression only for people who had not separated.

Both inside and outside intensity are now not significant, but this is not necessarily cause for rejecting our first hypothesis. Given the evidence from the cross-tabulations in Table 7-1, the most reasonable interpretation is that use of outside survival strategies is uniformly high and not affected by the inside intensity of work. This is further evidence of a severe crisis for state-sector employees.

Relevant for the second hypothesis, we find both the female dummy and the dummy for a person being of pensionable age to be significantly negative, indicating that these people work less both inside and outside the firm. Years of tenure (i.e., years of employment in that firm) are positive and significant in both regressions. The dummies for education are not significant, and the only significant age dummy is for those aged 26-35 (negative in the inside intensity regression). Thus it seems that women and pensioners work relatively less inside and do not make this up with more work outside the firm.[14]

[13]As right-hand-side variables we used the net employment reduction for each firm in 1992, 1993, and 1994 up to the date of interview. We also used the number of children, adults, pensioners, and students in the family, as well as the total number of people working in the family in the outside intensity regression. For the inside intensity regression, we used dummies for more than two nonworking dependents in the family and for whether no one else in the family was working. By law, state enterprises are supposed to take these two variables into account when deciding whom to fire. Alternative specifications of our regressions did not affect the significance and order of magnitude of the estimates.

[14]On average, women worked 32.5 hours and pensioners 31.7 hours inside the firm, compared with 36.3 hours for men.

## INCOMES

Given the difficulty of measuring the intensity of work directly, we also analyzed intensity using estimates of people's incomes from work inside and outside the firm. Measurement of inside activity is easier in this case—all but one respondent provided us with their official wages. Our assessment is that respondents in the state sector probably report their earnings accurately (salaries in the state sector are pretty much on the public record), but those working in the private sector are likely to understate their earnings somewhat. Incomes from formal jobs were reported in our survey.[15]

A cross-tabulation of the use of survival strategy against wage distribution rather than hours of work shows that of the highest 20 percent of the wage distribution, no less than 62 percent used at least one strategy. Of the lowest 20 percent, this figure is 76 percent, similar to the 79 percent for the unemployed without assistance. For people with higher wages, there was somewhat less use of all strategies, with the exception of foreign trips, although the first and second quintiles are very similar in their use of strategies. The dacha strategy seems particularly important for the unemployed without assistance, while a relatively high proportion of the nonseparated worked as taxi drivers.[16] Further, the lowest two quintiles of the wage distribution were significantly more likely to have engaged in survival strategies—76 percent of them had done so, versus 62 percent in the top quintile. The lowest two quintiles were more likely to have engaged in strategies than were unemployed people with assistance, but less likely than the unemployed without assistance.[17] This result supports Hypothesis 1.

To estimate survival strategy earnings, we conducted separate surveys of earnings from various survival strategies in the fall of 1994 (with informal focus groups of Kiev State Economic University students) and a more formal

[15]Average formal wages per category are given in Table 7-3, next to total incomes (in the first two columns). We asked for current wages in local currency (Ukrainian karbovantsy) and then converted all sums to dollars at the black market exchange rate prevailing on the day of the interview. We used our own black market exchange rate series, which has been collected daily since the fall of 1992. See Johnson and Ustenko (1995) for a more detailed discussion and time series. Our follow-up survey shows that premia and bonuses were small relative to regular monthly income. All these numbers match official statistics quite closely.

[16]More intensive dacha use may be worthwhile when a person can devote more time to it, and this is easier for someone without a formal job. Anecdotal evidence indicates that many people who work as taxi drivers use a car belonging to their employer for the purpose—for example, while going somewhere on business. This version of the taxi strategy has the added advantage that the driver does not pay for the gasoline. Interestingly, the dacha strategy is most commonly combined with the strategy of working as a taxi driver or making a foreign trip. Anecdotal evidence, as well as personal observation at Kiev station in Moscow during the summer of 1994, indicates that people transporting their own produce to Russia represent an important part of this phenomenon.

[17]A detailed table is available from the authors on request.

TABLE 7-3 Average Total Earnings and Formal Wages (in parentheses), Employed and Unemployed

| | Randomly Selected Nonseparated | Separated and Reemployed | Unemployed with Assistance | Unemployed Without Assistance |
|---|---|---|---|---|
| All | 46.3 (17.5) | 34.0 (20.5) | 22.4 | 39.4 |
| Men | 49.7 (19.0) | 37.4 (21.3) | 20.5 | 40.0 |
| Women | 41.9 (15.4) | 29.2 (18.8) | 24.6 | 39.9 |
| Higher education | 47.5 (18.9) | 39.6 (21.6) | 20.4 | 34.0 |
| Secondary education | 44.8 (16.1) | 36.6 (20.3) | 20.5 | 38.6 |
| Men with higher education | 46.8 (22.2) | 49.5 (22.4) | 21.7 (7 cases) | 19.2 (4 cases) |
| Women with higher education | 48.3 (15.4) | 29.7 (20.8) | 17.3 (2 cases) | 48.7 (4 cases) |
| Women with children | 41.6 (15.7) | 24.9 (19.2) | 28.0 | 59.0 |

NOTE: Total earnings include informal earnings and state assistance.

survey in early 1995. We have also conducted an independent assessment of dacha earnings as part of a separate research project on agricultural developments. As far as we can ascertain, the return from these strategies has not changed appreciably since the summer of 1994.

We use very conservative (i.e., low) estimates of what people can earn through their survival strategies. In effect, we are assuming that everyone uses a strategy at the lowest plausible level of intensity. Our estimates therefore present a lower bound of the extent to which people can compensate for low formal employment incomes through survival strategies. All the numbers given here are per month unless otherwise indicated.[18] We further estimate that work as a private taxi driver paid $8 per month if part-time and $80 per month if full-time. Renting out an apartment paid $35 per month and renting out a garage $10. The most difficult income to estimate is that from "another job," because affirmative answers to this question may cover all kinds of positions. We base our estimates on earnings in official jobs, but assume that the work is only part-time, so the average earnings are less than in primary employment. This implies a low estimate of $10 per month.

Table 7-4 shows that people with lower official earnings had larger relative incomes from secondary sources. People with lower earnings in their

[18]Even with very low estimates, small-scale farming earns a high return compared with formal-sector wages. Per month, the dacha strategy paid $3.3 if the answer was "a little," $45 if it was "a lot" and $140 if it was "to sell." The estimated net dollar earnings per group of trips (as noted above, we asked about one to three, four to seven, and more than seven trips) were, respectively, as follows: Poland, 70, 280, 490; China, 700, 2800 (no one took more than seven trips); Turkey, 400, 1600, 3200; W. Europe, 1000, 2000, 4000; Russia, 20, 80, 140. These numbers are divided by 12 for the monthly equivalent.

TABLE 7-4 Percentage of Secondary Incomes in Total Income

| | Secondary Incomes in Total (percent) | Index of Strategies (average) | Outside Earnings (average) |
|---|---|---|---|
| Unemployed without assistance | 100 | | $27.0 |
| Wage distribution | | | |
| 1st quintile | 77 | 1.65 | 38.5 |
| 2nd quintile | 60 | 1.52 | 23.7 |
| 3rd quintile | 44 | 1.43 | 26.4 |
| 4th quintile | 44 | 1.33 | 20.3 |
| 5th quintile | 29 | 1.47 | 20.3 |
| All sample | 54 | | |

formal job tended to work more (as measured by our survival strategy index) and earn more through outside work. Again the cross-tabulations support Hypothesis 1.

Also striking is the absolute magnitude of the compensation. In Table 7-3 we see that average total incomes were twice as high as official formal-sector wages for almost all groups, and three times as high for some groups. On average, people could more than compensate for low official incomes. Equally remarkable is the finding about the total earnings of unemployed people (last two columns of Table 7-3). Not surprisingly, unemployed people receiving assistance had low incomes, although even without considering benefits they averaged more than the randomly selected employed group earned officially. More striking, however, is the high average incomes of people who were separated and were not receiving assistance; this average is actually higher than for people who were separated and employed.

Average incomes can, however, be misleading, particularly for the unemployed. Table 7-5 shows the distribution of total earnings by employment status. The lowest part of the income distribution is significantly lower for unemployed people without assistance than it is for the randomly selected nonseparated people, but the medians are much closer together. This is because people could earn large amounts from survival strategies relative to official earnings, but for some reason, 30-40 percent of the unemployed did not engage in these strategies. Thus there was a very large dispersion of incomes among those unemployed without assistance.

Although on average survival strategies allowed people to compensate for low formal earnings, this was not true for everyone. The lowest quintile of wage earners earned less than $9.3 per month in formal employment. The lowest quintile of the income distribution (including all survival strategies) earned less than $14.3 per month, and the lowest one-third earned less than

TABLE 7-5 Distribution of Total Earnings by Employment Status (in dollars at market exchange rate)

| | Randomly Selected Nonseparated | Separated and Reemployed | Unemployed with Assistance | Unemployed Without Assistance |
|---|---|---|---|---|
| Minimum | 4.5 | 9.2 | 0 | 0 |
| 10th | 415.2 | 14.8 | 0 | 0 |
| 20th | 18.5 | 17.4 | 0 | 3.3 |
| 25th | 19.7 | 18.2 | 0 | 5.0 |
| 30th | 20.9 | 19.1 | 1.7 | 5.8 |
| 40th | 23.9 | 22.1 | 3.3 | 10.7 |
| Median | 30.7 | 25.6 | 5.0 | 28.3 |
| 60th | 40.2 | 29.9 | 10.0 | 38.3 |
| 70th | 52.4 | 35.0 | 25.0 | 45.0 |
| 75th | 60.6 | 38.5 | 25.0 | 45.8 |
| 80th | 63.3 | 42.6 | 26.7 | 46.7 |
| 90th | 74.3 | 66.3 | 45.0 | 115.0 |
| Max | 422.1 | 167.6 | 163.3 | 165.0 |

$17.2 per month. Of the lowest quintile of wage earners, 45 percent are in the lowest quintile, and 50 percent are in the lowest one-third of the income distribution.

In conclusion, differences in average total income are much smaller than those for average formal wages (supporting Hypothesis 1). Average earnings from survival strategies are the highest for the unemployed without assistance, while the lowest such earnings are for the reemployed—the group with the highest average official wages. Given that we use the lowest possible estimates of survival strategy earnings, we are showing the smallest plausible equalization effect. The effect is large primarily because official earnings were so low. In this situation, it does not take much in the way of survival strategy earnings to have a large compensating effect.

However, not everyone could compensate effectively. The income distribution within each formal employment group actually widens when informal incomes are included. To see which people were more or less able to compensate for low earnings in their regular jobs through informal activities, we need to use multivariate regression analysis.

## Regression Analysis

Table 7-6 shows the results from simultaneous equation estimation. The specifications and estimation procedures are the same as reported in Table 7-2, but now the left-hand-side variables are our estimates of inside and outside earnings. The first two columns are only for the nonseparated workers, while

TABLE 7-6 Regression Results for Inside and Outside Earnings

| | 1. Only Nonseparated | | 2. Nonseparated and Unemployed | |
|---|---|---|---|---|
| | Inside Earnings | Outside Earnings | Inside Earnings | Outside Earnings |
| Constant | 16.0* | 19.7 | 14.42* | 8.3 |
| | (1.63) | (13.7) | (1.58) | (12.1) |
| 18-25 years old | –3.90* | –6.38 | –2.99* | –4.05 |
| | (0.93) | (5.4) | (1.02) | (4.8) |
| 26-35 years old | –1.31 | 3.47 | –0.51 | 4.49 |
| | (0.74) | (4.2) | (0.83) | (3.76) |
| 36-45 years old | 0.50 | –0.64 | 0.80 | –0.47 |
| | (0.71) | (3.9) | (0.81) | (3.73) |
| Dummy form pension age | –3.98* | –8.72 | –2.35 | –7.49 |
| | (1.23) | (6.78) | (1.44) | (6.22) |
| Female dummy | –2.59* | –0.38 | –2.28* | –1.70 |
| | (0.52) | (3.65) | (0.60) | (3.48) |
| Dummy for specialized education | 1.60* | 0.92 | 1.48* | 0.09 |
| | (0.56) | (3.30) | (0.64) | (3.10) |
| Dummy for higher education | 3.40* | –3.74 | 3.40* | –5.89 |
| | (0.81) | (4.76) | (0.90) | (4.87) |
| Dummy for administrator | –0.22 | –3.23 | –0.93 | –2.52 |
| | (0.75) | (3.83) | (0.81) | (3.57) |
| Years of tenure | 0.051 | 1.11* | 0.18* | 1.16* |
| | (0.089) | (0.26) | (0.087) | (0.25) |
| Dummy for at least one dependent | 0.13 | n.u. | 1.27 | n.u. |
| | (0.73) | | (0.73) | |
| Dummy for no one else works | –0.25 | n.u. | –0.56 | n.u. |
| | (0.60) | | (0.68) | |
| Net reduction 1991-92 | 0.26* | n.u. | 0.23* | n.u. |
| | (0.37) | | (0.040) | |
| Net reduction 1991-93 | 0.003* | n.u. | –0.0045* | n.u. |
| | (0.0009) | | (0.001) | |
| Net reduction 1991-94 | –0.26* | n.u. | –0.23* | n.u. |
| | (0.04) | | (0.041) | |
| Outside earnings | –0.103 | n.u. | –0.142 | n.u. |
| | (0.065) | | (0.059) | |
| Number of dependents | n.u. | 4.13* | n.u. | 3.94* |
| | | (1.1) | | (0.96) |
| Number of children | n.u. | –2.29 | n.u. | –2.97 |
| | | (1.53) | | (1.52) |
| Number of adults | n.u. | 2.10 | n.u. | 1.90 |
| | | (1.21) | | (1.18) |
| Number of pensioners | n.u. | –0.12 | n.u. | 0.26 |
| | | (1.41) | | (1.42) |
| Number of students | n.u. | –2.96 | n.u. | –4.13 |
| | | (2.23) | | (2.15) |

TABLE 7-6 (Cntinued)

| | 1. Only Nonseparated | | 2. Nonseparated and Unemployed | |
|---|---|---|---|---|
| | Inside Earnings | Outside Earnings | Inside Earnings | Outside Earnings |
| Number who work | n.u. | 2.17 | n.u. | 4.39* |
| | | (1.42) | | (1.46) |
| Inside earnings | n.u. | –0.43 | n.u. | –0.16 |
| | | (0.74) | | (0.77) |
| Observations | 1,191 | 1,191 | 1,321 | 1,321 |

NOTES: Standard errors are in parentheses. Coefficients significant at the 5 percent level are indicated with an asterisk (*). "n.u." denotes that this variable was not used.

the last two also include the unemployed. In none of the specifications do we find these measures of inside and outside earnings to have significant negative signs. Again, however, this is not necessarily cause for rejecting Hypothesis 1 because the cross-tabulation evidence clearly indicates that most people obtained a relatively high level of outside earnings.

Relevant for Hypothesis 2, the dummies for women and for pensioners have a significant negative sign in the inside earnings regression, but are not significant in the outside earnings equation. The education dummies are significant in the inside regression, but also not significant in the outside equation. By this measure, it seems that no one was unable to compensate for poor low inside earnings.

Women earned an average of $28.9 from survival strategies, while men earned $29. Pensioners were somewhat behind, with an average of only $22.5, but their formal-sector earnings were a couple of dollars higher than those of nonpensioners.

## COPING AND NOT COPING

We consider a person to have been coping if his or her monthly income, including all survival strategies, was higher than $25 per month. This is a crude but probably robust measure. A person is considered not to have been coping if his or her total monthly income was less than $15. In our sample, 56 percent of men and 44 percent of women met this definition of coping, while 20 percent of men and 26 percent of women did not.[19]

Table 7-7 shows the results for probit regressions. In the first column, the dependent variable was equal to 1 if total income exceeded the $25 coping

[19]These definitions are of course fairly arbitrary, but they do capture the distribution of incomes.

TABLE 7-7 Probit Regressions for Coping and Not Coping

| Left-Hand-Side Variable | Coping (income over $25) | Not Coping (income under $15) |
|---|---|---|
| Constant | –1.60* | –0.064 |
| | (0.19) | (0.19) |
| 18-25 years old | –0.44* | 0.35 |
| | (0.21) | (0.21) |
| 26-35 years old | 0.084 | –0.075 |
| | (0.17) | (0.18) |
| 36-45 years old | 0.42* | –0.38 |
| | (0.16) | (0.18) |
| Female dummy | –0.91* | 0.44* |
| | (0.13) | (0.13) |
| Dummy for specialized education | 0.46* | –0.033 |
| | (0.14) | (0.14) |
| Dummy for higher education | 0.78* | –0.070 |
| | (0.18) | (0.19) |
| Years of tenure | –0.015 | 0.0044 |
| | (0.013) | (0.013) |
| Number of dependents | –0.00088 | 0.00073 |
| | (0.0053) | (0.0042) |
| Outside intensity | 0.15* | –0.227* |
| | (0.009) | (0.023) |
| Inside intensity | 0.0031* | –0.0040* |
| | (0.00044) | (0.00046) |
| Dummy for unemployed with assistance | 0.51 | –0.25 |
| | (0.53) | (0.63) |
| Dummy for unemployed without assistance | 0.49 | 0.060 |
| | (0.60) | (0.78) |
| Observations | 1,451 | 1,451 |

level, and in the second column it was equal to 1 if total income was less than the $15 minimum coping threshold.

The coping regression shows women were less likely to be coping in these ways, while those with specialized secondary or higher education were more likely to be coping. In confirmation of Hypothesis 3, we find that both inside and outside work intensity are significantly positive. The second column of Table 7-7 is the noncoping regression, and it again shows the female dummy to be significant, even when we control for the inside and outside intensity of work. Although not shown here, the dummy for pensionable age is not significant in any specification for either regression.

The likely explanation is that women had less access to some remunerative strategies. In particular, women did not work as taxi drivers because they did not own cars and did not generally work as drivers in the formal sector. Women probably took fewer trips (except to Russia) because of the risks involved. They also did less “parallel work” for some reason, possibly because of discrimination. It could also be that the nature of work in the nonstate sector does not favor women, but we are skeptical of this explanation because women previously did all kinds of work in the Soviet Union.

At the same time, our results raise a question about an important hypothesis of the established literature. Unemployment as a dummy is significant, but not when we control for the outside intensity of work. Undoubtedly, this is because of multicollinearity because the outside intensity is necessarily zero for unemployed people. However, it also suggests that access to survival strategies is at least as important as formal employment status in determining whether people are able to cope on their own.

## CONCLUSIONS AND POLICY IMPLICATIONS

How well does the established theory, based on Eastern European experience, explain labor market adjustment in Ukraine? It completely ignores informal activities, while the evidence indicates this is an important part of both how people survive and how they behave in the formal labor market. People can stay in the state sector and supplement their incomes with informal activities. Increases in outside "survival" work appear to be complementary to reductions in inside "formal" work. We find that the use of survival strategies is an important determinant of whether people can or cannot cope on their own.

At least in Ukraine, there has been a considerable flow of people between formal jobs, but unemployment remains low. The established theory of post-communist labor markets needs to be modified to include self-employment and the ability of people to generate their own incomes (albeit at a low level).

The Ukrainian nonstate sector, mostly individuals operating by themselves and in an informal way, expanded massively during 1992-1994. This growth occurred in large part because the collapse of the state sector and increasing administrative controls over the official economy meant people had to find ways of supplementing their official incomes. At the same time there has been de facto liberalization of entry into informal activities.

A substantial amount of income-earning assets is already controlled by private individuals. Real estate, vehicles, and some agricultural land are already in private hands to a significant degree (even if not formally privatized). State assets such as trucks, trains, and industrial premises can be accessed easily through informal markets.

It is fortunate that the state lost its ability to prevent people from using a wide range of assets as they see fit, because this enabled them to earn higher incomes. However, without proper privatization there is insufficient investment in these assets. Ukrainian people survived on their individual and collective inherited capital stock, and unless full private ownership is established, this capital will likely not be replaced as it depreciates.

It is important to stress, however, that until mid-1994, the Ukrainian private sector merely offered a way to survive. There was not enough stability for serious private-sector investment to take place. People working in this sector were earning just enough to survive. The private sector can be a powerful force for the positive transformation of work after communism. The clearest example of this effect is in Poland, where almost every aspect of the economy has been fundamentally transformed as a result of the emergence and growth of new business over the past five years (Johnson and Loveman, 1995). But this form of private-sector development requires an environment in which private business can establish itself in activities that require relatively sophisticated organizations. This happens only when private entrepreneurs are willing and able to make significant investments in fixed capital assets. Preliminary evidence suggests that the stabilization and proper liberalization pursued since the fall of 1994 have begun to have these effects.

## ANNEX 7-1[20]
## UNEMPLOYMENT

Our theory and evidence suggest a reinterpretation of what has happened to unemployment in Ukraine. Officially registered unemployment in the summer of 1994 was below 0.5 percent. This figure is remarkably low and much lower than the rate in most post-communist countries of Eastern Europe, where it ranged between 10 and 20 percent. It is commonly supposed that the official numbers are understatements, but even surveys indicate that open unemployment—people who do not have a job and would like one—in Ukraine is only between 3 and 6 percent.

The established explanations for the relatively low level of unemployment in Ukraine are that very few people are fired from state enterprises, and that there are many genuine unemployed who do not register because benefits are so low (see Coricelli and Revenga, 1995). We examine these hypotheses in turn.

### Firing and Hiring

At the beginning of 1991, the organizations in our sample had total employment of 13,498, and this figure remained approximately constant in 1991 and 1992; there was actually a 1 percent increase, most of which occurred in 1992. Of 26 organizations, 16 had an increase in employment during this period, and there were increases in all sectors, although a higher proportion of firms increased employment in the machine- and equipment-building sectors.

However, total employment fell 5 percent in 1993, and a further 5 percent from the start of 1994 to the time of our interviews in mid-1994. At the time

[20]An annex containing a detailed analysis on “gross separations” is available on request.

of the interviews, our sample therefore shows a total net decline in employment of 9 percent from January 1991 and a total net decline of 10 percent from January 1993. From January 1991 to the time of the interviews, the employment of women fell by 10 percent and that of men by 5 percent. Total employment in the sampled organizations at the time of our interviews was 11,664.

This net decline in employment masks the fact that there was a substantial amount of hiring in these same enterprises during 1992-1994. Strikingly, 24 out of 25 enterprises for which we have this information hired some people, and while only 3 enterprises had gross hiring above 10 percent of their January 1992 employment levels, 17 hired more than 5 percent of this total.[21]

In sum, the evidence indicates that people have been fired from all the state organizations we surveyed. It is true that firings were minimal until January 1993. As part of a labor force reduction, only 0.5 percent of men were fired during 1991 and 0.3 percent in 1992, although 1 percent of women were fired in both years. However, in both years, "other" firings were between 1 and 2 percent; this figure probably represents managers getting rid of workers they did not want. After January 1993 there was a sharp increase in firing: 3 percent during 1993 and 5 percent from the beginning of 1994 as labor force reduction, and 4-5 percent as "other." Even though Ukraine has lagged in terms of overall economic reform, there has been a substantial labor force reduction in many state enterprises. Many people have either been fired or been forced to quit. Why, then, has unemployment remained so low?

## The Unemployed

There were 351 people who identified themselves as unemployed among our respondents. Of this total, 19 percent were not receiving any benefits and were not registered as being unemployed, and 38 percent had been unemployed for less than 3 months. For up to 3 months from separation, people who have been fired as part of a labor force reduction get their benefits from the enterprise rather than the government. According to Ukrainian practice, people are not counted as unemployed until they register with the government's offices. The effect of this procedure is to exclude almost all short-term unemployed from the registered total.[22]

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[21] According to Ukrainian law, a worker can be dismissed as part of a labor force reduction only if he or she cannot or will not take another job in the enterprise. The simultaneous firing and hiring on the scale reported in our sample suggests that this legal requirement is not enforced.

[22] In the case of dismissal due to a labor force reduction, management must give the employee at least 2 months' prior notice. On the day of dismissal, the employee must receive any outstanding payments, including compensation for unused holidays, and an additional 1 month's pay. During the next 2 months, any ex-employee who has not found another job has the right to

The reemployment rate for quits is high. Annex Table 7A-1 shows that almost all quits among those surveyed were reemployed after 1 month and that the reemployment rate for people who had been fired rose steadily. Almost no one who had quit had registered as being unemployed or was receiving benefits.[23]

Therefore, in our survey, the registered unemployed (reported in national statistics) were only those fired people who had been unemployed for at least 3 months. This is just 34 percent of all the unemployed people in our sample, and converts to an unemployment rate among the population of 4 percent. If we assume that only people unemployed at least 4 months were registered unemployed, the implied unemployment rate falls to 2 percent.[24]

The reemployment rate among our sample was very high for anyone who would have been eligible for benefits. The average reemployment rate for fired people seems rather low at 28 percent, but it rises to 47 percent for people unemployed 4 or more months and keeps on rising (Annex Table 7A-1). It appears that people were not particularly attracted by the level of unemployment benefits. At least in our sample, there was almost no long-term unemployment.

Although our results imply a registered unemployment rate of 2-4 percent, the “true” unemployment rate—people without a job who are looking for work—in our sample is 11 percent (including both quits and people who had been fired).[25] If we assume that pensioners who had separated in the last 3 years would also have liked to work but could not, the unemployment rate increases to 14 percent.

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continue to receive a monthly salary from the enterprise. According to Ministry of Labor estimates, about 70 percent of employees who have been dismissed receive such allowances at their enterprises. To have a right to unemployment compensation, an employee must register at his/her local employment office during the 3 months following dismissal. If this is not done in time, the employee forgoes the right to unemployment compensation.

[23]Table 7-1 shows that the unemployed without assistance (primarily quits) were heavily engaged in working at their dachas and in taking trips to Russia. These were unemployed people who were looking for work, and who had significant side incomes that they presumably did not want to report to the state.

[24]This estimate is higher than the official statistic for a number of reasons. Our sample did not include young people who had never worked before or pensioners. Our sample also contained more industrial employment than is the case for the economy as a whole. About 20 percent of Ukraine’s population lives in rural areas, closely linked to agriculture, and the unemployment rate is probably lower there. Our sample may also have been biased toward including more people who had separated recently, and this would also tend to increase the unemployment rate.

[25]Taking gross separations since January 1993, removing retirements, and applying the differential reemployment rates for quits and fired implies that a total of 1,557 people were unemployed. This would be 11 percent of the January 1993 level of employment among the surveyed firms. We assume that everyone who had separated before January 1993 was reemployed. Given the high rates of reemployment for people separated more than 9 months, this is not unreasonable.

TABLE 7A-1 Rate of Reemployment

| Number of Months Since Separation | Reason for Separation: Quit | Fired |
|---|---|---|
| 1 or more | 96 | 34 |
| 2 or more | 96 | 34 |
| 3 or more | 99 | 39 |
| 4 or more | 100 | 47 |
| 5 or more | 100 | 54 |
| 6 or more | 100 | 70 |
| 7 or more | 100 | 82 |
| 8 or more | 100 | 90 |
| 9 or more | 100 | 91 |
| Whole sample | 69 | 28 |

In short, our work suggests that the actual unemployment rate in Ukraine is close to that in Eastern Europe. However, the peculiarities of the benefit system, with the enterprise paying for the first 3 months, mean that most of the short-term unemployed are not registered. Although this implies an overall unemployment rate similar to that in Eastern Europe, Ukraine has much less long-term unemployment. Most likely this is because the benefits are so low—typically around 20 percent of the minimum survival wage—while it is relatively easy to find a new job of some kind and to supplement that income with a survival strategy.

In contrast to the established view, separated people in our sample could readily find new formal jobs, and labor force participation had not declined as of the summer of 1994. Almost everyone was reemployed within 6 months. Even more important, people could generate new informal income-earning opportunities for themselves. This meant people were more likely to quit voluntarily and create job openings, even in companies that were contracting. As a result, in the summer of 1994, very few people in Ukraine were not working.

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# 8

# Observations on the Speed of Transition in Russia: Prices and Entry

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## INTRODUCTION

This chapter reviews two projects in which we have participated that seek to characterize the establishment and enforcement of property rights in Russia following the breakup of the Soviet Union. The first one empirically studies the extent to which price liberalization has been achieved in Russia. Price liberalization relates to property rights in the sense that when broad price controls are in effect, firms have poorly defined control rights over their cash flows, and thus cannot fully reap the benefits of ownership enjoyed in market economies. The second project makes the point theoretically that unless prospective entrants into established markets are rapidly afforded the same access to inputs and credits as existing enterprises, the right of entry is only nominal. In the case of Russia, the lack of such access effectively limits the benefits of the enforcement of property rights to firms that operated in the state network of the Soviet Union. The empirical project suggests that Russia has made admirable progress toward achieving price liberalization, despite substantial obstacles to this reform. The theoretical analysis explains fragmentary evidence suggesting that start-ups and firms operating outside the residual state

We have benefited from the comments of John McMillan, Werner Troesken, and participants in the workshop “Economic Transformation: Institutional Change, Property Rights and Corruption,” organized by the National Research Council’s Task Force on Economies in Transition. We have also benefited from the comments of participants in the University of Pittsburgh’s reading group on the Chinese economy. Berkowitz’s research was partially supported by a Faculty Research Grant from the Faculty of Arts and Sciences, University of Pittsburgh.

system in Russia are not performing as well as their counterparts in Central and Eastern Europe.

This chapter is organized as follows. The next section contains a brief historical overview of prices and entry of private firms in the Soviet Union. Obstacles to Russia's price liberalization efforts are then discussed. The following section provides evidence that despite these obstacles, a price system integrating intra- and intercity goods markets has emerged in Russia. Data on the emerging price system, however, suggest that firms and distributors are operating with significant transaction costs. Next, we argue that new private firms in Russia face more discrimination in input and credit markets than do comparable firms in Central and Eastern Europe. Using a theoretical model, we show that the relatively slow development of competitive access to input and credit markets may explain some of the fragmentary evidence suggesting that start-ups have had a much more positive impact on the standard of living in Central and Eastern Europe than in Russia. The final section presents conclusions.

## HISTORICAL BACKGROUND

It is clear that in the former Soviet Union, property rights were ill defined. Prices for state firms were centrally controlled, and nonstate firms (which were at times permitted to coexist marginally in certain sectors to alleviate shortages) operated in a precarious regulatory environment. The inefficiencies resulting from price controls and the arbitrary regulation of nonstate firms are well understood. The maintenance of prices at levels at which demand exceeded supply encouraged buyers in state-sector markets to allocate time to socially inefficient activities (e.g., queuing, reselling, and bribing), while the enforcement of prices at which supply exceeded demand resulted in the accumulation of excessive inventories of goods. More generally, broad price controls, coupled with artificial mechanisms designed to stimulate state firms to fulfill administratively set plans, created an economic environment in which fulfilling consumers' needs was a low priority.

Because of regulation-induced imbalances in the state sector, socialist governments were compelled to tolerate a certain amount of private business activity. As a result, private farmers furnished a large share of the urban food supply, while nonstate firms were at various times significant suppliers of clothing, handicrafts, construction services, small electronics, and repair services (see Grossman, 1977; Simes, 1975; Shlapentokh, 1989). While the prices, quality, and quantity of state-sector goods were determined according to administrative criteria, prices, quality, and quantity in the private sector were generally flexible and responsive to consumer demand. Nevertheless, state regulators and politicians curtailed private activity whenever it became too large or profitable. In periods of retrenchment from socialist reform, private firms were often shut down, nationalized, or subjected to extortionary taxation, and many owners were fined or jailed.[1] This uncertain regulatory environment led to myopic behavior in the private sector: (1) operations tended to be small and labor-intensive, (2) many private firms produced low-quality goods that could be sold quickly at high prices in shortage markets;[2] and (3) private entrepreneurs often simply resold goods purchased or acquired from the state sector.

## PRICE LIBERALIZATION AND THE DEFINITION OF PROPERTY RIGHTS[3]

Price controls are no longer a major issue in the Central and Eastern European countries. These countries rapidly released the overwhelming share of state-controlled prices in their initial liberalization packages. By 1995, only 5 percent of consumer prices in the Czech Republic remained regulated, and less than 10 percent in Hungary and the Slovak Republic. In Poland, the central government continues to place price controls on utilities, medicines, and rents in public-sector housing and has an agricultural farm support program, but the overwhelming majority of prices are unregulated.[4]

In contrast, price liberalization in Russia has, since its inception, been a point of contention among federal, regional, and local governments. This section summarizes the evolution of price liberalization in Russia and offers several explanations for the persistence of price controls. It also argues that the persistence of controls impairs the development of the firms' ownership rights over cash flows and, more generally, that it impedes the effective establishment of property rights.

In January 1992, a federal decree liberalized the overwhelming share of state retail prices and state-administered wholesale prices. However, the prices of basic consumer goods (e.g., bread, milk and other dairy products, vegetable oil, baby foods, medicines, salt, sugar, electricity, and fuels), as well as many services (e.g., public transportation, housing rents, public utilities, and communication services) were placed under temporary controls (Koen and Phillips, 1993:4-5). At the same time, the federal government also began to curtail its subsidies to regional governments for the purchase of consumer goods.

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[1] This observation was first made by Åslund (1985) in his classic study of legal nonagricultural private activity in the former German Democratic Republic and in Poland. The position of legal private firms in the former Soviet economy is analyzed by Jones and Moskoff (1991).

[2] This observation is made generally for all formerly socialist economies by Kornai (1990, 1992).

[3] Much of the material from this section is taken from Berkowitz (1996) and Berkowitz et al. (1996).

[4] These data are taken from European Bank for Reconstruction and Development (1995:Annex 2.2, 39, 44, 52, 55).

Local responses to these federal decrees varied widely. At one end of the spectrum, many oblast (county) and city governments adjusted, or even freed, regulated prices under their jurisdiction in January and February because they could not afford to pay their own producers subsidies for charging low prices. However, at the other extreme, locally initiated price controls were rampant in 1992 and 1993. Table 8-1 presents the results of a survey of 132 Russian cities (conducted in mid-1992 and mid-1993), showing that many continued to control food prices. Many local governments also employed protectionist measures, such as issuing local moneys and ration tickets in an attempt to curtail nonresidents' purchases of the cheap goods sold in state stores. By mid-1992, 23 oblasts that had previously been net exporters of agricultural goods were reported to have set up export barriers (Koen and Phillips, 1993:11 and footnote 27). Some local authorities that had tried to keep food and other consumer prices artificially low were taking additional measures to block the outflow of these subsidized goods from their regions.

Locally initiated price controls slowed the integration of a domestic market (Gardner and Brooks, 1994). Mafia groups, often in collusion with local government officials, also limited trade between cities and curtailed the operations of some firms. Many suppliers found it difficult to sell in particular markets because local mafias demanded exorbitant rents. This situation is

TABLE 8-1 Controls on Food Prices, Mid-1992 and Mid-1993, for a Sample of 132 Russian Cities

| Product | Percentage of Cities Where the Price Remained Controlled Around July 1, 1992[a] | Percentage of Cities Where the Price Remained Controlled Around July 1, 1993[b] |
|---|---|---|
| Milk | 44 | 33 |
| Kefir | 36 | 23 |
| Fat cottage cheese | 29 | 20 |
| Rye bread | 30 | n.a. |
| Mixed rye-wheat bread | 28 | n.a. |
| Grade 1 and 2 wheat bread | 32 | 48[c] |
| Top-quality wheat bread | 10 | n.a. |
| Sugar | 30 | 14 |
| Salt | 17 | 9 |
| Meat products | 11 | 15 |
| Butter | 6 | 5 |
| Vegetable oil | 14 | 7 |

[a]Data from State Committee on Statistics (Goskomstat, 1993) for the Russian Federation. Taken from Koen and Phillips (1993:32); cited in Berkowitz (1996).

[b]Data from Goskomstat for the Russian Federation.

[c]This figure combines all four bread groups.

n.a. = not available

well illustrated by the following anecdote from the Russian press (Effron, 1994, cited in Berkowitz et al., 1996):

> "It really is scary, but despite the fact that the markets are empty, it's still impossible to sell your produce" in Moscow, St. Petersburg and other large Russian cities, said Tatyana Vasilyeva, president of the local Krasnodar branch of AKKOR, which represents 16,680 private farmers. Highway robbers, traffic police who demand payola in exchange for free passage and payoffs to local gangsters make a mockery of a free market, she said. . . .
>
> Melnik, a Krasnodar farmer, said his cooperative sent a truck load of tomatoes to Moscow, but the farmers were stopped at the outskirts of the city, where racketeers together with corrupt traffic police insisted that the contents of the truck be handed over at rock-bottom prices.
>
> "If you do get through, they tell you what price you can sell for, and no lower," Melnik said. The complaints of beatings, threats and price-fixing have been repeated by farmers from Siberia to central Russia.

Four years after the institution of its so-called "Big Bang," the issue of price controls remains problematic in Russia. As of the beginning of 1995, the federal government retained controls on only a limited group of basic necessities and certain producer goods and services. However, communists in the federal legislature continued to lobby for the reimposition of broad price controls on food goods, domestically consumed heat and electricity, and state-owned housing (Cherkasov, 1996) that would contradict federal regulatory norms. At the same time, approximately one-third of all prices were already subject to locally initiated direct and indirect price controls (European Bank for Reconstruction and Development, 1995:55). In 1995, the governor of Pskov oblast and the Mayor of Moscow continued openly to regulate retail prices in their territories despite a federal edict prohibiting such controls (Borodulin, 1995). In 1993 and 1994, agricultural producer prices were 30-40 percent lower than world prices for major commodities such as grain and meat.[5] Federal policies that could have sustained these low prices, such as export controls, administrative prices, and mandatory state deliveries, were not in effect in 1993-1994. As there was still significant regional dispersion in agricultural prices during this period, and many oblasts and cities openly admitted maintaining low prices for food goods, Brooks et al. (1996:Ch. 1, 7) conclude that local ". . . policies and local barriers to trade are probably among the chief constraints depressing producer prices."

Locally initiated price controls are responsible for substantive welfare losses associated with both queuing and corruption. Further, local government efforts to limit the extent of consumption by nonresidents, as well as the resale of underpriced goods, interfere with interregional trade flows. Such

[5]These data are cited in Brooks et al. (1996:Ch. 1, Table 1.8; the original sources are cited on p. 13).

protectionist measures limit the realization of potential gains from trade within the domestic market and impose real losses on consumers. In the case of China, low state-sector prices are not so problematic. Many enterprises under local jurisdiction are obligated to sell a specified amount of their final output at low and fixed state prices. As quota enforcement is generally effective, price controls in China do not result in a massive diversion of low-priced goods from basic users in the local market. However, as the analysis by Murphy et al. (1992) suggests, because quotas are poorly enforced in Russia, price controls can lead to massive diversion of goods that can be easily resold.

Why do some local governments continue to try to regulate prices? What are their incentives for maintaining policies that appear to impose tremendous local and national welfare losses?

One explanation, based on an influential article by Shleifer and Vishny (1992), is that these price controls generate rents for local governments and the firms under their jurisdiction.[6] The basic idea of the model is captured in Figure 8-1. Price and quantity are on the vertical and horizontal axes, respectively. The lines marked *d* and *mr* represent a local demand schedule and its corresponding marginal revenue curve, respectively. Normal costs are constant at a level *c*. A firm earns a "normal profit" when it charges the price *c*, and *c* therefore represents a marginal or average cost. However, *c* may also include per unit subsidies supplied by local or other government sources.

Shleifer and Vishny argue that price controls provide a mechanism for managers and their regulators in local governments to enrich themselves. During the transition, many firms, especially suppliers of consumer goods and services, have come under the jurisdiction of local governments. Nevertheless, the federal government is still able to impose a high tax on reported profits that exceed the normal rate. Thus, managers and their regulators in the local government can make money only if they can conceal excess profits. The spread between the posted price of *c* and the actual market price, multiplied by the sales quantity, represents potential "bribe revenue" that can be concealed from federal tax collectors. This is illustrated by the shaded rectangle in Figure 8-1. The posted price of *c* is the firm's marginal cost, which generates the normal per unit profit. The manager and local government officials equate marginal revenue with marginal cost and pocket the difference between the market and posted prices.

There are, however, two problems with using the Shleifer-Vishny model to explain locally initiated price controls. First, the federal tax rates applied to enterprises under local jurisdiction have fallen, while the local tax shares on profits, value-added taxes, and payroll taxes have increased. Thus, there is less incentive to raise money in this concealed fashion. Second, a local poli-

[6] Shleifer and Vishny develop this theory to explain the persistence of price controls under socialism. It is natural, however, to apply the theory to transition.

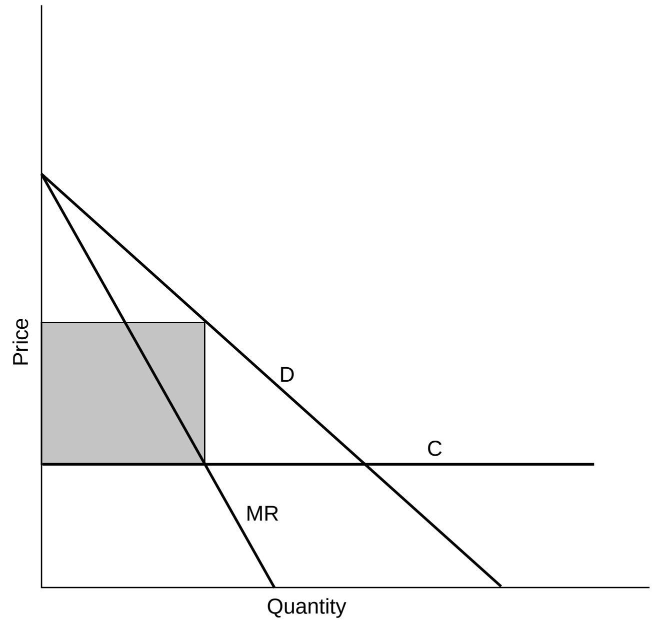


FIGURE 8-1 Concealed profits. See text for discussion.

tician who tries to get rich by collecting bribes in exchange for consumer goods risks alienating his/her constituents, who can vote the politician out of office in future elections.[7] Such pressure to please constituents did not exist under the socialist system, when voting was an exercise designed to legitimate candidates already chosen by the local Communist Party. However, since March of 1990, deputies to the local soviets (parliaments) have had to run for office in competitive elections. Although there is some evidence of fraudulent electoral practices, survey data confirm that most elections are conducted fairly and that the new system has forced local politicians to be more accountable to their constituents (Hahn, 1994).

Even in a situation with free and fair elections, local politicians might still institute price controls if they believed they could collect bribes without being detected by their constituents. Thus, the Shleifer-Vishny model could apply to the imposition of "sneaky price controls." Local governments could charge an artificially low posted price to cover normal costs and collect monopoly rents in the form of unobserved side-payments. The persistence of low producer prices for agricultural goods and the low prices of many primary energy goods

[7] Shleifer and Vishny (1993:611) note in a later article that ". . . increased competition within the ruling parties as well as from the opposition parties . . ." would curtail bribe-taking behavior on the part of government officials.

could be evidence of the existence of sneaky price controls that allow local politicians to collect unobserved rents from exports. However, price controls on locally sold food and consumer goods could not be sneaky for very long. These goods are sold in local markets on a daily basis, and it is local constituents who must pay the posted prices and bribes. Eventually they, and others, would learn that their actions were enriching their elected politicians.

Berkowitz (1996) develops a model in which local politicians maximize constituent loyalty rather than bribes. In this model, a locally regulated state firm and an unregulated private firm compete in price, subject to capacity constraints in the local market.[8] The private firm maximizes profits, while the state firm maximizes a political objective represented as a weighted sum of consumer surplus and industry profits. In this scenario, a local government will set a low price that induces rationing in the state sector when the private sector has a small capacity, and therefore can be induced to behave competitively. However, if the private sector is large enough and is able to exercise monopoly power, the local government is more likely to set a higher market-clearing price in the state sector. Thus, private capacity is a critical determinant of whether a local government sets a low rationing price or a higher market-clearing price.

The reason for this result is that private firms in a small and competitive private sector will always sell at full capacity and hence undercut any state price higher than the competitive price. Therefore, when the private sector is small and competitive, the state sector serves the public interest by setting the lowest possible state price and transferring all of the gain to its constituents. However, when the private sector is large enough to exert monopoly power, its pricing policy depends on state-sector prices. If the latter prices are high, the private sector will undercut the state firm and sell at full capacity, whereas if those prices are low, the private sector will choose the monopoly price and constrain sales to less than full capacity. While increases in state-sector prices will have a direct negative effect on the welfare of constituents shopping in state stores, a sufficiently high state-sector price will have the indirect positive effect of constraining monopolistic behavior in the private sector. When this second (indirect) effect dominates the first (direct) effect, local governments will tend to support price liberalization. This will occur in situations where the private sector is large enough to have substantial monopoly power and where state-sector technology is inefficient.

It is not possible to test the Berkowitz model rigorously, as the necessary data on private and state capacity holdings are not available. Some educated guesses about private versus state capacity holdings, however, can be made using data cited in Brooks et al. (1996:Ch. 1, Table 8-1.12). During 1991-1994, the share of milk procured and marketed by state organs in the Russian Federation fell minimally, from 98 to 93 percent. However, the nonstate

[8]It is straightforward to extend the analysis to more than one private and/or state firm.

(private) market share of potatoes more than doubled, from 31 to 67 percent, during the same period. This suggests that private capacity is much higher for potatoes than for milk in the average local market.[9] Tables 8-2a and 8-2b show that differences between private and state potato prices were, on average, very low in the Central and Volga regions of Russia from February 1992 through February 1995. On average, however, state milk prices were much lower than private prices in the Central cities of Moscow, Bryansk, Kaluga, Oryol, and Novomoskovsk and in most of the cities in the Volga region. As the survey was designed to minimize quality differentiation between state and private products, the data suggest there was a great deal of state-sector rationing in the milk market, where private capacity is small. In the potato market, where private capacity is much larger, state prices tended to be close to the market-clearing level prevalent in the private sector.

This section has argued that many local governments in Russia ignored federally mandated price liberalization. It has also suggested possible incentives for the persistence of price controls. An important question remains: Have local price controls succeeded? Specifically, has rationing persisted, and have prices failed to provide information about the demand for and supply of goods within and across cities? Alternatively, has a market price system emerged in the Russian Federation following the Big Bang of January 1992? These questions are explored in the next section.

## PRICE LIBERALIZATION AND RESOURCE ALLOCATION

Working with 110 pairs of time series of state and market commodity prices in Russia (five food types across the 25 cities listed in Tables 8-2a and 8-2b, with 15 missing pairs), Berkowitz et al. (1996) study empirically the issue of whether local resistance to the federally initiated price reforms of the Big Bang has succeeded in preserving the market segmentation evident in the New Independent States, both within and across cities. Their evidence suggests that it has not. Beginning with intercity comparisons of state and market prices, they find that differences in the levels of these prices have gradually diminished, that market/state price ratios have become increasingly uniform across cities, and that the volatility of innovations to these ratios has decreased dramatically. Further, they find widespread evidence within cities that state and market prices are cointegrated, and that market prices are causally prior to state prices in the sense of Granger (1969) (see below). Finally, they find widespread evidence of cointegration and causality between state and market prices across cities.[10] These findings suggest that despite the obstacles posed

[9]It is also the case that the share of private sales in the Central and Volga regions is very high for potatoes and very low for milk.

[10]Goodwin et al. (1996) find similar, although less dramatic, evidence of this type using an alternative data set.

TABLE 8-2a Sample Means of Private Market/State Store Relative Prices, Central Region[a]

| Region | Milk | Potatoes |
|---|---|---|
| Moscow | 5.94 | 2.52 |
| Bryansk | 1.95 | 1.39 |
| Vladimir | 1.43 | 1.34 |
| Ivanovo | 1.53 | 1.09 |
| Tver | 1.76 | 1.45 |
| Kaluga | 2.33 | n.a. |
| Kostroma | 1.15 | 1.21 |
| Oryol | 2.29 | 1.42 |
| Ryazan | 1.11 | 1.22 |
| Smolensk | 1.35 | 1.15 |
| Tula | 1.51 | 1.28 |
| Novomoskovsk | 1.90 | 1.42 |
| Yaroslavl | n.a. | 1.15 |
| Rybinsk | 1.20 | 1.30 |
| Average | 1.96 | 1.38 |

[a]Sample means are computed for the period February 1992-February 1995. Data are taken from the survey used in Berkowitz et al. (1996).

n.a. = not available

TABLE 8-2b Sample Means of Private Market/State Store Relative Prices, Volga Region[a]

| Region | Milk | Potatoes |
|---|---|---|
| Astrakhan | 3.44 | 1.29 |
| Volgograd | 5.15 | 1.38 |
| Kamyshin | 2.00 | 1.08 |
| Samara | 4.40 | 1.56 |
| Syzran | 2.50 | 1.50 |
| Togliatti | 2.24 | 1.72 |
| Penza | 1.63 | 1.44 |
| Saratov | 3.99 | 1.55 |
| Balakovo | 1.38 | 1.19 |
| Ulyanovsk | 2.38 | 2.20 |
| Kazan | 2.56 | 1.60 |
| Average | 2.96 | 1.50 |

[a]Sample means are computed for the period February 1992-February 1995. Data are taken from the survey used in Berkowitz et al. (1996).

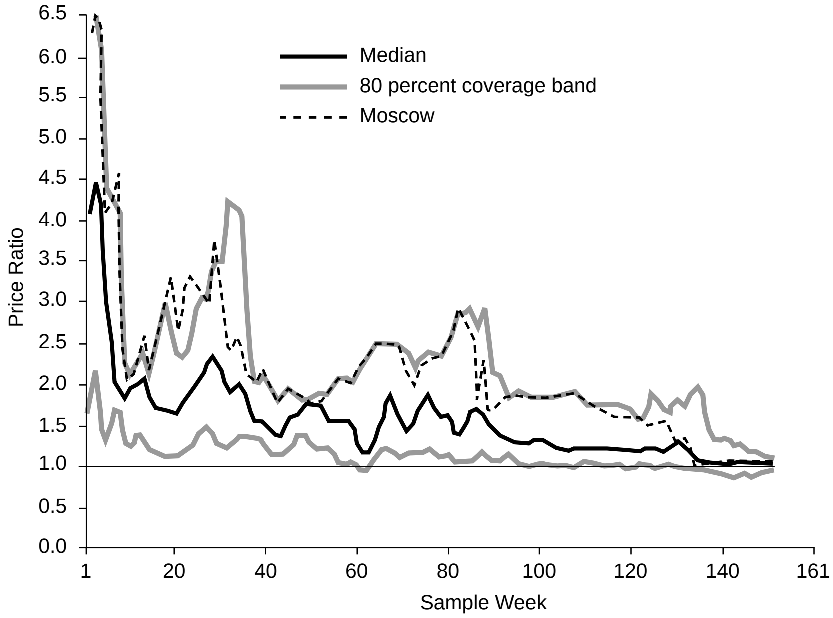


FIGURE 8-2 Market/state price ratios, vegetable oil. NOTE: The first sample was taken on February 5, 1992; the last sample was taken on February 21, 1995.

by resistant local governments, mafia activity, and inadequate infrastructure, Russia's efforts to implement economic reforms have generated tangible results: state prices have become responsive to changing market conditions, and important economic linkages are being forged across cities. The following is a brief summary of these results.

Figure 8-2 provides an overview of the distribution of the ratios of market and state prices of vegetable oil across the cities in the Berkowitz et al. sample.[11] Prices were sampled approximately weekly (there were 50 observations in each year) and cover the 3-year span from February 1992 through February 1995. Four time series are plotted in the figure: the median ratio, the upper and lower bounds of the 80 percent coverage band for the ratios included in the sample, and the ratios observed for Moscow. Note that the distributions lie above unity and are skewed upwards early in the sample, but eventually contain unity; also, the median ratio falls precipitously early in the sample, and gradually thereafter. Evidently, price-subsidization activities have

[11]Results obtained for the other prices studied by Berkowitz et al. differ in their specifics, but paint a similar general picture; they are omitted here because of space limitations.

faded during this period. Further, note the increasing similarity of the ratios across cities over time: the average dispersion of distributions over the last 50 observations is less than half the average over the first 100 observations. Hence local pockets of subsidization activity also seem to have faded. A final note concerning these ratios, not evident in Figure 8-2, is that they have become far more predictable over time. Using current and lagged observations of price ratios to generate one-step-ahead forecasts, Berkowitz et al. find that the variance of the errors associated with these forecasts over the first year of the sample is twice as high as the variance of the errors obtained over the entire sample; that is, state and market prices have come to exhibit far greater correspondence over time.

Berkowitz et al. also assess the dynamic interaction between state and market prices within cities, with an eye toward determining whether state prices can be viewed as responsive to changes in market conditions, as represented by innovations in market prices. They do this by testing for causality between state and market prices.[12] In short, a variable (e.g., the market price of vegetable oil) is said to Granger cause another (e.g., the state price of the same product) if lagged observations of the market price can be used to improve upon forecasts of the state price obtained using only lagged observations of the state price. Evidence of this causal pattern suggests that state prices are responsive to market innovations. Evidence of the opposite pattern suggests that the state has a statistically quantifiable degree of market power over the price of this good; that is, changes in the state price generate a market response. Evidence of both patterns simultaneously is suggestive of a feedback relationship between the two prices.

Table 8-3 details the results of the Berkowitz et al. causality tests by reporting pairs of p values obtained for each city in testing the null hypothesis that the market price does not cause the state price and that the state price does not cause the market price.[13] The table also includes two sets of summaries. The first is a summary column headed "Conclusion": if the market price of a good in a particular city was found to cause the state price at a 20 percent significance level, Berkowitz et al. concluded that "market causes state"; if the opposite causal pattern was found, they concluded that "state causes market"; if causality was found to run in both directions, they concluded there was "feedback"; and if no causality was found in either direction, they concluded "no causality." Second, there is a summary statement at the bottom of the table that tallies the number of instances of each of these four possibilities

[12]The practice of conducting causality tests to evaluate linkages between markets dates at least back to Gupta and Mueller (1982).

[13]The tests were conducted using the Wald statistic, which has an asymptotic $\chi^2$ distribution given the stationarity of the time series under investigation. Berkowitz et al. detail the steps taken to ensure the validity of this assumption for their data.

TABLE 8-3 Results of Granger Causality Tests Within Cities (commodity = vegetable oil)

| Region | City | Dependent Observations | p Value for $H_0$: m ≠ > s | p Value for $H_0$: s ≠ > m | Conclusion |
|---|---|---|---|---|---|
| Central | Moscow | 125 | 0.018 | 0.055 | feedback |
| | Bryansk | 86 | 0.002 | 0.405 | m = > s |
| | Vladimir | n.a. | n.a. | n.a. | n.a. |
| | Ivanovo | n.a. | n.a. | n.a. | n.a. |
| | Tver | n.a. | n.a. | n.a. | n.a. |
| | Kaluga | n.a. | n.a. | n.a. | n.a. |
| | Kostroma | n.a. | n.a. | n.a. | n.a. |
| | *Oryol | 87 | 0.135 | 0.406 | m = > s |
| | Ryazan | 131 | 0.000 | 0.001 | feedback |
| | Smolensk | 45 | 0.007 | 0.044 | feedback |
| | Tula | 84 | 0.064 | 0.001 | feedback |
| | Novomoskovsk | 48 | 0.000 | 0.000 | feedback |
| | Yaroslavl | n.a. | n.a. | n.a. | n.a. |
| | Rybinsk | n.a. | n.a. | n.a. | n.a. |
| Volga | *Astrakhan | 145 | 0.016 | 0.888 | m = > s |
| | Volgograd | 143 | 0.010 | 0.017 | feedback |
| | Kamyshin | n.a. | n.a. | n.a. | n.a. |
| | Samara | 136 | 0.562 | 0.675 | no causality |
| | Syzran | 71 | 0.019 | 0.009 | feedback |
| | Togliatti | n.a. | n.a. | n.a. | n.a. |
| | Penza | 50 | 0.003 | 0.000 | feedback |
| | Saratov | n.a. | n.a. | n.a. | n.a. |
| | Balakovo | n.a. | n.a. | n.a. | n.a. |
| | Ulyanovsk | n.a. | n.a. | n.a. | n.a. |
| | *Kazan | 143 | 0.362 | 0.204 | no causality |

NOTES: Summary: At the 20 percent (10 percent) significance level, m = > s in 11 (10) of 13 cases; s = > m in 8 (8) of 13 cases; feedback is present in 8 (8) of 13 cases; and no causality is present in 2 (3) of 13 cases.

Cities with asterisks denote cases in which the null hypothesis of no cointegration could not be rejected. Results for these cities were obtained using differenced data. Otherwise, results were obtained using detrended data. The notation $x = > y$ denotes the inference that the variable $x$ Granger causes $y$; feedback denotes a case in which $x$ causes $y$, and $y$ also causes $x$.
n.a. = not available

obtained across cities at both the 20 and 10 percent significance levels. (In this summary, an instance of feedback would generate three tallies: one for "*m* causes *s*," one for "*s* causes *m*," and one for "feedback".)

As Table 8-3 indicates, Berkowitz et al. found evidence that "*m* causes *s*" for vegetable oil prices in 11 of the 13 cases they examined; in 8 of these cases, they also found that "*s* causes *m*," and hence concluded that there was feedback. In no case was the state price found to cause the market price exclusively; market conditions appear to be an important driving force behind changes in these prices.

Finally, the causality tests described above were repeated for state and market prices across cities to assess the strength of economic linkages among cities: evidence of causal relationships among prices across cities suggests that market disturbances are being transmitted across local borders. The causality tests were conducted for every possible combination of cities in the sample. Berkowitz et al. had data on vegetable oil for 13 cities, and hence considered $13*(13 - 1)/2 = 78$ city combinations. In 69 of these combinations (78 percent), evidence of at least unidirectional causality between market prices was obtained at the 20 percent significance level; in 72 of these combinations (92 percent), similar evidence was obtained using state prices. These results indicate quite clearly the existence of statistically quantifiable economic linkages in Russia.

As noted in the previous section, producers and traders have operated in a difficult economic environment in post-Big Bang Russia. Some local governments, often in collusion with mafias, have erected export controls at borders. Thus, profitable trade has been blocked or subjected to high border taxes. Furthermore, traders and importers have had to rely on the notoriously inefficient transport sector (Holt, 1993). Private firms selling in local markets have paid high taxes to the local government, as well as protection money to local mafia groups. State firms have often been pressured by local governments to sell goods at artificially low prices. Berkowitz et al.'s evidence suggests that despite these problems, the importance of market forces in influencing state and market prices has clearly emerged following the Big Bang. It seems that traders, middlemen, and firms have succeeded in integrating city and regional markets despite very difficult circumstances.

## START-UPS AND THE ENFORCEMENT OF PROPERTY RIGHTS

At the beginning of the transition, the Russian government and governments throughout the New Independent States and Eastern Europe passed laws encouraging the formation of nonstate firms and loosening administrative controls on state-owned enterprises. Implementation of legislation such as the Law on Cooperatives of 1988 in the Soviet Union, the Act on Economic Associations of 1989 in Hungary, the Law on Economic Activity of 1989 in Poland, and the Entrepreneurial Law of 1990 in the Czech and Slovak Federal Republic unleashed rapid growth in both registered upstart private and cooperative firms and transformed state-owned enterprises, which had a much stronger incentive to earn profits. Thus, a market structure emerged, especially for consumer goods and services, in which former state-owned enterprises competed for profits with an emerging private sector comprising small and medium-sized enterprises, which in many cases were new start-ups.

At this point, it is still difficult to evaluate accurately the efficiency of these emerging markets. Nevertheless, the available evidence suggests that their performance has been mixed. For example, in the first and second years following enactment of the Law on Economic Activity in Poland, the new private sector, which comprised both new start-up firms and transformed state-owned enterprises, accounted for an impressive 11 and 19 percent, respectively, of gross domestic product. The Polish private sector continues to be a source of quality consumer goods and services in 1996. Berg (1994), Cannon (1995), and Johnson and Loveman (1994) argue that start-ups have accounted for impressive growth in gross national product per capita in Poland since 1992. Zemplinerova and Stibal (1995:251) argue that newly formed small and medium-sized enterprises—comprising start-ups, spinoffs from former state-owned enterprises, and companies formed from small-scale privatizations and restitutions—are an important reason for the impressive growth performance in the Czech Republic. Survey evidence presented by Webster (1993a, b), Webster and Swanson (1993), and Johnson (1993) suggests that start-ups have been an important supplier of high-quality goods that were in short supply under socialism.

There is scattered evidence that private entrants in Russia have not had the same impact as their counterparts in Central and Eastern Europe. A year and a half after the introduction of the Law on Cooperatives in the New Independent States, the private sector, which also comprised new start-ups and spinoffs of state-owned enterprises, provided a very small percentage of consumer goods. In a study of the market for clothing and footwear, it was found that purchases from cooperatives accounted for only 1.6 to 2.4 percent of expenditures made by workers' and employees' families. Soviet sources argue that the main reason for this is the "high prices, the unattractive appearance and the low quality of footwear and clothing provided by the cooperatives" (Shelley, 1992:318). Based on a 1992 survey of start-ups and spinoffs in St. Petersburg, Charap and Webster (1993) concluded that the contribution of these firms to market supply was limited. Anecdotal evidence in the Russian press indicates that these shortcomings persisted through 1995.

Differences in the extent to which property rights are effectively enforced are a possible reason for the variance in performance of start-up private firms in Central and Eastern Europe and the New Independent States. An entrant has well-enforced property rights when it can compete with existing firms in obtaining the inputs and credits necessary to be profitable. However, it is a well-known problem in transition economies that input and credit markets are underdeveloped. Kornai (1990, 1992:Ch. 19) argues that at the beginning of the transition, bureaucrats still retained substantial control over the overwhelming share of real and financial resources. This bureaucratic control put many start-ups at a disadvantage. For example, Hungarian firms in operation prior to the 1989 reforms had developed connections within the state sector, and therefore had privileged access to credit, capital goods, and inputs. This dense network of personal connections between bureaucrats and state managers in newly private firms "created barriers for some newcomers who were without these connections" (Webster, 1993a: 9). In the New Independent States, firms that were offshoots of old state enterprises or had been established by local governments had preferential access to state resources (Jones, 1992:81-82). In contrast, start-ups formed after the reforms of 1988 were often forced to engage in bribery to obtain necessary goods or credit. Preliminary evidence suggests that in many sectors, market allocation has replaced bureaucratic allocation more rapidly in Central and Eastern Europe than in Russia.[14] This suggests that the speed of development of input and credit markets is an important predictor of the long-run efficiency of emerging industries.

Berkowitz and Cooper (1997) analyze the speed at which bureaucratic control over credit and input markets affects the performance of start-ups and overall sectoral efficiency. They develop a dynamic model of an industry in transition in which a restructured state-owned enterprise competes with a start-up. Firms compete in quality and quantity in a differentiated duopoly. The model starts with a pretransition phase in which the state-owned enterprise is regulated by planners. At the beginning of the transition, restructuring is immediately effective, and the enterprise is forced to behave like a firm in a market economy. At the same time, a start-up that is more efficient than the state-owned enterprise is allowed to enter the market. These two firms repeatedly compete in a differentiated oligopoly.[15] Initially, credit and input markets are underdeveloped and controlled by bureaucrats. These conditions increase the entrant's costs in the early rounds of competition. Over time, bureaucratic allocation is phased out, and the start-up and former state-owned enterprise have equal access to inputs and credits.

As long as costs are not too asymmetric, the underlying static model has two rankable equilibria in the long run when bureaucratic discrimination against the start-up no longer exists. In either equilibrium, there is strict product differentiation. In the efficient equilibrium, the low-cost start-up takes on the high-quality role, while in the inefficient equilibrium, the high-cost former state-owned enterprise takes on the high-quality role. Aggregate supply, product differentiation, and consumer surplus, as well as individual firm profits, are higher in the efficient equilibrium. The long-run efficiency of the transformed industry depends on which Nash equilibrium is selected.

The solution to the equilibrium selection problem is motivated by the lack of information and experience facing both transformed state-owned enterprises and start-ups at the beginning of the transition in Central and Eastern

[14] See de Melo and Ofer (1994), Webster (1993a,b), Webster and Charap (1994), Webster and Swanson (1993), and Zemplinerova and Stibal (1995).

[15] Start-ups are frequently more efficient because their managers are often drawn from the elite of the labor force in terms of education and job experience (de Melo and Ofer, 1994:9). Restructured state-owned enterprises may have higher costs because they are often forced to hire redundant labor and provide inexpensive social services to their employees.

Europe and the former Soviet Union. Start-ups entered markets in a chaotic period of rapid structural change. New firms were entering industries, old firms were operating under new incentive schemes, and laws and institutions were rapidly changing. Even the most basic sources of information, such as telephone books and transportation schedules, were often lacking (see Sheppard, 1994). The roles of firms within industries were not well defined; no firm was clearly the producer of "luxury" or "economy" goods. All of these factors imply that managers faced a significant amount of strategic uncertainty. In other words, firms made choices under a great deal of uncertainty, not only about market conditions, but also about their competitors' actions in terms of both the quantity and quality of the goods being produced.

To capture this chaotic environment, it is assumed that inexperienced managers of start-ups and former state-owned enterprises would have few guides to their opponents' likely current and future behavior other than their opponents' past behavior.[16] Thus, firms are bounded rationally and use their observations of their opponents' past actions in forming expectations about their opponents' current and future strategies. This captures the feedback effects of history and initial conditions on current behavior. In a set of computer simulations, it is shown that the efficient equilibrium is always selected when there is no cost discrimination against the start-up. Furthermore, the probability of selecting the efficient equilibrium increases with the speed of bureaucratic interference in credit and input markets. The idea is that cost discrimination pushes the entrant toward a relatively low-quality role in early periods, and thus toward a low-quality role in the long run. Therefore, a start-up may get stuck using a myopic strategy of supplying low-quality goods even though it would make more profits by producing higher-quality goods.

The model suggests that bureaucratic control over the allocation of inputs and credit, even though transitory, can push the market to an inefficient equilibrium in which the aggregate quantity and average quality of goods are low. Moreover, as Kornai (1990, 1992) argues, in the past bureaucrats opposed to reform have always used instances in which nonstate firms supplied low-quality goods or failed to alleviate chronic shortages as grounds for further interference with private activity. Thus at best, inefficiency means there is a loss in overall welfare, while at worst, it creates favorable conditions for the reversal of reforms. Such a reversal may occur in Russia should the Communists gain more power in the near future. The Communist leadership in Poland, however, is unlikely to harass start-ups as they have demonstrated their capacity to make a substantial contribution to raising the domestic standard of living.

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[16]Another source of information for inexperienced managers would be to observe behavior in nearby nations with established market economies. Such observations would tend to offset the impact of initial conditions on the performance of start-ups.

## CONCLUSIONS

This chapter has analyzed the evolution of prices during the transition in Russia and has drawn some comparisons with developments in Central and Eastern Europe. Evidence on progress with respect to price liberalization is generally positive: while the federal government has had difficulty in getting some local governments to comply with the federally mandated price liberalization, the statistical analysis of food markets in the Central and Volga regions conducted by Berkowitz et al. (1996) suggests that city and spatial markets rapidly integrated through a flexible price system within a short period following the Big Bang. Thus, while local governments may have had a strong incentive to interfere with the price system, many appear to be no longer willing or able to do so.

The chapter has also drawn some preliminary comparisons of the efficiency of start-ups in Russia and Central and Eastern Europe. The empirical evidence is still fragmentary (see European Bank for Reconstruction and Development, 1995:Ch. 9). Nevertheless, there is evidence that start-ups in Central and Eastern Europe have made a larger contribution to domestic welfare than have start-ups in Russia. One hypothesis explaining this difference in performance is that there has been a more rapid development of mechanisms to enforce the property rights of start-ups in Central and Eastern Europe. A more rapid development of input and credit markets early on in the transition also encouraged the latter start-ups to provide higher-quality goods and achieve a higher market share than is the case for their counterparts in Russia.

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# 9

# Social Policy and the Labor Market in Russia During Transition

*Alastair McAuley*

## INTRODUCTION

The introduction of market relations, or transition as it has become known, was intended to improve the efficiency with which resources were allocated, revive economic growth, and thus ensure for the populations of the countries of the former Soviet Union a level of prosperity closer to that enjoyed in Western Europe. Change of any kind involves costs, and it was always expected that there would be costs associated with the transition to a market economy. But it was (and is) believed that ultimately, the reform would be effective: those who gained would be able to compensate those who lost and still remain better off; all would benefit. In this context, an appropriate structure of social policy can contribute to greater labor market flexibility and efficiency, whereas inappropriate policies can result in rigidity and inefficiency. Appropriate social policy can also ensure that the full burden of the transition does not fall upon the shoulders of the most vulnerable groups. Moreover, the costs of transition have been much more substantial and long-lasting than most observers (and the advocates of reform themselves) anticipated, and this has increased the importance of social policy.

The argument of this chapter may be summarized as follows. The labor market in Soviet-type economies was designed to fit in with the other components of the planned economy. As a result, it differed from the labor market in modern industrial economies in a number of significant ways. Chief among these was the fact that the economy was characterized by full and substantial security of employment; indeed, many workers expected to be able to retain their present jobs (at their present places of work) indefinitely. For those who wished to change enterprises, there was usually no difficulty in finding alternative employment. This situation was more a consequence of the choice of overambitious macroeconomic targets by planners than a result of specific policies in the labor market. But it meant that the authorities could use records of employment rather than contributions as the basis for entitlement to social insurance benefits. They could also use the enterprise (or its trade union organization) as a major vehicle for the provision of social benefits. Finally, since substantial social benefits were provided through the state or state enterprises, wages were relatively low. Differentials were also small and failed to reflect either differences in the scale of investment in human capital or the risk to which different occupations were exposed. This meant that the labor market was both inefficient and inflexible: it took a long time to reallocate labor, and hence new industries found it difficult to expand rapidly. It also meant that the labor process itself was inefficient: productivity was low, and the structure of employment appeared “old-fashioned” by comparison with that found in Western Europe.

The Russian government has attempted to reconstitute the framework of social protection and to reform labor market institutions to bring them more into line with the structures found in advanced industrial economies. The breakup of the Soviet Union itself and the subsequent opening up of the domestic product market have been important, as have the abandonment of central planning and the consequent changes to the structure of demand. As a result of the changes induced by these various pressures, the labor market has apparently become surprisingly flexible. There has been considerable adjustment in the structure of both employment and earnings without high levels of unemployment. But the system still contains rigidities, and these contribute to the fact that productivity remains low.

The opening up of former planned economies means that their labor markets are now exposed to pressures from the global economy from which socialism offered some protection. Most if not all advanced industrial economies have experienced increased competition from so-called emerging market economies in the last 10 to 15 years. Increased competition in traditional industrial sectors has undermined the security of both earnings and employment enjoyed by workers in such sectors as engineering and light industry. As a result, employees, especially skilled industrial workers, have experienced a deterioration in their relative economic status in most industrial market economies. How to respond to this development constitutes perhaps the major social challenge facing Europe and North America at the end of the twentieth century.[1] Transition economies face a similar challenge. It is not clear how far this has been realized by policymakers in Russia—or, indeed, in the rest of the region.

[1] This issue is discussed at greater length in World Bank (1995).

The remainder of the chapter is divided into five sections. The next section sets forth briefly the key characteristics of the labor market and social policy in a planned economy. The third section outlines the reconstitution of social policy that has occurred and examines developments in employment policy. The fourth section assesses the impact of these innovations on the operation of the labor market. The final section presents a summary of the discussion and draws conclusions about the effectiveness and flexibility of labor markets in transition economies.

## TRANSITION AND THE SOCIALIST LABOR MARKET

The labor market and the labor process in the Soviet Union differed from what was to be found in industrial market economies. This was a consequence of the institutions of a planned economy and the policies pursued by Gosplan. It was also due to the fact that the socialist economy was partially insulated from global economic forces and that the level and structure of output were determined by planners' preferences rather than by consumer demand. Since the demand for labor is derived from the demand for output, planners' preferences determined the demand for labor and hence the structure of employment. As a result, a higher proportion of the labor force was engaged in manufacturing than would have been expected given the level of development in the region (as measured, for example, by gross domestic product [GDP] per capita). On the other hand, employment in the service sector was lower than expected. Planners' preferences or the exigencies of control were also responsible for the fact that average establishment size was very much larger than in a market economy in all sectors of the economy.

Socialist economies were characterized by full—indeed over-full—employment. Full employment and endemic labor shortages can be seen as the counterpart of excess demand in product markets, rather than the result of specific employment policies. Although full employment was proclaimed as a major achievement of socialism, one could suggest that it contributed to the economic crisis that resulted in the collapse of the planned economy

Full employment and the growth of labor hoarding made the socialist labor market rather rigid. It was difficult to develop new industries quickly, and it was difficult to introduce new forms of labor contract (Nuti, 1996a; Marnie, 1992; see also Granick, 1987). This in turn compounded difficulties in the innovation process and contributed to the problems experienced by the socialist system in adopting new technologies. This situation was reinforced by the structure of incentives. Wage differentials were small and largely failed to reflect the productivity-enhancing effects of investment in human capital.

These labor market institutions, however, constituted an important part of the socialist social security system. This system was based on three pillars:

price control, extensive social consumption, and the right to work.[2] The right to work—and, more particularly, full employment—ensured that all families had access to income, either from their earnings or from social insurance benefits linked to previous employment. It also meant that enterprises could be used as a channel for the distribution of certain benefits or social services. Wages may have been low, but price controls and subsidies to producers ensured that necessities remained affordable for the bulk of the population. Finally, the state provided health care, education, and certain other services free of charge at the point of consumption. This system was already under strain in the 1980s; indeed, one could argue that it contributed substantially to the social and economic crisis that resulted in the collapse of the communist system. Such a system is clearly incompatible with a market economy. Reconstitution of the social security system has been a necessary precondition for transition and for the emergence of more flexible labor markets.

The performance of the Russian labor market has been affected by a number of factors apart from the employment policies of the Russian government and its reform of social policy. The most important of these are the collapse of central planning and the Soviet state, general economic reform, and stabilization policy. The economic and social crisis of the 1980s and the political response it evoked have resulted in a fundamental change in the economic and political environment of Central and Eastern Europe and the New Independent States (NIS). The combination of lax macroeconomic policies and more or less extensive price control had resulted in significant suppressed inflation in all socialist economies in the 1980s. In the Soviet Union, this took the form of a "monetary overhang," which by the early 1990s had undermined all the government's attempts to establish (or reestablish) equilibrium in the market for consumer goods.[3] In January 1992, in an attempt to eliminate "excess" money balances and revive the distributive role of the price system, formal control over most retail prices was abandoned. This led to a sharp jump in prices and initiated a period characterized by much higher inflation rates than in the late 1980s. Inflationary pressure was increased by an ill-thought-out attempt to maintain a common currency throughout the NIS and by errors in stabilization policy.

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[2]For a more extended discussion of this issue, see Center for Cooperation with Economies in Transition (1996a:120-122).

[3]It is important to remember just how far out of equilibrium the markets for consumer goods were in Russia in 1991. In the last quarter of the year, most stores were empty most of the time, despite sharp increases in the prices of many foodstuffs and some luxuries earlier in the year. Coupled with the virtual confiscation of a large volume of savings through the device of declaring the 100-ruble note no longer acceptable as "legal tender," this resulted in the nominal value of money wages in 1991, greatly exaggerating the volume of goods and services that could be purchased with them. Therefore, conventional calculations of real wages and real incomes over the period 1990-1992 substantially overstate the decline in living standards that occurred in Russia (see Gavrilenkov and Koen, 1994).

The very high rates of inflation experienced by all transition economies—and especially by those in the NIS—have placed additional demands on the new social policy system and have had an impact on the operation of the labor market. Inflation has wiped out the savings of most Russian households—all the more so since, under socialism, most people were forced to hold their accumulated wealth in the form of cash or deposits in the state savings bank. At the same time, however, inflation has probably made it easier to adjust differentials.

Finally, the functioning of the labor market in Russia—and in most of the other transition economies—has been affected by the evolution of the tax system. The concept of taxation was not fully developed under socialism, and none of the countries of Central and Eastern Europe or the NIS (with the possible exception of Hungary) had developed effective tax-collection systems. This has affected the ability of successor governments to develop adequate social safety nets, or even to undertake routine government activity without incurring budget deficits, thus contributing additional inflationary pressure.

In such circumstances, the Russian government has succumbed to an understandable if regrettable tendency to impose a tax on anything it thinks will contribute to state revenue, irrespective of the impact of such taxes on the efficiency of resource allocation or the equity of income distribution.[4] As a result, the Russian tax system has become both complex and, in principle, rather distortionary. Tax collection, however, is still inadequate, with many enterprises and individuals evading taxes and others delaying payment for as long as possible.

There are three sources of distortion that affect the operation of the labor market and thus deserve to be mentioned here. First, the bulk of the resources used to provide social insurance benefits[5] are raised by means of payroll taxes.[6] As a result, these taxes amount to some 40 percent of the wage bill.[7] However, there is a considerable shortfall in the amount of revenue collected

[4]And where the federal authorities restrain themselves, individual republics, krai, and oblasti have a tendency to step in.

[5]By social insurance benefit I mean a benefit in cash or kind paid to an individual as a result of (1) the prior payment of a contribution and (2) the occurrence of a specific event. For more discussion of this classification see Barr (1996).

[6]There are in fact four separate funds, each responsible for a particular type of social insurance benefit and for the collection of its own "contributions." It should be pointed out, however, that this apparently inefficient system of earmarked taxation dates back to the end of the Soviet period. It was not adopted as a result of the budgetary crisis experienced in transition economies. Rather, it was a response to the widespread belief that planners undervalued social services and hence were always prepared to reallocate resources out of such sectors as health care in order to achieve plan targets in the productive sphere.

[7]In most Central and Eastern European states, they are even higher, ranging from 41 to 53 percent of the wage fund (see Rutkowski, [1996]).

through these taxes.[8] This puts some strain on the funds responsible for providing particular forms of support, or rather on the state budget, since it has a residual responsibility to ensure that particular programs are funded. Second, in the early transition period, many if not most governments introduced tax-based income policies in an attempt to restrain wage inflation, especially in the state sector. Both payroll taxes and the so-called excess-wage tax introduce a wedge between take-home pay and the gross cost of labor to the enterprise. This in turn reduces the demand for labor, and thus contributes to unemployment (Nuti, 1996a:51). Third, in Russia as in many market economies, there is evidence to suggest that the small-business sector has proven to be a particularly strong source of demand for labor. As part of its policy to encourage this sector—and hence to increase the demand for labor—the Russian government has introduced a simplified system of taxation for small businesses. There are, however, continual complaints in the press from small-business leaders that such a regime is not working and that their members are faced with increasingly burdensome demands from the tax police.

## SOCIAL AND EMPLOYMENT POLICY

Innovations in social and employment policy and in institutions have changed the way the market for labor operates in Russia. Some observers argue that the market has become more flexible and efficient; others claim that it is still rigid and that greater differentials should not be taken as unambiguous evidence of greater flexibility. This section describes the reconstitution of social policy that has occurred since 1991 and outlines developments in employment policy. The effects of these changes on the functioning of the labor market are analyzed in the next section.

The social security system that developed in the Soviet period was well suited to the structure of the labor market under economic planning; it was inappropriate for the very different circumstances to be found in a market economy (see Nelson, Kornai, and Ferge, in this volume). The Russian government has embarked on a program designed to reconstitute the country's social security system. This program comprises three elements.

First, since a market economy cannot and does not guarantee full employment, the system can no longer rely on employment to ensure a minimal level of social security. Second, in the context of widespread private ownership—and the harder budget constraints that the market entails—the state can no longer rely upon enterprises to act as the major channel through which social security and services are provided. Third, the authorities have embarked on a review of the system of subsidies that, together with the system

[8] See Organization for Economic Cooperation and Development (1995:127) and Goskomstat Rossiia (1996:277-78).

of price controls, played an important role in determining the real incomes of the poor.

The decision to abandon the so-called socialist economic system has had implications for both labor market institutions and employment policy. It is often difficult to disentangle changes in these areas from the reform of social policy and social security institutions. For example, abandonment of the so-called guarantee of the right to work and of the commitment to full employment has led to the introduction of unemployment benefits and the adoption of a range of active labor market policies.[9] Likewise, privatization has resulted in a partial withdrawal of the state from the direct determination of wages and salaries and the adoption of tax-based income policies instead. Both of these developments have had implications for the flexibility with which the Russian labor market operates. So, too, have changes in the legal framework governing employment and the labor contract.

The transition to a market economy has meant the abandonment of a commitment to guaranteed employment. This change has involved acceptance of the possibility of unemployment, and the authorities have taken responsibility for providing a degree of financial support to those who lose their jobs. The real value of government support has been considerably reduced. In part this has been a consequence of general budgetary constraints. It has also been a response to the more general debate on the appropriate scope for state support.

The second element in the reconstitution of the social security system in Russia relates to the role of the enterprise. In the context of state ownership of the means of production and virtual universal employment, the distinction between the enterprise and the state bureaucracy as channels for the delivery of social security was not regarded as important. In the Soviet Union, therefore, the personnel departments of state enterprises were responsible for the payment of a range of benefits. Enterprises were also responsible for providing a number of social services. Much if not all of this activity is inconsistent with the role of the enterprise in a market economy. Furthermore, fear of losing access to particular social services may deter workers from changing jobs, thus reducing economic flexibility. These concerns have led the Russian government to relieve enterprises of formal responsibility for the payment of many social insurance benefits. More important, perhaps, they have resulted in a determined campaign to persuade enterprises to divest themselves of their social assets.

The third element of the reconstitution of social security in Russia is a review of the level and distribution of consumer subsidies. In the planned

[9]In fact, unemployment benefits—and hence, implicitly, abandonment of the right to work—were introduced by the Soviet government in 1990. They thus predate the formal decision to abandon socialism.

economy, where prices played at best a marginal role in the allocation of resources, the government relied on price controls and subsidies to producers to ensure that low-paid workers could afford to purchase a minimum basket of consumer goods. A range of goods and services was also provided free at the point of consumption. In a market economy, such a policy approach is associated with significant distortions and considerable inefficiency. The Russian government has moved quickly to eliminate price controls on a broad range of foodstuffs and many other consumer goods. It has also increased the price of energy and attempted to reduce the implicit subsidies incorporated in the prices paid for utilities. This new policy has had a number of consequences. It has led to an end of apparent shortages, as well as the widespread queuing and black markets with which they were associated. It has also resulted in increases in the supply of some goods, through either more production or increased imports; for example, there has been a sharp increase in the stock of both cars and telephones in private hands. This is an example of the supply response that the market was intended to engender. On the other hand, the new policy has resulted in a significant change in the structure of relative prices. In conjunction with the high rate of inflation, it has led to a significant increase in the cost of living—particularly for poor households.

The impact of the above changes in the structure of social protection on the level and composition of support provided by the authorities in Russia is shown in Table 9-1. The table reveals that there has been a very substantial decline in the real value of consumer subsidies and that this decline has not been fully compensated by increases in the value of cash benefits paid out.

The new policy on consumer subsidies has met with opposition from at least three groups. Consumers, and particularly those who claim to speak for the poor, have argued that the policy has resulted in significant impoverishment.[10] Second, domestic producers and those who claim to speak for them have argued that in the absence of either a degree of tariff protection or a measure of subsidization, they are unable to compete with the flood of foreign imports (from both the so-called near and far abroad). The government has shown itself to be responsive to such arguments; in any event, it has continued to provide significant subsidies to industry. Finally, local political leaders have also expressed opposition. For some, the new policy has represented too radical a break with the past; for others, it has threatened the industrial base upon which their power and prosperity depended.

The fact that goods markets in Russia are now more or less in equilibrium means that access to particular goods and services is rationed by price—and by the availability of money income. This has forced the authorities to reconsider both the level of social guarantees the state was able (or willing) to give and the social risks against which it was prepared to insure the population.

[10] For further discussion of this view, see Cornia et al. (1996).

TABLE 9-1 Social Protection Expenditures: Russia, 1992-1994 (public expenditure on health care and social security as a percent of GDP)

| Social Protection Expenditures | 1992 | 1993 | 1994 |
|---|---|---|---|
| Consumer subsidies | 14.0 | 7.0 | 7.0 |
| Pensions | 4.0 | 5.9 | 5.4 |
| Health care | 2.6 | 3.3 | 3.1 |
| Unemployment benefits | 0.0 | 0.0 | 0.6 |
| Family allowances | 1.1 | 1.1 | 1.0 |
| Social assistance | 0.4 | 0.6 | 0.5 |
| Total | 22.1 | 17.9 | 17.6 |

SOURCE: Organization for Economic Cooperation and Development (1995:126).

This is a political process fraught with conflict, and consensus is still a long way off. The debate has also been carried on against a background of budgetary stringency that has resulted in the adoption of modest levels of social guarantees.

There has also been some attempt to review both the range of universal and insurance benefits provided and the terms upon which they are payable. This process was initiated before the collapse of communism, but the Russian authorities were forced to review the system adopted in 1990 because rapid inflation soon made existing levels of support obsolete. Yet despite considerable discussion, the authorities have made few changes to the complex and somewhat ad hoc system of allowances they inherited from the Soviet government.[11] Russia has not yet introduced a means-tested social assistance benefit available to all who could demonstrate need. In consequence, Russia's social safety net contains significant holes, and many families fall through them.[12]

Labor law plays a more important role in personnel management in Russia than it does in Britain or, I believe, in other countries in the common-law tradition. For this reason it is worth noting changes to the code of labor law that have recently been adopted by the Duma. Even though Western labor economists do not believe the guarantees contained in the Soviet Labor Code constituted a serious restriction of managers' ability to dismiss workers, the recent revision of the code eliminates many of those guarantees. It also confers some additional rights on management. It formally eliminates the concept of the right to work and substantially reduces the rights of consultation previously enjoyed by trade unions with regard to safety, conditions of employment, and compensation.

[11]For more details see Goskomstat Rossiia (1996:139-143).

[12]The social assistance programs referred to in Table 9-1 relate to expenditures undertaken by oblast and republican governments largely out of their own resources. For the most part this assistance is given in kind rather than in cash.

The authorities—and more particularly the Ministry of Labor—have retained responsibility for setting the minimum wage and determining the structure of wages and salaries paid in the budget sector.[13] The ministry did not seek to determine the level and structure of wages paid in state or privatized enterprises directly. Rather, it sought to contain wage inflation indirectly through a tax-based income policy—now abandoned.

It was clear to the architects of *perestroika* in the second half of the 1980s that there was scope for improving the flexibility of the labor market in the Soviet Union. At the very end of the decade, the precursor of the Federal Employment Service (FES), *Federativnaia sluzhba zaniatosti*, was set up to this end. The Russian section of this all-union organization was transformed into the FES in 1992. The FES has set up a network of employment offices in all major cities, and in many smaller ones, which provide the unemployed with information about vacancies. These offices are also responsible for maintaining a register of the unemployed, and thus determining who is entitled to receive unemployment benefits. In addition, the FES and its local branches are responsible for the organization of active labor market policies. The FES provides retraining, or more often pays other organizations to provide such programs. It also organizes programs of public works. It does not, however, provide employment subsidies—or does not do so on a large scale.

In sum, the transition to a market economy has been accompanied by a reconstitution of the social security system in Russia and by more or less significant changes in both labor market institutions and employment policy. There has been a fundamental shift in the philosophy underlying the Russian approach to welfare: the state no longer seeks to provide support for its citizens "from cradle to grave." Rather, it assumes that individuals will take on far more responsibility for their own lives. In practical terms, this has resulted in reductions in the subsidies provided for a range of goods and services and an attempt to ensure that prices correspond more closely to marginal costs. Unemployment compensation has been introduced, and there have been some changes to the terms by which other social insurance or social security benefits are paid. But there is still no social assistance program. The state has largely abdicated responsibility for determining the level and structure of wages. It has attempted to strengthen the formal rights enjoyed by management with regard to both hiring decisions and the labor process. Finally, it has reconstituted the agencies responsible for the implementation of active labor market policies. In the next section, an attempt is made to assess the extent to which these changes have resulted in increased labor market flexibility.

[13]The budget sector refers to the bureaucracy and those sectors that are directly funded by the budget—educational establishments, medical institutions, and so on.

## THE OPERATION OF THE LABOR MARKET

There are no clear and simple indicators of either labor market flexibility or the efficiency with which the market allocates and reallocates labor. Consequently, the same statistical record may be interpreted differently by different economists—and this has certainly happened in Russia. For example, despite rising unemployment, there continue to be substantial levels of new hires in many sectors. Layard (1995a) and others have interpreted this as a sign of increased flexibility; Nuti (1996a) has dismissed it as no more than "churning" (see also Layard and Richter, 1995). It is my view that the figures cited below show the Russian economy has been exposed to a series of significant shocks. While the labor market has demonstrated substantial flexibility in the way it has absorbed these shocks, it still suffers from rigidities. Also, the institutional framework and the policies of the government continue to impose considerable hardships on individual families.

Changes in the composition of the labor force in Russia are reported in Table 9-2. The table shows that the economically active population has declined by about 2.5 million since the collapse of the Soviet Union. About a fifth of this decline can be attributed to a reduction in the total population; the remainder is due to changes in the population of working age and to the withdrawal of those who either do not wish to work or have become discouraged in the search for employment. Over the same period, employment has fallen by about 5 million, and unemployment (based on International Labor Organization [ILO] definitions) has risen by about 2.5 million. In 1995, the unemployment rate in Russia was 8.2 percent. Given the scale of the collapse in aggregate output and the extent of the shocks to which the economy had been exposed in the preceding 5 years, this rate is quite modest.[14] Table 9-2 also contains an estimate of unemployment in March 1996, which suggests that the increase in unemployment has leveled off, at least for the moment. Finally, Table 9-2 shows that, based on ILO definitions, women account for some 45 percent of total unemployment (it should be noted that they never accounted for more than half of total employment).

Table 9-2 also provides information on *registered* unemployment and on the numbers receiving unemployment benefits. These figures show that in 1992, the register contained approximately a one-seventh of total unemployment; by 1996, coverage had improved substantially, but the register still contained only about two-fifths of those classified as unemployed according to ILO definitions. In 1992, about two-thirds of the registered unemployed were in receipt of unemployment benefits. In 1995, the proportion had risen to almost 90 percent. Table 9-2 provides some further information on the composition of registered unemployment.

[14]Unemployment remains relatively modest even when some allowance is made for those workers who are on enforced and unpaid leave. For more details, see Nuti (1996a:45).

TABLE 9-2 Employment and Unemployment: Russia, 1992-1995 (thousands)

| Employment and Unemployment | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|
| Total population | 148,326 | 148,295 | 147,997 | 147,938 |
| Economically active population | 75,665 | 75,012 | 73,962 | 73,140 |
| Employed population | 72,071 | 70,852 | 68,484 | 67,100 |
| Unemployed population | 3,594 | 4,160 | 5,470 | 6,040 |
| Registered unemployed | 578 | 836 | 1,637 | 2,327 |
| In receipt of benefit | 371 | 550 | 1,395 | 2,026 |
| Economically inactive population | 72,661 | 73,283 | 74,039 | 74,798 |

SOURCES: Goskomstat Rossii (1995:16, 54); Goskomstat Rossii (1996:21).

The apparent failure of the FES may help explain why so large a proportion of the unemployed is found to be in poverty, a statistic that casts doubt on the effectiveness of this component of the social safety net.[15] Doubt must also be expressed about the contribution made by active labor market policies to any increase in the effectiveness with which the labor market reallocates labor.

There are more women than men registered with the FES. This may reflect the fact, or the perception, that the sorts of vacancies of which the FES is notified are more suitable for women than for men, or it may be a consequence of men's greater proclivity to find unregistered work in the so-called second economy.[16] Youth account for some 36 percent of registered unemployment; this is only slightly less than the 41 percent reported in the 1995 Russian Labor Force Survey.[17] Thus, the young do not appear to be shunning the FES in substantial numbers (or at least not disproportionately). In 1995, the average duration of unemployment was approximately 6 months. This is quite a short time, and if not a statistical artifact is evidence that the labor market is making significant numbers of matches.[18] As the level of unemploy-

[15]Furthermore, since the FES's active labor market measures are focused primarily on those who are registered as unemployed, the figures in Table 9-2 also call into question the effectiveness of the service. These reservations are reinforced by estimates of the structure of FES expenditures. In 1994, the FES spent some 2407md (milliard, equal to an American billion) rubles. This amount was allocated as follows (in percent): administration—27, benefits—38, active policies—5, other—30. (See *Goskomstat Rossiia, 1995*:278.)

[16]For a more extended discussion of the problems faced by women in the post-Soviet labor market, see Lakunina (1995:21-30), Nuti (1996b:Ch. 10), and Goskomstat Rossiia (1996:25).

[17]See Goskomstat Rossia (1997:94), which shows that some 10 percent of the unemployed are aged 16-19, 18 percent are aged 20-24, and 13 percent are aged 25-29. Further, in the youngest age group, only 8 percent of males are unemployed, but 12.5 percent of females. This probably reflects the fact that boys aged 18 are liable for conscription (see also Goskomstat Rossiia, 1996:25).

[18]According to law, the registered unemployed are entitled to unemployment benefits for no more than 12 months. This could mean that the maximum duration *on the register*—and hence

TABLE 9-3 The Sectoral Composition of Employment: Russia, 1990-1995 (percent)

| Employment by Sector | 1990 | 1992 | 1995 |
|---|---|---|---|
| Total employment | 100.0 | 100.0 | 100.0 |
| State and municipal enterprises, etc. | 82.6 | 68.9 | 37.6 |
| Private enterprises | 12.5 | 18.3 | 36.4 |
| Social organizations, funds | 0.8 | 0.8 | 0.7 |
| Joint ventures | 0.1 | 0.1 | 0.4 |
| Mixed ownership | 4.0 | 11.7 | 24.9 |

SOURCES: Goskomstat Rossii (1995:57); Goskomstat Rossii (1996:23).

ment rises, however, it is to be expected that the average duration of unemployment spells will lengthen.

The nature and scale of the reallocation that has occurred are depicted in Table 9-3. Table 9-3 records the dramatic decrease in state employment. More than a third of the labor force is now employed in private enterprises and another quarter in so-called mixed enterprises. Part of this change is the automatic consequence of privatization; the workers involved have not changed their places of work. But part of it reflects real structural change: new enterprises have been established and existing ones broken up into components whose structure is more suited to the imperatives of the market. These changes also underlie the changes that have taken place in the sectoral composition of employment in Russia. This reflects not only the switch from plan to market determination of demand, but also in part the collapse in output that followed the breakup of the Soviet Union (see Goskomstat Rossiia, 1996:23).

A characteristic feature of all planned economies was the large average size of enterprises. This was due primarily to the absence of those very small firms that are characteristic of a market economy. It has been argued that this feature of the planned economies was a source of rigidity (Nove, 1977). I have not been able to locate detailed figures on changes in the size distribution of enterprises in the economy as a whole since the beginning of the transition, but available data show that the number of enterprises in industry rose from 26,900 to 138,000 between 1990 and 1994; the average number of employees in industrial enterprises fell from 781 to 126 over the same period (see Goskomstat Rossiia, 1995:310). It also was reported by Goskomstat Rossiia (1996:690) that on January 1, 1995, there were some 896,900 small enterprises (i.e., those with up to 50 employees) employing some 8.9 million persons.

as a registered unemployed person—is only a year. But since some 14 percent of persons are reported as having been unemployed for more than 12 months, I do not believe the estimates are affected by this type of censoring bias (see also Goskomstat Rossiia, 1996:25).

Taken at face value, these figures suggest that there has been a substantial increase in small enterprises, but that the extent of restructuring elsewhere in industry at least remains limited. On further reflection, however, the above figures must come as something of a disappointment to reformers. They suggest that in Russia, some 4 years after the beginning of transition, there were fewer than 900,000 small businesses, while in Poland (an economy perhaps one-fifth the size of Russia's), there are more than 2 million small and medium enterprises (Åslund, 1997). Furthermore, figures not cited here suggest that the registration of new enterprises in Russia has slowed considerably since 1995. One explanation for this trend is that with the economy in deep recession, the time is not auspicious for the creation of new businesses; an alternative is that the burdens of both taxation and bureaucratic regulation have driven new entrepreneurs underground, as it were, and into the informal economy. There is probably an element of truth in both assertions.

In short, not only has there been considerable structural change in the Russian economy, but there also has been a substantial movement of employees out of those sectors which traditionally employed the bulk of Soviet workers. At the same time, there has been an increase in employment in trade and catering, in other services, and especially in the financial and information technology sectors (see Goskomstat Rossiia, 1996:23). This change has been associated with privatization, or at least the creation of so-called joint-stock companies. It also has been accompanied by the creation of substantial numbers of small enterprises.

Structural change has not been accompanied by either high levels or (as far as we can tell) long durations of unemployment. There has, however, been substantial turnover in the labor market. The figures in Table 9-4 show that in 1993, new hires in the economy as a whole amounted to about one-fifth of the workforce, while separations were equal to one-quarter. This represents a significant level of turnover. New hires were at approximately the same level in 1994 and separations even higher. In 1995, separations fell slightly, to 25.7

TABLE 9-4 Labor Turnover: Russia, 1993-1994 (percent of average employment in relevant sector)

| | 1993 | | 1994 | |
|---|---|---|---|---|
| Labor Turnover | New Hires | Separations | New Hires | Separations |
| Economy as a whole | 21.1 | 25.1 | 20.8 | 27.4 |
| Industry | 20.1 | 28.8 | 18.2 | 32.0 |
| Agriculture | 11.3 | 14.5 | 12.4 | 19.6 |
| Construction | 38.7 | 44.1 | 34.9 | 45.9 |
| Transport | 26.4 | 29.6 | 23.0 | 29.6 |
| Trade and catering | 22.7 | 27.7 | 25.5 | 33.7 |

SOURCE: Goskomstat Rossii (1995:61).

percent of average employment, while new hires rose to 22.6 percent. Figures for 1996 are not yet available. Given the structural changes in employment described earlier, I do not think one can dismiss these figures on turnover as simply "churning." The increase in the difference between new hires and separations in 1994 is evidence of a softening in the labor market at that time, and is the source of the increase in unemployment recorded in Table 9-2. But this softening either ceased or moderated in 1995-1996. This is evidence that the labor market has shown itself to be quite flexible.

Formally, if a market is operating efficiently, an increase in supply or a decrease in demand should result, *ceteris paribus*, in a fall in price. As suggested above, there has been a decline in the demand for labor in Russia. The figures given below show that there has also been a sharp decline in average wages. It is this at least as much as the persistence of soft budget constraints that has permitted employment to remain as high as it has.

Real wages declined by almost three-fifths between 1990 and 1995 (see Goskomstat Rossiia, 1995:77; 1996:10). As noted earlier, the fact that markets were substantially out of equilibrium in the last years of the Soviet Union means that this decline significantly overstates the extent to which a worker's claim on resources has fallen. But there has been a more or less marked reduction in the standard of living attainable by a majority of employees in Russia, and this remains true whatever plausible allowance is made for activities in the unregistered economy.

The decline in real wages has been accompanied by an increase in differentiation. On the one hand, there has been a decline in the minimum wage relative to average earnings. The ratio of minimum to average wages in the Soviet Union at the end of the 1980s was much lower than the two-thirds or so that is typical of European market economies; it was equal to approximately one-quarter. Over the last 5 years, this ratio has declined steadily, and the minimum wage is now less than 10 percent of average earnings. It is also only about one-fifth of the poverty line (see Standing and Vaughan-Whitehead, 1995:48; Goskomstat Rossiia, 1995:80, 83; 1996:48, 139). As such, the minimum wage has ceased to function *as a minimum*. It now operates as a unit of account for certain purposes (for example, certain fines are specified in multiples of the minimum wage) and as an anchor for the pay scale in the budget sector. In this respect, it operates as a not insignificant disincentive to government employment. It may also contribute to the petty corruption that is reputed to be widespread in Russia's regions.

There have also been marked changes in the earnings of employees in different branches of the economy, and there is some reason to believe that these changes reflect differences in profitability and changes in the level of demand for sectoral output. Some of these changes in earnings are reported in Table 9-5. One way of measuring the increase in differentiation is to calculate the ratio of the average earnings of the top and bottom 10 percent of earners.

TABLE 9-5 Sectoral Differentiation in Earnings: Russia, 1990-1995 (average monthly earnings as percent of economy-wide average)

| Sectoral Differentiation in Earnings | Year | | | |
|---|---|---|---|---|
| | 1990 | 1993 | 1995 | $K_d{}^a$ |
| Economy as a whole | 100 | 100 | 100 | 26.4 |
| Industry | 110 | 108 | 114 | 20.6 |
| Oil extraction | 165 | 311 | 289 | |
| Oil refining | 97 | 204 | 221 | 15.2 |
| Coal mining | 158 | 249 | 233 | |
| Engineering | 101 | 82 | 84 | 16.3 |
| Light industry | 82 | 70 | 54 | 15.8 |
| Agriculture | 82 | 61 | 47 | 23.8 |
| Construction | 124 | 133 | 136 | 24.7 |
| Transport | 115 | 151 | 157 | 13.3 |
| Trade and catering | 85 | 80 | 86 | 17.8 |
| Credit, finance, and banking | 135 | 243 | 164 | n.a. |
| State administration | 120 | 115 | 110 | n.a. |

[a]$K_d$ is defined as the ratio of the earnings of the top and bottom 10 percent of employees in the relevant sector or branch.

n.a. = not applicable

SOURCES: Goskomstat Rossii (1995:8); Goskomstat Rossii (1996:40).

Table 9-6 shows that according to this indicator, differentiation more than tripled between 1991 and 1995. The final column of Table 9-5 shows that this differentiation is made up of inter- and intra-sectoral components. It probably reflects the introduction of price signals to attract those with scarce skills to particular positions; it also surely contains some component of reward for the "risks" taken by top managers. This is suggested by a diagram reproduced in a recent United Nations Development Programme (UNDP) report (based on unpublished Goskomstat data), which implies that in March 1995, the average earnings of managers were about 650,000 rubles a month, those of skilled workers and specialists were some 300,000-325,000 rubles, and those of the unskilled only 200,000 rubles a month (Granick, 1996:24). The same source indicates that earnings in private enterprises were on average at least 700,000 rubles a month, while those in public and mixed ones were only 235,000-260,000 rubles.[19]

Both the decline in the ratio of the minimum and average wages and increases in differentiation have resulted in substantial changes in the distribution of earnings, as Table 9-6 shows. These changes mean there is now a substantial problem of low pay in Russia. This problem is compounded by a

[19]The UNDP report also contains the intriguing claim that the earnings of employees aged less than 29 were significantly higher than those of employees aged 30-49 and more than 49. The figures given are 380,000, 300,000, and 225,000 rubles per month, respectively, for the three age groups (Granick, 1996:Fig. 3.4).

TABLE 9-6 Inequality in Earnings: Russia, 1991-1995 (percent of wage fund)

| Share of Wage Fund Received by Quintile of Employees | 1991 | 1994 | 1995 |
|---|---|---|---|
| 1st (lowest) | 7.7 | 4.1 | 3.9 |
| 2nd | 12.6 | 9.1 | 8.6 |
| 3rd | 16.9 | 14.7 | 14.2 |
| 4th | 22.9 | 22.9 | 22.6 |
| 5th | 39.9 | 49.2 | 50.7 |
| Ratio of earnings of top and bottom 10 percent of earners | 7.8 | 23.4 | 26.4 |

SOURCE: Goskomstat Rossii (1996:46).

feature of the Russian experience that has not been mentioned thus far in this chapter—that of arrears. A significant number of workers, primarily those in state employment or those who work in privatized state enterprises, are not paid the wages due them on time. I have not found figures that chart the scale of this phenomenon or how it has evolved over time, but it is widely believed in Moscow that it has increased. Arrears can only compound the problem of low pay.

The analysis of the Russian labor market provided in this chapter has so far not attempted to estimate the impact of the informal economy on either employment or living standards. This has been deliberate: I believe that for many if not most of the questions discussed here, the official statistics provide a reasonable picture of the actual situation in Russia. But anecdotal evidence (and some elements in the official statistical record) suggest that the so-called second economy is so large and so pervasive that some attention should be paid to possible sources of additional income and employment not recognized by the authorities.[20] There are three issues that merit some discussion: the scale and nature of the so-called informal or shadow economy; its impact on recorded employment, or, more important, on unemployment statistics; and its impact on measured incomes, and hence on poverty and inequality.

The informal economy in Russia as in most other countries comprises three main elements: (1) illegal activities such as the production and trade of narcotics or, possibly, prostitution; (2) activities that are not in themselves illegal, but involve attempts to avoid paying taxes or the evasion of regulations in some other way (for example, operating without a license or in contravention of health and safety regulations); and (3) activities that for one reason or another escape the statistician's measuring rod—perhaps because they are

[20]These issues are discussed further in other chapters in this volume. See, in particular, the chapters by Polishchuk, Leitzel, and Johnson et al.

thought to be insignificant (e.g., the production of home-grown vegetables by the nonfarm population in most western industrial economies) or because the statistical authorities have proved to be incompetent or inept.

It is possible that Russian households derive considerable income from outright illegal activities such as narcotics trading, but to the best of my knowledge, such activities are excluded from national income—and hence from the statistics on income—as they are in all countries using the United Nations national income accounting framework. It is also possible that, through ignorance or incompetence, the Russian statistical authorities failed to include substantial areas of *private-sector* activity in the first years of transition. They have made considerable efforts to close the gaps in their coverage, and they do try to estimate the value and volume of significant flows—including that of home-produced foodstuffs by the urban population. But there is still significant tax evasion, and some of it is undoubtedly associated with activities that go unrecorded in the national-income statistics.[21] Nevertheless, I believe that macroeconomic statistics of economic activity give a substantially accurate account of what is happening in the economy. The only caveat I would offer here relates to Goskomstat's (1996:119) estimate of the decline in the share of wages in aggregate personal—and national—income. It appears that Goskomstat now assigns all or a considerable part of the earnings of private-sector enterprises to *entrepreneurial income*; individual recipients of these incomes continue to consider them wages and salaries, and that is how they would be classified in the national accounts of many countries.

On the other hand, the Family Budget Survey is seriously flawed. There were always problems with the sampling frame it used, and its enumerators are now encountering an increasing reluctance to provide information, particularly about income.[22] Since the Family Budget Survey is the primary source of information about the *distribution* of income in Russia, this weakness suggests that one should approach estimates of inequality (and perhaps poverty) with a degree of caution. However, there is reason to believe that the tendency to underreport income is greater at the upper end of the distribution; insofar as this is so, official estimates may understate as much as overstate the level of inequality. (Goskomstat itself is aware of this weakness and has tried to compensate for the missing data in various ways.) There are other indicators pointing to the fact that inequality has increased; at present, the official estimates are probably the best guide to the extent of this increase.

[21] For a fuller account of the way in which Goskomstat attempts to capture the second economy, see Layard (1995b).

[22] As evidence of the problems faced by this survey, it is interesting to note that average monthly income in 1995 was estimated to be 284.2 thousand rubles per capita according to the Family Budget Survey; according to the national income accounts, per capita money income was reported to be 532.9 thousand rubles (Goskomstat Rossiia, 1996:32,101).

Finally, there is the question of the impact of the unofficial economy on recorded estimates of employment and unemployment. In a sense, this is a secondary problem, since the question in Russia is why unemployment is so low rather than so high. It is worth making two comments, however. First, much of the activity possibly omitted from the statistics—such as home-grown vegetables and do-it-yourself repairs—may well take place during an employee's leisure hours rather than as the main occupation of someone registered as unemployed. Second, it is entirely possible that those recorded as unemployed by ILO definitions but not registered as such with the FES are working in the second economy, as well as looking for work. It is also possible that many of those temporarily unemployed (or, as the Russians put it, on administrative leave) are involved in some form of unofficial economic activity. If so, however, this only increases one's assessment of the degree of flexibility in the labor market.[23]

## SUMMARY AND CONCLUSIONS

The argument of this paper can be summarized as follows. The decision to abandon socialism and the planned economy in Russia required a fundamental reconstitution of the system of social protection provided by the state. The decision to give up the commitment to full employment and the right to work meant that social support could no longer be channeled through enterprises. This outcome was reinforced by the decision to privatize the bulk of industrial (and other) firms; the new owners could no longer be expected to undertake the state's social policy commitments without compensation. Transition to a market economy also required the revival of the price mechanism. On the one hand, this has involved the abandonment of price controls; on the other, it has involved an ongoing review of the state's social programs. So far, the result has been a sharp reduction in the scale of price subsidies, which has been offset only partially by increases in the range and value of cash allowances.

In addition to its decision to withdraw substantially from control over the setting of the prices of both goods and labor, and thus to allow more scope for the operation of market forces, the Russian government has provided a measure of support. In setting up the FES it has provided a vehicle for the implementation of active labor market policies. The FES is also responsible for so-called passive policies and, in particular, for the payment of unemployment benefits to those who register with the service as unemployed. Although

[23]One final comment is worth noting. For many casual observers, both bribery and theft constitute part of the second economy. But since, arguably, these activities do not create additional value, they are better seen as either redistributive mechanisms or asset transfers than as a component of national income. For this reason, they have been ignored in the above discussion.

I have expressed some doubts about the effectiveness of the work of the FES, its existence has probably contributed to the improved operation of the labor market.

Under the Soviet system, the Russian economy was relatively protected from global pressures. This in turn meant that on the one hand, the structure of production—and hence employment—was outmoded, while on the other, workers continued to enjoy a security of employment that the system could no longer afford. Productivity was low, and so was the standard of living. The breakup of the Soviet Union and the abandonment of economic planning have opened the economy to the pressures of international competition. The labor market has had to deal in a short period of time with a succession of shocks—inflation, the collapse in output, international competition—which in different circumstances it might have taken longer to absorb. This has affected the apparent success of the transition to a market economy.

The evidence presented in this chapter suggests that there has been substantial adjustment to the new structure of employment in Russia. This adjustment has occurred with lower—or perhaps not higher—levels of unemployment than those observed in other transition economies. This suggests that the labor market has shown itself to be quite flexible—because of or despite the reconstitution of social protection.

A combination of the willingness of Russian workers to accept cuts in real earnings, soft budget constraints permitting enterprises to operate at a loss for considerable periods, and managerial paternalism (leading to the use of enforced leave or wage freezes rather than mass dismissals) has enabled the economy to adjust to the new economic environment. But this new environment is rather different from that which was expected at the end of the 1980s. Because of the way planners' preferences determined the pattern of output and the demand for labor, much of the human capital invested in the Russian labor force has proven to be inappropriate to the new environment. A few with scarce skills have reaped substantial rents as consumers' preferences have replaced the plan; most have seen their living standards fall.

There is still more adjustment to occur: compared with the situation in other European industrialized countries, employment in manufacturing and agriculture in Russia is too high and will fall further. Earnings in these sectors are likely to remain relatively depressed until adjustment is substantially complete. The decline in real wages and the consequent collapse in Russian living standards cannot be ascribed to the failure of economic reform or to failures in the operation of the labor market. The latter has shown itself to be quite flexible. But the 1990s are a rather more hostile environment for labor than were the 1960s, as demonstrated by the experience of countries such as Britain, France, and the United States.

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# IV

# Social Trends, Household Behavior, and Social-Sector Policies

# Social Costs, Social-Sector Reforms, and Politics in Post-Communist Transformations

*Joan M. Nelson*

## INTRODUCTION

The social costs of attempting to transform command into market economies have been very high—far higher than almost anyone anticipated at the beginning of the post-communist transitions. The impact on people of dismantling old economic institutions and rules of the game and beginning to build new ones has been compounded in many countries by the effects of the dissolution of the Soviet empire and the disruption or collapse of governmental capabilities. At the same time that the scope of social costs has become clearer, the challenges of restructuring social programs in a manner consistent with the needs and constraints of mainly market economies have begun to emerge. A triple shift in social-sector concerns is under way:

- A shift in the definition of the key problems from an almost exclusive focus on the immediate impact of transformation policies on welfare to a much broader array of long-term structural concerns.
- A corresponding shift in policies from an initial emphasis on limiting or buffering the social costs of transformation to addressing the challenges of restructuring social security, health, and education systems to be compatible with and sustainable within mainly market economies. At the same time,

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social-sector reforms have moved from the margins to the center of the transformation agenda, especially in those countries that have addressed fairly successfully the initial challenges of macroeconomic stabilization and liberalization.

• A shift in concerns regarding the political implications of social costs. Initial concerns focused on the possibility of a backlash against poverty, unemployment, and social stress that might jeopardize or reverse market reforms, democratic consolidation, or both. Fear of reversal persists in much of the former Soviet Union, but has ebbed in most of Eastern Europe; attention is shifting to the ways in which changes in social structure and social policies may shape the long-term character and quality of post-communist political systems.

These shifts introduce far more complex and controversial challenges—for data collection, analysis, policy formulation, and policy implementation—than the already formidable challenges of initial safety net concerns. The next section of this essay briefly sketches the changing nature of and forces driving the social-sector agenda. The following section examines major political and institutional obstacles to social-sector reforms. The final section turns to the implications of social trends and policies for still-evolving post-communist political systems.

First, however, a caveat is necessary. The post-communist world—Eastern Europe and the former Soviet Union—includes a tremendously varied array of states. Several of the chapters in this and earlier parts of this volume explore contrasts among countries or regions. This essay, however, glosses over important differences among countries with respect to pre-communist and communist histories, the nature and sharpness of the break from communism, socioeconomic structure, and a great deal more. Its goal is not to describe or analyze in detail, but to provide an overview and perspective on major trends in social costs, social-sector policies, and their political implications in the course of transformation.

## THE EVOLVING SOCIAL-SECTOR AGENDA

### Initial Policies: Selective Gradualism and Safety Nets

When most of Eastern Europe and much of the former Soviet Union began to transform their economic systems from command to mainly market models after 1989, few anticipated the scope and depth of economic disruption and social costs that would result. Despite widespread disillusionment with communism's economic performance, ordinary people had no grasp of the depth and pervasiveness of its distortions and inefficiencies, and therefore no premonitions of the extent and speed of collapse once key controls had been lifted.[1] Paradoxically, some ardent market reformers (domestic and foreign) seem to have underestimated transformation costs for the opposite reason: they were so thoroughly convinced of the massive inefficiencies of the old systems that they hoped changes in key incentives would trigger rapid improvement after only brief disruption. The repercussions from the collapse of the Council for Mutual Economic Assistance (CMEA), the disintegration of the Soviet Union, and (more briefly) the Middle East War were also unexpected.

Although the extent of social costs was a surprise, both the public and reformist officials certainly did expect costs; many were deeply concerned. Broadly, policy responses took two main forms: (1) "selective gradualism," or measures to delay (and therefore, it was hoped, soften) those reforms that would most directly harm large numbers of ordinary people, and (2) compensatory programs, mainly through direct cash transfers.

Selective gradualism with respect to consumer price decontrol and state enterprise reforms was designed to prevent or delay social costs from occurring. Many countries retained full or partial price controls for medicines, rents, utilities, and sometimes selected food staples for months or years after most other price controls and consumer subsidies had been removed. Most governments also moved quite slowly on privatizing or otherwise reforming large state economic enterprises, in part for technical reasons, but also because of concern about the social costs and political risks of rapidly rising unemployment. For instance, in the Czech Republic, despite far-reaching and determined market-oriented reforms in general, bankruptcy legislation that would have forced action on inefficient state enterprises was thrice delayed; when it was finally passed, its implementation was again postponed.

In contrast to selective gradualism, compensatory programs were designed to mitigate the impact of costs after they occurred. Concern focused mainly on the unemployed and the elderly, but also on families with young children. Between 1987-1988 and 1993-1994, most post-communist countries increased cash social transfers, usually by 2 to 4 percentage points of gross domestic product (GDP). Hungary and especially Poland did much more; by 1993-1994 both were spending almost a fifth of GDP on these programs. The Czech Republic, Moldova, Romania, and Russia maintained but did not increase cash transfers as a share of GDP.[2] However, even in those countries that substantially increased money transfers and partly indexed some benefits, inflation eroded their real value. In countries where increases were smaller, the real value of social transfers shrank to a fraction of earlier levels. More-

[1]In some Eastern European countries, there may also have been widespread expectations of generous Western aid, comparable to the Marshall Plan in Western Europe after World War II (personal communication from Valerie Bunce).

[2]See Milanovic (1997:40, Table 4). Data are not given for the Central Asian countries.

over, most transfers (with the exception of the new unemployment compensation programs) were targeted to categorical groups (the elderly, or families with children), but not to the poor within those groups. As market reforms increased inequality, the lack of targeting to the poor made transfers still less effective in reducing poverty.[3]

At best, selective gradualism and compensatory programs could only partially mitigate the costs of the initial period of adjustment. Social costs varied tremendously across countries (as well as within countries, with major cities generally faring far better than rural areas and smaller towns). Costs were determined largely by initial conditions, including the scope and depth of poverty in absolute terms, and by the character of macroeconomic reforms, which ranged from consistent and determined to vacillating, partial, and chaotic. In Hungary before 1989, only about 1 percent of the population was poor (measured by an absolute, cross-national standard of $120 a month at 1990 international prices); in 1993 that figure was 2 percent. In Poland, poverty increased from 6 to 12 percent during the same period (using the same yardstick); in Bulgaria it increased from 2 to a startling 33 percent. In Russia as well, poverty swelled dramatically to more than a third of the population by 1993 (World Bank, 1996a:69, Table 1). In the absence of at least partly effective stabilization and liberalization, compensatory programs are a bucket brigade confronting a forest fire. Once major macroeconomic reforms are in place, such programs can become more effective (Åslund, 1997).

## Will Resumed Growth Solve Social-Sector Problems?

Analysis and debate regarding the actual social costs of the initial post-communist periods will undoubtedly continue for a long time, given the knotty problems of appropriate concepts, standards of comparison (across time periods and among countries), quality of data, and interpretation.[4] It has long been recognized that much production and income go unrecorded in official data. Estimates of the importance of the informal economy grow steadily; however, middle- and upper-income households may well benefit more than poorer ones from informal opportunities. Household survey data for several countries indicate that a great many households increased their holdings of consumer durables and/or their savings even in the early years of the transformation. Rather than suggesting increased incomes, however,

[3] I am indebted to Nick Barr for the observation that categorical transfers were reasonably well targeted for comparatively flat income distributions under communism, but became poorly targeted once incomes became more unequal.

[4] For concise summaries of some of the conceptual and data difficulties, see World Bank (1996a:67, Box 4.1) and van de Walle (1996:5-6).

that fact may reflect liberalized exchange rates and dramatically appreciated currencies.[5]

Direct data and indirect clues on the subjective impacts of transformation are also emerging. For many, especially older, less educated, and rural people, the tremendous changes have imposed overwhelming psychological costs in terms of insecurity and uncertainty, the devaluing of lifetime contributions to now-crumbled systems, and (for Russians) the collapse of national prestige along with empire. These impacts may be indirectly but dramatically signaled by the accelerated increase in mortality rates among adult men, particularly in Russia, in the early 1990s.[6] For others, particularly the younger and better educated, the transformation is quite literally liberating, with respect to both economic opportunities and political freedom.[7]

From a policy perspective, however, the key questions do not hinge on understanding of the recent past, but on prospects for the near-term future. In particular, in those post-communist countries that have turned the corner, will price stability and economic growth erase the social costs of the initial shocks?

By 1994, most of Eastern Europe had stopped its economic slide. Polish GDP increased steadily from 1992. Most Eastern European countries had brought inflation to or below 30 percent by 1995; six of ten grew 5 percent or more in that year (World Bank, 1996a:173, Table A.2). Growth remains fragile in some Eastern European and several Soviet successor states, and a few, including Bulgaria, Belarus, Serbia, and Bosnia, show little progress. Unemployment has responded fairly rapidly to improved economic conditions: in most Eastern European countries, unemployment peaked in 1993 or 1994 and has since declined.[8] Measured poverty levels have been slower to respond. In Poland, with the longest record of growth, different measures of

[5]I am indebted to Branko Milanovic for this point. He offers the following example. In 1989, a Polish worker's average monthly wage in zlotys could be converted at the parallel exchange rate for roughly $20. (The official exchange rate was available only to state companies.) A simple imported VCR would cost the equivalent of 10 months' salary. In 1995, that worker's real zloty salary was about the same, but could be converted at the liberalized legal foreign exchange rate for $200; a VCR could be purchased with 1 month's salary. Currency appreciation was particularly dramatic in Russia.

[6]However, mortality rates among men had been increasing in the Soviet Union from the late 1970s. See National Research Council (1997).

[7]For survey data regarding attitudes toward transformation, see the reports based on successive rounds of the New Democracies Barometer, available through the Centre for the Study of Public Policy, University of Strathclyde, Glasgow.

[8]See Allison and Ringold (1996:23). Irena Topinska of the University of Warsaw notes that legislation concerning unemployment, taking effect in January 1995, may have affected the actual unemployment rate in Poland, but she confirms that unemployment has been decreasing somewhat (personal communication).

poverty tell varied stories; while poverty seems to have stopped increasing, 1995 data show no clear downturn.[9]

One major factor limiting the effects of growth in cutting poverty and other social costs is the dramatic increase in inequality in all post-communist countries, coupled with dwindling state redistributive capabilities. In most countries, growing inequalities in income and wealth are coupled with failure to rationalize the tax system and collect taxes effectively, and thus to direct some of the winners' gains from growth into programs targeted to reducing poverty.

More specifically, the transformation process has created large pools of poverty that will not shrink automatically as economies strengthen. Two problems in particular stand out: (1) the large number of acutely depressed regions and cities that depended on industries that are now dying, and (2) the growing pool of long-term unemployed. As noted earlier, in most of Eastern Europe, unemployment has declined since 1993 or 1994. However, workers who have been unemployed for more than a year comprise a growing proportion of the still-substantial totals. By 1995, long-term unemployed were more than 40 percent of total unemployed in all Eastern European countries except the Czech Republic, and exceeded 60 percent in Bulgaria and 87 percent in Macedonia (Allison and Ringold, 1996:27-28). In most of the Eastern European countries for which data are available, roughly a fifth of the long-term unemployed are under 25 years of age, while two-thirds to three-quarters are between 25 and 60; substantial portions are unskilled or have comparatively limited education (supplementary tables provided by Dena Ringold). Experience in Western Europe and elsewhere indicates that it is particularly difficult for the long-term unemployed to find and keep new jobs (see, for example, Boeri and Scarpetta, 1994). Other longer-term problems are probably emerging in some of the poorest countries. For instance, in Albania, it is likely that child labor has increased, and school attendance (particularly by girls) has dropped (personal communication from Katherine Verdery).

If brisk and sustained growth can be achieved, many of the households near the center of the income distribution that were pushed into hardship in the early 1990s will rise once again above the poverty line. But some of the costs of the initial transformation—sharply increased inequality, dying industries, and the long-term unemployed—pose problems for social policy that will not yield to growth alone.

## The Need for Systemic Reforms in Social Sectors

In addition to the enduring problems created by the initial stages of transformation, post-communist countries face an array of social-sector challenges that have quite different causes. Even more than the problems generated by

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[9]Personal communication from Irena Topinska, University of Warsaw, and Branko Milanovic, The World Bank. Data for 1996, still being analyzed, may indicate a slight decline in poverty.

the transition process, these additional problems require not simply safety nets or add-ons to existing social-sector programs, but far-reaching reforms in the entire systems of social transfers and services.

One of communism's undeniable and proudest achievements was the expansion of access to education and health services for entire populations. However, as Schieber and Klugman (in this volume) detail with respect to health, major inefficiencies were built into the design of these services, including excessive emphasis on hospital care and low priority for public health measures addressing some of the most important causes of poor health and mortality, such as personal behavior (alcohol, smoking, diet), environment, and safety.

Moreover, as broader economic difficulties and budget pressures developed in many communist nations from the 1970s on, problems deepened in the health and education systems. The quality of services deteriorated, while queuing, reliance on personal connections, and corruption (including widespread use of under-the-table fees) increased. So, too, did informal and illegal privatization. For example, it became common for doctors to offer fee-for-service treatment after normal hours, using public facilities and equipment.

Despite these shortcomings, old social-sector institutions might have continued to function semi-adequately in the absence of the larger transformation. But as command economy arrangements are dismantled or crumble and formal and informal market arrangements emerge, social-sector programs and policies need fundamental redesign to operate in the new context and to address new as well as old needs. For example, under state socialism, a wide array of health, education, housing, and other services and benefits were channeled largely through state industries and farms. As these are dismantled, privatized, and/or streamlined, they are shedding their social functions. Moreover, more mobile labor forces and the growing importance of small firms necessitate entirely different arrangements for delivering social services and benefits.

Financing also needs to be rethought. For instance, in many post-communist countries, pension and health systems are funded largely through payroll taxes (see Fox, in this volume). These taxes swell the wage bill by as much as half, discouraging new investment in general and labor-intensive investment in particular.

Both market economies and more democratic political systems demand changes in content, as well as finance and delivery systems, especially in education. Beyond the obvious requirements for new or revised curricula (for instance, in business management, economics, and social sciences more generally), basic teaching approaches and techniques must give more emphasis to initiative, flexibility, and problem solving (for a comprehensive overview, see Heyneman, 1996).

More broadly, as Kornai discusses (in this volume), post-communist nations need social service and benefit systems that provide more choice and place more emphasis on individual responsibility. Such changes will demand revised assumptions about entitlements and social contracts between state and citizens—assumptions discussed in more detail later. Shifts toward choice and individual responsibility will also require much more sophisticated publics, with a better grasp of the implications of alternative options for themselves and others (including the next generations). Altered perspectives and increased sophistication are difficult challenges in established market democracies; they may prove still more wrenching in Eastern Europe and especially in the Soviet successor states.

Changes in the division of responsibilities and financing between national and subnational governments do not necessarily accompany market-oriented reforms. But in the half-dozen years since the collapse of communist monopolies on power, many post-communist countries have decentralized major responsibilities for public services and facilities from national to provincial and local governments. The trend has often been driven by financial pressures and general administrative overload on central governments, as well as by reactions against communism's strong central controls and a desire to spread both power and participation. Devolution is particularly marked in the education and health sectors. Whatever the motives, the effects thus far have often been tremendous confusion regarding who is responsible for what, and mismatches among responsibilities, finances, and technical and administrative capacities.

In some post-communist countries, aging populations add pension reform to the formidable agenda of social-sector issues (see Fox, in this volume). In 1990, between 10 and 13.5 percent of the population of most Eastern European countries, and Russia and the Ukraine as well, was over 65 years of age. (In Albania and the Central Asian republics, the elderly are a far smaller proportion of the population.) Long-established patterns of early retirement and generous disability, a surge in retirements at the outset of the transition, and the rapid growth of the informal sector and tax evasion intensify the effects of age structure on pension systems. In 1993, 1.9 workers in Russia and Poland were contributing to the pension system for every retiree drawing on it; the ratio in Hungary was 1.5:1 and in Bulgaria only 1.2:1. Pensions consumed 10.4 percent of GDP in Hungary in 1992 and more than 15 percent of Poland's GDP in 1994 (see Svejnar, 1996:Tables 1, 4, 5). There is almost universal agreement among specialists that the commitments embedded in existing systems are unsustainable. Moreover, in some countries, including Hungary and Poland, pensions' large and growing share of government expenditures may well be squeezing other social-sector expenditures, including education and health for children (see also Ferge, in this volume).[10]

[10]The inadvertent intergenerational clash between growing outlays on pensions and health care for the elderly and dwindling programs for children is also an emerging theme in debates over social security reforms in the United States and some other industrial democracies.

As social-sector reforms move to the center of the policy arena, a still larger issue may loom in the Central European countries with very high total levels of social expenditures: a clash between social spending and the levels of saving and investment needed to spur rapid growth. If the Czech Republic, Hungary, and Poland wish to catch up with Western European income levels within one or two generations, the argument runs, they must reduce current very high levels of social expenditures relative to gross national product (GNP)—levels that perpetuate high taxation and inhibit public and private investment (Sachs and Warner, 1996). The same point can be made regarding Slovenia and Slovakia. The argument moves beyond the earlier emphasis on the need to reduce public spending to contain inflation and highlights a long-term clash between particularly high levels of social expenditures and rapid growth. That clash is further sharpened by the fact that some key social-sector reforms, including certain pension measures, can be extremely costly in the short or medium run.

In other parts of the post-communist world, social spending claims a much more modest share of GNP. Moreover, national and local public revenues have virtually collapsed in Russia and some other countries. Not only has the real value of pensions and other social assistance shrunk in Russia, but payments are often delayed for months. For many of those still in the labor force, delays in wages spell poverty; miners, teachers, and others have periodically struck in protest (see McAuley, in this volume). In contrast to Central Europe, in Russia the need is not for cuts in mandated or actual social spending, but for restoration of state capacity to collect taxes and administer public programs, including social services and transfers. Indeed, restoring and reorienting state capabilities is crucially important, above all in Russia, but depends on decisions and actions that go far beyond the social sectors themselves.

In sum, the social-sector agenda has evolved with almost bewildering speed in the past half-dozen years. From the understandable initial preoccupation with minimizing and buffering the social costs of transformation, the agenda must now address the persistent transformation legacies of deeply depressed regions and long-term unemployed, the inefficiencies and distortions inherited from the communist era, the demands of emerging market economies, the opportunities and problems of rapid decentralization, and (in some cases) the threat of fairly imminent pension crises. In some countries, the overall balance between social spending and the requirements of rapid growth poses a still larger issue. These formidable challenges cannot be met by modest improvements in existing systems. They demand systemic reforms—far-reaching changes in organization, financing, administration, and incentives. In parts of the post-communist world, they also require a still broader revitalization of basic state capacities.

## THE POLITICS OF SOCIAL-SECTOR REFORMS

While the agenda has ballooned, thus far (as Kornai notes in this volume) there has been remarkably little change in social-sector institutions and operations—or at least, little change designed primarily to reorient and improve social programs.[11] Many of the reforms that have occurred or are in process are substantially (though usually not entirely) driven by financial pressures. In Hungary, for instance, current (1996) designs and legislation for far-reaching changes in the pension and health systems were initiated by the Ministry of Finance and have been coordinated by that ministry, though other ministries and interests are active in the process. Other changes in actual operations are not the product of planned reforms, but ad hoc responses (especially by local governments) to the shedding of social service functions by state enterprises, devolution of responsibilities from higher levels of government, dwindling tax revenues, and other trends.

This scenario is not unique to post-communist countries. As Graham points out (in this volume), in Latin America and other regions, countries that have drastically reduced state economic intervention and opened their economies are now beginning to address social-sector reforms. Several have launched major pension and/or health reforms, but many are finding it difficult to move ahead rapidly in these sectors. In Western Europe, the United States, and Japan, the need for reforms in pensions and social benefits (and, in the United States, health services) is well recognized, yet there is little action.

To some extent, slow progress on social-sector reforms is simply part of a much broader pattern: reforms entailing major institutional change are inherently slower and more complex than macroeconomic stabilization and liberalization measures. Price changes, like devaluation and interest rate adjustments and the dismantling of controls and subsidies, are often politically controversial, but they are not complex administratively. With the backing of top political leaders, such measures can be put into effect by a small number of senior economic officials. Moreover, they take effect rapidly, sometimes overnight. Institutional reforms, such as financial-sector restructuring, privatization or rationalization of large state enterprises, and liberalization of labor markets, are much more complex. They demand the cooperation of a much wider range of branches and agencies of government, and they take months, sometimes years to put into effect. Moreover, while many of the initial costs of stabilization are temporary and distributed over much of the population, institutional reforms usually result in permanent losses to specific groups, prompting particularly vigorous resistance.

[11]For a discussion of changes in health-sector institutions, see Schieber and Klugman (in this volume). Regarding education, see Heyneman (1996).

Major social-sector reforms may be even more difficult than other kinds of institutional reforms. Four characteristics of social services converge to make systemic reforms particularly challenging:

- There are no templates. Even within technical circles there is only limited consensus on the design of reforms.
- The beneficiaries of social services and transfers often view them as entitlements to which they have a moral claim.
- Major social service reforms are particularly complex organizationally. They involve large numbers and many categories of players—people whose cooperation is crucial for the success of the reforms. Complexity in turn implies a long timetable: major social service reforms are likely to take years to put in place and begin operating effectively. (Transfer programs can be modified more quickly.) Therefore, there are many potential veto actors and veto opportunities.
- At any given moment, the evident costs of postponing action are small, even though the cumulative costs of inaction may be immense. Therefore, politicians have little incentive to act.

These difficulties, it should be noted, hinge only to a small degree on the specific reforms being promoted. They apply to reforms that emphasize privatization, but also to those that rely on public-sector approaches. Similarly, they are relevant regardless of whether new arrangements incorporate extensive user participation or rely on professional and technical control. The difficulties spring from the nature of social services and transfer programs. Each difficulty is discussed in more detail below.

### The Lack of Templates

The lack of templates for social service reform flows in large part from two facts. First, education and health programs serve multiple goals and constituents, and it is difficult to reduce the trade-offs among goals and groups to a single common denominator. Should priority be given to the quality of health care or its coverage? Should education emphasize national unity or distinctive ethnic and geographic heritages (including languages)? There are technical considerations, but no adequate technical answers to these and similar questions; they must be resolved in the context of specific national (and sometimes subnational) circumstances and priorities.

Even at the level of technical considerations, there is only limited consensus. For instance, health specialists agree regarding high pay-offs from public health (as distinct from curative) programs, but most doctors do not accept the implications. Health-sector analysts argue among themselves about the most desirable arrangements for financing health care under varied circumstances. In education circles, the conventional wisdom regarding the high returns to primary education (as distinct from secondary and tertiary levels) is now under challenge. With regard to pension systems, a consensus is emerging, in part as a result of World Bank leadership, on the weaknesses of existing pension systems. But intense debate continues regarding the design of funding and other reforms to correct those weaknesses.

The lack of templates also reflects the strong public goods component of social services. The latter fact implies a major role for the public sector, but the division of responsibilities among public (national and subnational) agencies, voluntary organizations, private for-profit actors, and households and individuals is highly flexible and immensely controversial. (For contrast, consider the considerable—though far from complete—consensus that has emerged since the early 1980s regarding the risks of direct government ownership and the potential advantages of mainly market mechanisms in industrial production.)

From one perspective, the wide array of potential models frees debate within each country. But the practical effect has been, and is likely to continue to be, extreme difficulty in reaching national political consensus regarding reforms. Even after a decision has been reached to move ahead on specific measures, lack of consensus on a broader vision or design for the sector is likely to leave the door open to stalling, backtracking, and inconsistent initiatives. In much greater degree than in other sectors undergoing major institutional reforms (for example, the financial sector), reforms in health and education are likely to unfold in a start-stop manner, as a series of successive approximations. That approach can have some advantages, opening the way for experimentation and learning by both agencies and individuals. But evolutionary, start-stop approaches also have high costs, including reduced credibility and therefore lowered incentives to adjust. Those drawbacks are still more acute if there are actual rollbacks or sharp changes in direction, rather than simply an incremental approach to reform.

## Entitlements

The psychology and politics of entitlements are a major obstacle to the reform of pension systems around the world. Entitlements are benefits that are guaranteed by law or even by a country's constitution, and are viewed not as privileges but as rights. Moral claims rest on more than legal foundations. Often pensioners believe (usually erroneously) that they have paid in full or overpaid during their working lives for the pensions they receive after retiring. In the post-communist world, the same belief may take a slightly different form: pensions have been paid for, in effect, during a lifetime of working for low wages for the state. Changes viewed as reducing the value of pensions therefore prompt resistance fed not solely by economic concerns, but also by moral outrage.

In Eastern Europe and the former Soviet Union, many regard a broad array of social services and benefits as entitlements. Under communism, there was a widespread expectation that the state would guarantee economic security and a modicum of comfort in exchange for political acquiescence and (poorly paid) work. That social contract between state and citizens had come to be viewed with growing cynicism toward the end of the communist era; the state was seen to have reneged on its commitments. Nonetheless, most people continued to regard a generous array of public services and benefits as the norm or standard for a legitimate and desirable state. Indeed, for Eastern Europeans, the vision of "joining Europe" probably includes not only an array of consumer goods, better housing, and other material gains, but also much-improved education and health services—assumed to be provided by the state. At the very moment when the insecurities and inequalities of market economies are becoming ever clearer, radical revision of these expectations—or, put differently, a radical renegotiation of the social contract—may be particularly difficult. Resistance is likely to be even more intense in Russia and some other post-Soviet states, where more of the population regards the disintegration of the social contract not as a result of the failures of communism, but as a direct outcome of market-oriented reforms.

## Complex Organizational Changes

In modern states, delivery of health and education services entails large-scale, multilayered organization. Even where control is highly centralized, actual delivery of primary education and health care must be decentralized. In all but the smallest countries, higher-level facilities are also widely scattered. Provincial and local governments often play important roles in education and health provision. As noted earlier, this is increasingly the case in most post-communist states. Therefore, reforms involve the cooperation of executive branch agencies and often legislative bodies at all levels of government. However, ministries frequently are sharply divided, with different branches holding quite different perspectives. Operating ministries and agencies also are often at odds with budget authorities: even reforms intended to reduce costs eventually are likely to incur up-front costs. Not only the ministry of finance but often subnational financial authorities must concur, and come to detailed agreements regarding the allocation of financial, technical, and managerial responsibilities.

Health and education are big employers. In many countries, teachers and health workers are the largest categories of public employees. They are often highly organized. Moreover, both in the post-communist world and in other regions, public-sector teachers and health workers have been hard hit by the budgetary pressures of the last 15 or 20 years. Their real wages have dropped sharply; in some countries, many have slipped from middle-class status into poverty. Driven by both perceived self-interest and professional commitment to established programs, doctors often oppose changes that emphasize public health over curative programs and clinics and other preventative and primary care facilities over hospitals. Teachers' unions have been formidable opponents to proposed reforms in education systems in a number of Latin American countries and in Poland, Hungary, and Russia. Effective reforms in organization, financing, administration, and program norms must usually be negotiated, at least to some degree, with the service providers themselves.

That conclusion is reinforced by the fact that the quality of outputs in health and education depends in unusually high degree on the motivation and initiative of the service providers themselves. In other public services where large numbers of workers deal directly with the public—for example, the post office or the customs service—much less initiative and judgment are required to provide reasonably good service. At the same time, it is difficult to monitor and measure the effort and performance of health and particularly education workers fairly, perhaps especially in the case of primary-school teachers scattered across thousands of small schools. Reforms attempting to decentralize responsibility and introduce performance-linked incentives face particularly difficult principal-agent problems of the kind described by Przeworski (in this volume). Reforms can be effectively halted by widespread informal resistance or indifference among service providers, even without open strikes or demonstrations. Solutions often entail either enhanced consumer choice among providers (for instance, through school vouchers) or direct monitoring by user groups—parents of school children, for example. Such approaches have considerable potential, but they swell the number of actors involved in effective reforms.

In part because of the multiple levels and categories of actors involved and in part for technical reasons, social-sector reforms typically take years to implement. In Chile, systemic reforms in education took a decade even under Pinochet's authoritarian rule—not because of (suppressed) resistance, but because of the reforms' technical and organizational complexity.

The organizational complexity of health and education systems affects the politics of systemic reforms in these sectors. If many actors must cooperate to put a reform into effect, any one of them can weaken or stop the reform; there are many potential veto actors. If implementation entails multiple steps over several years, there are many potential veto opportunities. Moreover, the long timetable means that the benefits of reforms often do not become apparent to users for some time. That makes it difficult to mobilize proreform coalitions to counter opposition from vested interests.

### Politicians' Incentives: Low Apparent Costs of Delay

Most politicians prefer to defer controversial measures. Sometimes a politician is genuinely convinced that specific reforms are highly desirable and is willing to run the political risks. More often, politicians make difficult decisions only when they are convinced that the risks of action are less than those of failing to act. In the context of post-communist transformation, certain sets of reforms are obviously urgent: inaction courts disaster. Examples include measures to cope with rapidly accelerating inflation and/or low and dwindling foreign exchange reserves, and aspects of financial-sector reform.

Systemic social-sector reforms, however, seldom have this urgent edge. At the beginning of the transformation, social safety net provisions—especially with respect to unemployment compensation and pensions—were indeed viewed as urgent and were rapidly enacted, but they did not entail basic changes in existing systems. In those countries with large and rapidly increasing elderly populations, the costs of failure to adjust existing pension systems can be fairly precisely predicted and timed, but in most cases, massive shortfalls remain some distance in the future. The costs of delay in reforming education and health delivery arrangements, including financing, are much more difficult to gauge precisely.

In these circumstances, politicians' incentives will favor delay. The costs and risks of action are likely to be seen as clearly outweighing the costs of inaction. Hesitation is reinforced by the facts reviewed above: the absence of a consensus template and disagreements among technical specialists regarding the design of reforms; the predictable opposition from citizens who believe reforms threaten their entitlements; and the formidable complexity, long timetables, and delayed benefits of major social service reforms. The pattern in many post-communist countries is likely to be similar to that in many industrialized democracies and some Latin American countries: growing recognition of the need for reform, but slow, partial, and inconsistent action.

## Overcoming Obstacles to Social-Sector Reforms

In the mid-1990s, a number of countries have moved ahead with significant social-sector reforms despite the above gloomy prognosis. Social security reforms are well under way in Argentina, Bolivia, Peru, Uruguay, and (more tentatively) Mexico; Argentina is also undertaking major reforms in the health sector. In Eastern Europe, Latvia has adopted far-reaching pension reforms, as Fox discusses (in this volume). Hungary and Poland are likely to take major actions in 1997.

Paradoxically, the crisis atmosphere generated by macroeconomic pressures and stabilization policies may itself foster reforms in social (as well as other) sectors. In Chile in the 1980s and in Argentina, Bolivia, and Peru in the early 1990s, social service reforms were part of much broader reform agendas undertaken by political elites convinced that their nations faced fundamental economic and political risks. A sense of crisis and far-reaching economic and societal change broader than the social sectors themselves can help overcome the obstacles discussed above through several channels.

First, protracted crises tend to weaken vested interests and lower aspirations. Labor unions in much of Latin America are much weaker in the mid-1990s than they were a decade or more earlier; structural economic changes have also undermined union power in much of Eastern Europe. Moreover, benefits from old arrangements may become so severely eroded that the commitment of vested interests to the status quo dwindles. For example, where pensions have become almost derisory, as in Russia, existing arrangements have few supporters. Weakened unions and eroded benefits are not inherently desirable. But such factors may indeed facilitate reforms that would have been impossible earlier.

Second, crises and major political and economic changes involve new stakeholders in specific issues. New stakeholders in turn make possible new coalitions and altered relationships. Most obviously, ministers of finance and economy have become much more attentive to social-sector issues. As more open economies expose local industries to international competition, progressive businessmen may become more concerned about the quality and content of secondary and technical education; this trend is already evident in some Latin American countries. In many countries, nongovernmental organizations are also taking a rapidly increasing role in direct provision of certain social services and in pressing for better governmental programs.

Third, both ongoing pressures and structural changes stretch receptivity to new ideas. In Latin America, many stakeholders viewed the fiscal pressures that became acute in the early 1980s as temporary; their first instinct was to wait until things "returned to normal." Only after roughly a decade during which it became increasingly clear that the "golden age" would not return has a serious search for alternative solutions begun. In Eastern Europe, despite recognition (and, for many, strong desire) that the reforms of the early 1990s would bring fundamental changes, many expected only temporary economic hardships, and very few anticipated major changes in the social sectors more specifically. It has taken several years to begin to recognize important longer-run resource constraints and trade-offs among resource uses, and to perceive the implications of changing economic structure for the design and delivery of social services.

In short, changed circumstances can improve the prospects for social-sector reforms, despite the obstacles catalogued earlier. As Graham emphasizes (in this volume), reformers' tactics also matter. I argue elsewhere that sustainable institutional reforms demand different political tactics than do macroeconomic stabilization and liberalization, and that reforms undertaken in later stages of the adjustment process inherently have different political dynamics than do the initial measures (see Nelson, 1994:13-20). More specifically, precisely because of the political difficulties and vulnerabilities of social-sector reforms, the *process* through which policies are formulated is crucial to their success.

In Pinochet's Chile, radical reforms in education, health, and social security could be designed by technical specialists and mandated by the executive (though even in this setting, considerable education and persuasion accompanied the launching of the measures). In more open political systems, it is obviously far more difficult to push through measures that command little support. If such measures are adopted, perhaps in the context of financial crisis, they are vulnerable to reversal. For example, New Zealand adopted radical hospital privatization and other health care measures in the early 1990s as part of a broader program of market-oriented reforms responding to severe and long-standing economic troubles. The health measures were bitterly controversial. After the elections of October 1996, they were abandoned (while spending on health and education was increased) as part of the bargaining to create a new governing coalition. In contrast, monetary policy was merely eased, without moving sharply away from the design or intent of earlier reforms.

In short, sustainable social-sector reforms almost surely require much more investment in public education and broadened support than do reforms in many other sectors. That process can be immensely frustrating (as the United States discovered a few years ago with respect to health-care delivery reforms). Yet shortcuts may well leave measures vulnerable to early reversal or erosion, thereby lengthening the route to sustainable reform.

This point bears on the roles international agencies and advisors should and should not play in promoting social-sector reforms in the post-communist world (and elsewhere). These agencies can make extremely important contributions to the internal debates now beginning in Eastern Europe. They have a wealth of information and experience from many countries, which can critically to inform debate in sectors that have tended to be somewhat parochial. They are also well qualified to point out the implications of sectoral policies for broader economic stability and growth. However, they may well be tempted to go beyond advisory and educational roles, pressing and perhaps even insisting on rapid action. Similar pressure in other fields, such as macroeconomic management or financial-sector restructuring, has often proved a useful catalyst for sustainable reforms. The argument here is that the intrinsic features of social-sector reforms, including the fairly wide array of feasible designs, simultaneously reduces the justification for external pressure and heightens the risk that measures adopted under pressure will not be politically sustainable.

## THE POLITICAL IMPLICATIONS OF TRANSFORMATION COSTS

### Initial Political Concerns: The Threat of Backlash

As Eastern Europe and (somewhat later) the successor states of the former Soviet Union began to adopt market-oriented reforms, concerns about high social costs focused both on welfare (as already discussed) and on possible political implications. Reformers and their foreign supporters worried that the dislocations and sacrifices of economic transformation would fuel a backlash against market-oriented reforms, democratic governments, or both. That backlash could take a variety of forms: direct support for the return to power of communist politicians and parties; scapegoating and extreme ethnic or nationalist appeals (possibly leading to violent clashes within or between countries); widespread protest and instability; or spreading disillusion and alienation, indirectly opening the way for extremist groups or the military to seek the violent overthrow of governments and the reversal of economic reforms.

Seven years later, it is striking how few instances there have been of these scenarios. Politics has been fragmented, quarrelsome, and indecisive in many countries and polarized and stalemated in some. In several countries, very little economic reform and/or political opening has occurred. But neither democratic politics nor market-oriented economic reforms have been reversed once clearly started.

Nationalist and extremist ethnic politicians have appeared, but generally have not drawn enough support to dominate politics, nor is there any consistent pattern linking support for such groups to the severity of social costs. Ethnic conflict has indeed broken out in a number of ethnically heterogeneous countries (Tajikistan, Moldova, Georgia, the Russian Federation, and of course former Yugoslavia), but has not emerged in other states with diverse populations. Bunce (1996) argues that such conflict has been largely unconnected with overall economic performance, and is much better explained by whether leaders and citizens tend to define the political community in ethnic rather than residential terms and by specific actions of political leaders toward ethnic minorities (Bunce, 1996).[12]

Starting with the parliamentary elections in Lithuania in November 1992, formerly communist politicians and parties that were fairly clearly descended

[12]In contrast, Woodward (1995) argues that stabilization and liberalization efforts guided by the International Monetary Fund were a major factor in the complex causes of Yugoslavia's disintegration after 1990. Economic hardship heightened ethnic tensions, the need to strengthen central government authority over macroeconomic policies triggered resistance in regional governments, and media and politicians exploited increased political openness to press divisive claims. The analysis may well hold for Yugoslavia; however, in much of the rest of the post-communist world, one or more of the preconditions or concomitants of the Yugoslav dynamics would appear to be absent.

from the old communist parties won pluralities in half a dozen parliamentary elections: Poland (September 1993), Russia (December 1993), Hungary (May 1994), Bulgaria (December 1994), and Estonia (March 1995). Many observers expected market-oriented reforms to be rolled back, or at least to slow abruptly. Yet despite their desire to ease the social costs of reform, the new social-democratic coalitions did not reverse the broad thrust of economic or political reforms. Indeed, in Poland, Hungary, and Lithuania, post-communist social-democratic parties clearly moved toward the center of the political spectrum.

Initial fears of backlash turned out to be off target because they were based on far too simple a model. (Such expectations have proved similarly unreliable in Latin America and elsewhere.) The model posits a direct and strong causal relationship running from social costs to widespread political protest and/or the emergence of powerful antidemocratic and antimarket movements. Without attempting a detailed discussion, we can briefly review a few of the flaws in that model.

Worsened living conditions do not automatically generate political protest, even in permissive political settings. People's reactions to rising prices, falling real incomes, and deteriorating services are shaped by their assessments of the causes of these trends and the prospects for improvement. Many in Eastern Europe and some in the former Soviet Union hold communism and its legacies responsible for much hardship. Moreover, if today's hardships are believed to be the price of reasonably likely improvements tomorrow—or next year—patience is rational. These beliefs are widespread in Central Europe, but weaken farther east. Within individual countries, age and education quite rationally influence whether one focuses on the costs or opportunities of transformation. For instance, Eastern European opinion surveys indicate that younger people in particular prefer unaffordable to unavailable goods.[13]

Even if hardships are attributed to the current government and the future looks bleak, political protest is only one of a wide array of possible responses—and by no means the most probable. Indeed, in the post-communist world (as in much of Latin America and Africa during hard times in the 1980s), most people cope primarily by using individual initiative and household, kinship, neighborhood, and community networks. Many households gain from interhousehold transfers; other survey evidence documents the varied forms and sizable quantitative importance of informal earnings. Less constructive individual responses range from excessive drinking or beating one's spouse to seeking solace in religion.

While blind anger can prompt riots, sustained collective political action depends on participants' perceptions that that course is worth the costs and

[13]Richard Rose, drawing data from the fourth round of the New Democracies Barometer survey in Eastern Europe, reported in World Bank (1996b).

risks—and is likely to be more effective than alternative uses of time and energy. Many of those hardest hit by the transformation—older, less educated, and often rural people—are likely to view protests and demonstrations as risky and ineffective. Solidaristic groups such as miners may well resort to protest to exert pressure for specific claims such as payment of back wages, but are not likely to extend their demands to broader goals.

Moreover, not many leaders or groups are eager to provoke antisystem efforts. In most of Eastern Europe and increasingly in Russia, elections are now viewed as the sole legitimate route to power. More specifically, communist parties or their reoriented successors seek to establish their credentials as players in the system rather than challengers outside of it. Therefore, they will appeal for electoral support by criticizing the social costs of transformation, but have not been quick to try to organize disorderly protests.

In short, the links between social hardship and political protest are mediated by a large number of subjective interpretations and expectations, by institutional and organizational contexts, and by explicit or (more often) implicit rational assessments of the benefits and costs of alternative courses of action. In the post-communist world as in much of the noncommunist world, severe economic hardships have prompted a great deal of complaint and considerable protest, but only rarely a sustained backlash strong enough to derail economic reforms or political openings already under way.

## Longer-Run Impacts: What Kinds of Societies and Polities Are Emerging?

A focus on the risks of reversal is a very narrow lens through which to examine the political implications of the costs of transformation. While they probably will not provoke reversal, social costs (and benefits) already incurred or still unfolding will profoundly shape the character and quality of rapidly evolving and still fluid political systems. Preoccupation with reversal may lead to neglect of other, less dramatic yet ultimately crucial impacts.

A glance at current trends in much of Latin America suggests some of the issues at stake. Bolivia, Mexico, and several other countries adopted stabilization programs and market-oriented reforms in the mid-1980s, several years before the beginning of the transformation in Eastern Europe; Argentina and Peru launched particularly draconian reforms at roughly the same time as Central Europe. Since Latin American economies were largely market economies, despite extensive government intervention, structural adjustment has been far less profoundly disruptive there than in the post-communist world. Where initial measures contained hyperinflation (Bolivia, Argentina, Peru), they brought early popular support. In Argentina and Peru, they also generated striking macroeconomic success, including initially rapid growth and sharply expanded exports. But many of the benefits of new growth have been channeled to the top. While the proportion of poor has dropped somewhat since 1990, the absolute numbers have grown (fed by rapid population growth, a problem not shared by most post-communist countries). Moreover, growth has not generated many formal-sector jobs. In Argentina, despite several years of rapid growth in the early 1990s, roughly one in six workers remains unemployed. Violence of all sorts, from crime to guerrilla insurrection, has increased sharply. Social services in most countries continue to deteriorate (see Schrieberg, 1997; for more careful empirical evidence, see Londoño and Székely, 1997).

Similar but more intense trends are all too obvious in Eastern Europe and the former Soviet Union. As more post-communist states succeed in stabilizing their economies and introducing basic elements of market systems, concern grows about what kinds of societies are being created by the new institutions. Surveys indicate that many people value new political, religious, and personal liberties and prefer the wider array of consumer goods, even with high price tags, to the scarcity economy. But unemployment remains very high even in those countries that have begun to grow. Concerns about the pathologies of half-installed market mechanisms are widespread. Most citizens are frightened and cynical regarding organized crime unchecked by ineffective or corrupt police and courts, sometimes linked to high officials. Many are also deeply worried by the decline—in some countries, the virtual disintegration—of social services and transfers that used to provide considerable security and opportunity.

Already high and rapidly increasing inequality may be generating particularly undesirable effects, especially in societies that until recently had comparatively narrow spreads in income, opportunity, and security.

Low-end poverty—the possible emergence of a pool of long-term unemployed, the plight of many elderly living alone, the hardships faced by many large families—is clearly a humanitarian or welfare challenge. It is less clear to what extent and in what ways poverty also threatens to erode system legitimacy or distort representativeness. The hard fact is that in most societies with more or less open political systems, the very poor play little role in politics. That fact is not desirable, but if post-communist systems replicate the pattern, they will not be very different from most other open or semi-open political systems. However, the fact of considerable poverty may be an insidious solvent of social solidarity and national self-respect among citizens in general. This may be particularly true in countries that did not have (or denied that they had) extensive poverty before the transformation.

The impoverishment of large segments of the old middle strata of society may have more powerful effects on evolving political systems than the emergence (or growth) of severe poverty in post-communist societies. Civil servants, teachers and professors, medical and scientific workers, and other professionals in public service have been hard hit by falling revenues and budget cuts. Many of the most articulate and active proponents of democratic values have been drawn from these groups in the past. Much the same can be said of some of the greatly weakened trade unions. Disillusionment and alienation in both groups weakens democratic prospects. In some post-communist countries, the declining state-dependent middle class may be counterbalanced by a rapidly growing class of small- and medium-scale entrepreneurs. It remains to be seen whether the new middle classes will believe that their best prospects are linked to liberal and democratic as well as stable governments.

At the top end of the socioeconomic scale, the fact that some people have grown extremely rich in the course of the transformation carries clear-cut risks for stable societies and open political systems. In most post-communist countries, the manner in which the very rich have acquired their wealth (as well as the fact that many among the wealthy were also well placed under communism) erodes confidence in the rule of law and the fundamental fairness and transparency of new political and economic arrangements. Still more important, in some cases (perhaps most clearly Russia), the growing links between economic wealth and political influence corrode the integrity of democratic processes. In an ironic echo of Marx, government is indeed increasingly the instrument of the rich. Institutional arrangements—such as laws governing the financing of parties and political campaigns or the concentration of the media—can help limit the political influence of wealth. Thus far, however, there are few such laws and even less enforcement. Opportunistic networks, relationships, and norms of behavior that emerged in the chaos of initial transformation may well jell. Democratic politics need transparency and credibility as much as markets. The political implications of highly concentrated wealth threaten both.

Regional inequalities, too, can distort and fragment national unity and political systems. Sometimes regional inequalities combine dangerously with ethnic or religious cleavages, as in Serbia, Slovakia, and perhaps Latvia and Estonia. Like increased vertical inequality, geographic or horizontal inequality is bound to increase with the introduction of mainly market systems. But the collapse of central taxing authority in some of the post-communist countries—again, most obviously Russia—removes the main means of mitigating regional inequality and its political consequences.

Sharp inequalities not only pose direct political risks, but also may slow economic growth. A growing (though not yet conclusive) body of cross-national evidence suggests that over time, more equal access to education and to credit is associated with more rapid economic progress, while markedly unequal income distributions are associated with slower growth, perhaps in part because they generate populist policies and/or political unrest.[14] More-

[14]For an excellent review of theories and empirical research, see Benabou (1996).

over, higher inequality in one period reduces the effects of growth in reducing poverty in later periods; at the same rate of growth, poverty will fall more rapidly in societies with less unequal distributions of income and wealth (Ravallion and Chen, 1996:24-27).

Containing the explosive growth of inequality and mitigating its social and political effects will require a wide range of instruments and strategies. As already noted, restructuring taxes (including revised relations between national and subnational units) and building capacity to collect them is one crucial approach. In some countries, continued direct or indirect subsidies and controls have created opportunities for immense profits for the few (see Åslund, in this volume); dismantling these vestiges of old systems is a key step in capping the growth of inequality. Appropriate regulations to encourage and protect lively media competition and to limit the influence of wealth on elections are also vital.

On any list of strategies for containing and mitigating inequality, revitalized and reoriented social services and transfers must have a major place. They are among the most direct and visible approaches for increasing security against the risks and costs of ill health, disability, and old age, and for opening opportunities and improving life prospects through education. Moreover, in much of the world, but particularly in the post-communist countries, ensuring reasonably high-quality social services is viewed as a prime responsibility of a legitimate state—whether that responsibility is discharged directly through public programs or through combinations of public and private provision and finance. Under state socialism, universal entitlement to state-provided services was viewed as a major force for equity and social cohesion. Proposals for reforms to address new and old needs within resource constraints—for example, proposals for targeting to replace universal entitlements—are not simply pragmatic solutions to technical problems. Such proposals spotlight competing interpretations of equity, social justice, and community cohesion.

As social-sector reforms move higher on the reform agenda, their design will be powerfully shaped by financial considerations and by some of the specific needs generated by the broader shift to market economies (such as the need to find alternatives for the functions previously served by state economic enterprises). Those are indeed vital considerations. But they must not exclude attention to other goals—in particular, the need to counterbalance emerging severe inequalities in security and opportunity and to encourage social cohesion.

This essay argued earlier that social service reforms are burdened by special political obstacles. Therefore, politically sustainable reforms probably require more consultation, persuasion, and negotiation than do many other sectoral reforms. The goal of consolidating democratic institutions provides a further reason for focusing on the *process* of designing social-sector reforms, as well as on the designs themselves. Because social-sector institutions are so central to the security and opportunity of most of the population, the way reforms are determined will be regarded as an important test of democratic institutions. A process that takes time to disseminate information, permit debate, consult stakeholders, and perhaps experiment with pilot efforts is more likely to build confidence in democracy than is a process controlled more fully by technocratic and financial perspectives—even though the latter approach is likely to produce more rapid and coherent action.

The very fact of growing concern about the character of emerging post-communist societies, together with the embryonic but growing realization that considerable redesign of social services is unavoidable, may create a climate for a broad public debate, rather than one dominated mainly by vested interests. In short, both the process of social-sector reforms and their specific design can make major contributions to shaping livable societies and legitimate political systems—or can fall short of that potential.

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# 10

# Reform of the Welfare Sector in the Post-Communist Countries: A Normative Approach

*János Kornai*

## INTRODUCTION

Efforts are being made around the world to reform the welfare sector, or at least to debate how it should be changed.[1] This process has proved difficult everywhere. In the United States, the Clinton Administration's health-care reform effort was stymied, while in Germany and Austria there has been strong resistance to attempts to introduce modest reductions of a few percentage points in welfare spending. Similar efforts in France produced crippling strikes.

Given the difficulty of the process in the rich, developed countries, one should anticipate that it will be much more so in post-communist countries, where the conditions for reform are far less favorable. The Soviet Union and the communist countries of Eastern Europe were legally committed to providing universal welfare services. These entitlements applied to every citizen and included free health care, free education (including higher education), and a state pension for every worker. In addition, the state provided enormous subsidies covering almost all basic needs (e.g., food, medicine, and housing), as well as a system of day care, kindergartens, and after-school centers that were practically free of charge. The nonstate provision of welfare services was not permitted.

[1] Rather than defining the welfare sector as a concept, I will list its main components: a pension system; health care; provision for children, the sick, and the aged outside the home; and various state allowances. There are also borderline activities and institutions that some might include, such as public education, subsidies on basic goods and services, or public housing.

The public had ambivalent feelings about the welfare sector. They took the state's extreme paternalism and their consequent material security for granted, while being critical of the generally low levels at which those services were provided. While the promise of universal entitlements aroused great expectations among the public, the actual standards for their provision embittered many, who felt that the communist state had failed to keep its promises.

As a result of the dramatic changes of 1989-1991, the post-communist countries experienced the deepest economic crises in their history. Production fell dramatically, along with household income and consumption. The purchasing power of what were already very modest monetary transfers (e.g., pensions, allowances) and the standards for services in kind (e.g., health care) deteriorated drastically. Broad segments of the population in many countries sank below the poverty line of minimum subsistence. Many post-communist economies, already suffering from serious fiscal deficits, plunged into, or were poised on the brink of, fiscal crisis. This rendered them incapable of ensuring even the minimal fulfillment of the state's previous universal commitments.

The debate about reforming the welfare state is taking place in the midst of these unpropitious circumstances. The public's sense of security, hitherto unquestioned, has been deeply shaken. Full employment and labor shortages have abruptly given way to mass, persistent unemployment. Table 10-1 shows the increase in poverty in the post-communist countries, while Table 10-2 shows changes in some key demographic and health characteristics between 1989 and 1994. Most people had expected that the pledges the communist regimes had enshrined in law, and had in fact kept, albeit at a disappointingly low level, would be redeemed by the new, democratic regimes at a higher level. The gulf between the state's commitments (and popular expectations) concerning entitlements and the extent of their fulfillment remains a source of persistent tension.

Throughout the post-communist region, welfare is the sector that has experienced the smallest degree of transformation. While the role of the state in other social and economic spheres has been narrowed or transformed considerably, in the welfare sector it remains almost as bloated as before, leaving insufficient scope for private enterprise or for freedom of choice. All the well-known features of the command economy remain: hypercentralization, rationing, and excessive bureaucratization. The chronic shortage economy that prevails in post-communist states also displays the usual symptoms: forced substitution, queuing, delays, and the resort to personal connections and corruption to side-step bureaucratic bottlenecks. At the same time, the bureaucracy that runs the state and semistate corporatist welfare sector, fearing erosion of its power, resists all reforms that point toward decentralization, competition, and the market.

TABLE 10-1 Increase in Poverty, Post-Communist Countries

| Country | Poverty Headcount (in percent) 1987-88 | Poverty Headcount (in percent) 1993-95 | Total Number of Poor (in millions) 1987-88 | Total Number of Poor (in millions) 1993-95 | 1993-1995 Data: Shortfall as Percentage of the Poverty Line[a] | 1993-1995 Data: Total Poverty Deficit as Percentage of GDP | 1993-1995 Data: Elasticity[a] | 1993-1995 Data: Type and Year of Data[b] |
|---|---|---|---|---|---|---|---|---|
| Poland | 6 | 20 | 2.1 | 7.6 | 27 | 1.4 | 0.4 | SA:I/93 |
| Bulgaria | 2[c] | 15 | 0.1 | 1.3 | 26 | 1.1 | 0.3 | A:93 |
| Romania | 6[c] | 59 | 1.3 | 13.5 | 32 | 5.4 | 0.7 | M:3/94 |
| *Balkans and Poland* | 5 | 32 | 3.6 | 22.4 | | | | |
| Hungary | <1 | 4 | 0.1 | 0.4 | 25 | 0.2 | 0.2 | A:93 |
| Czech Republic | 0 | <1 | 0 | 0.1 | 23 | 0.01 | 0.01 | M:1/93 |
| Slovakia | 0 | <1 | 0 | 0.0 | 20 | 0.01 | 0.01 | A:93 |
| Slovenia | 0 | <1 | 0 | 0.0 | 31 | 0.02 | 0.01 | A:93 |
| *Central Europe* | <1 | 2 | 0.1 | 0.4 | 25 | 0.01 | 0.01 | |
| Lithuania | 1 | 30 | 0.04 | 1.1 | 34 | 2.9 | 0.5 | A:94 |
| Latvia | 1 | 22 | 0.03 | 0.6 | 28 | 2.3 | 0.6 | Q4:95 |
| Estonia | 1 | 37 | 0.02 | 0.6 | 37 | 4.2 | 0.7 | Q3:95 |
| *Baltics* | 1 | 29 | 0.1 | 2.3 | 33 | 3.1 | 0.6 | |
| Russia | 2 | 50 | 2.2 | 74.2 | 40 | 4.2 | 0.6 | Q2-3:93 |
| Ukraine | 2 | 63 | 1.0 | 32.7 | 47 | 6.9 | 0.5 | M:6/95 |
| Belarus | 1 | 22 | 0.1 | 2.3 | 26 | 1.2 | 0.5 | Q1:95 |
| Moldova | 4 | 66 | 0.2 | 2.9 | 43 | 7.0 | 0.6 | A:93 |

| | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| *Slavic and Moldova* | 2 | 52 | 3.5 | 112.1 | 39 | 4.8 | 0.5 | |
| *Total Without Central Asia* | 3 | 43 | 7.2 | 137.2 | 31 | 3.1 | | |
| Kazakhstan | 5 | 65 | 0.8 | 11.0 | 39 | 9.2 | 0.7 | A:93 |
| Uzbekistan | 24 | 63 | 4.8 | 13.3 | 39 | 12.4 | 0.6 | A:93 |
| Kyrgyz Republic | 12 | 88 | 0.5 | 4.0 | 68 | 64.4 | 0.2 | Q3:93 |
| Turkmenistan | 12 | 61 | 0.4 | 2.4 | 40 | 7.7 | 0.6 | A:93 |
| *Central Asia* | 15 | 66 | 6.5 | 30.7 | 47 | 9.8 | 0.5 | |
| *Total Transition* | 4 | 45 | 13.6 | 168.0 | 35 | 3.5 | | |
| *Comparators*[c,d] | | | | | | | | |
| UK | 1 | <1 | 0.6 | 0.5 | | | | A:88,92 |
| Turkey | 31 | | 16.7 | | 33 | 3.8 | 0.5 | A:87 |
| Malaysia | 15 | | 2.5 | | 24 | 1.1 | | A:87 |
| Colombia | | 35 | | 11.6 | 40 | 5.4 | 0.3 | A:92 |
| Brazil | 33 | | 48.3 | | 44 | 4.4 | 0.3 | A:89 |
| Ecuador | | 35 | | 3.9 | 31 | 4.4 | 0.5 | A:94 |

[a]The poverty line used here is uniformly US$4.00 PPP (PPP = purchasing power parity; i.e., consumer prices are adjusted according to purchasing power). For some countries this is lower, and for others higher, than the poverty line used within the country. “Shortfall” refers to the difference between the average income of people below the poverty line and the poverty line.

[b]A = annual data; SA = semiannual data; M = monthly data; Q = quarterly data. 1/93 means, for example, that the data refer to January 1993; I/93 means that the data refer to the first half of 1993.

[c]1989.

[d]The poverty line used here is also US$4.00 PPP per day.

SOURCE: Milanovic (1997:75-76). Reprinted with permission.

TABLE 10-2 Selected Demographic and Health Characteristics, Post-Communist Countries

| Country and Year | Crude Death Rate (deaths per 1,000 persons) | Infant Mortality Rate (deaths in the first year per 1,000 births) | Life Expectancy |
|---|---|---|---|
| **1989** | | | |
| Albania | 5.4 | 30.9 | 72.1 |
| Bulgaria | 11.9 | 14.4 | 71.3 |
| Croatia | 11.3 | 11.7 | 72.2 |
| Czech Republic | 12.3 | 10.0 | 71.8 |
| FYR Macedonia | 6.9 | 36.7 | — |
| Hungary | 13.7 | 15.7 | 69.6 |
| Lithuania | 10.3 | 10.7 | 68.7 |
| Poland | 10.0 | 16.0 | 71.1 |
| Romania | 10.7 | 26.9 | 69.6 |
| Russia | 10.7 | 18.1 | 69.6 |
| Slovakia | 10.2 | 13.5 | 71.1 |
| Slovenia | 9.3 | 8.1 | 72.8 |
| Turkmenistan | 7.7 | 54.7 | 65.1 |
| Ukraine | 11.7 | 13.0 | 70.9 |
| **1994** | | | |
| Albania | 5.25[a] | 35.7 | 73.7[a] |
| Bulgaria | 13.2 | 16.3 | 70.9 |
| Croatia | 10.4 | 10.2 | 73.1 |
| Czech Republic[a] | 11.4 | 8.5 | 72.9 |
| FYR Macedonia | 8.1 | 27.3[a] | — |
| Hungary | 14.3 | 11.6 | 69.4 |
| Lithuania | 12.5 | 16.5 | 68.7 |
| Poland | 10.2[a] | 13.3[a] | 71.7[a] |
| Romania | 11.7 | 23.9 | 69.5[a] |
| Russia | 15.6 | 18.6 | 64.1 |
| Slovakia | 9.6 | 11.2 | — |
| Slovenia | 9.7 | 6.5 | 74.1 |
| Turkmenistan | 7.9 | 42.9 | 63.9 |
| Ukraine | 14.7 | 14.3 | 68.4 |
| Central and Eastern Europe average[a] | 11.4 | 14.4 | 71.1 |
| Former Soviet Union average[a] | 13.1 | 23.5 | 66.1 |
| European Union average[a] | 10.1 | 6.79 | 76.9 |

[a]The data are for 1993.
SOURCE: Goldstein et al. (1996:10).

Where can the post-communist states look for a model of an efficient welfare state? Every welfare state—without exception, in the most developed and moderate-income countries alike—operates dysfunctionally and faces current or potential crises. The post-communist countries will therefore have to undertake for themselves the design of the kind of welfare sector they need.

We must recognize that the debate on welfare reform in the post-communist states is in a shambles. It is taking place on various planes: among politicians, within and between political parties, between finance ministries and the ministries responsible for managing the welfare sector, among opposing pressure groups, and among various schools of thought in the academic world. Reforms too often reflect compromises between diametrically opposed principles, or embody no guiding principle whatsoever.

This chapter seeks to contribute to the debate by clarifying the principles on which the reform of the welfare sector should rest. In so doing it explicitly adopts a normative approach to the problem. A rigorous, axiomatic discussion is not undertaken here. Although such a discussion would reveal that the principles presented in the chapter are logically interrelated and form a coherent theoretical structure, the present argument is developed at a lower level of abstraction. Nevertheless, it offers an intellectual and ethical compass and should help transfer the debate to matters of principle. The discussion begins by setting forth some ethical postulates that form an essential basis for the reform effort. It then presents a number of desirable attributes for the new welfare institutions and coordinating mechanisms. This is followed by a discussion of the desirable proportions of welfare allocation. The final section provides concluding remarks.

## ETHICAL POSTULATES

Although I am an economist, I do not base my argument here on economic principles, or advocate reform because the welfare sector is too costly or cannot be financed over the long run. Rather, this study embodies a set of ethical principles. It is addressed to "the reformer," be that a politician, government official, expert adviser, union official, or academic. Each principle should be understood as a *memento*—something to keep in mind when proposing a reform. These principles also represent a *credo*—the set of values I espouse and that underlie the proposals developed here. Economic principles are considered later, but they are not treated here as the foundation for reform. This discussion attempts to provide "minimalist" solutions, in other words, to stipulate only the minimum requirements—that which is necessary and sufficient as an ethical starting point for welfare reform. The institutional attributes and allocative proportions presented in later sections should flow from these moral imperatives.

*Principle 1—The sovereignty of the individual: Reforms should maximize the sphere within which individuals make decisions. The state's sphere should be correspondingly curtailed*.

The main problem with the welfare system inherited from the communist regime is that it leaves too wide a sphere of action, and a corresponding range of resources, in the hands of the government, the political process, and the bureaucracy, rather than with the individual. This infringes on such fundamental human rights as individual sovereignty, self-realization, and self-determination.[2] When government spending on welfare decreases, along with the taxes that finance it, citizens are not having their rights infringed upon; rather, they are regaining rights of individual determination and disposal.

Principle 1 not only ensures the individual's right to make his/her own decisions, but also requires that individuals be *responsible* for their own lives. They must give up the habit of having the paternalist state think for them, and must be assisted by reformers in this "detoxification." Implementing this principle gives citizens broader rights to choose, but they must recognize that they will also be responsible for their choices and bear the consequences. The workshop for which this study was originally commissioned was held in the United States, where this is considered a trivial requirement, ingrained in all citizens. However, for generations that came to maturity under the communist system, a different principle was instilled: that the ruling party-state was responsible for everything, and that individuals should accept its decisions, trusting that they were in capable hands. Since the state provided for any unforeseen eventualities (e.g., illness, disability, death of the breadwinner), there was no need to prepare for the uncertainties of tomorrow.[3] The reform of the welfare state must be based on the development of a new ethos that emphasizes the sovereignty and responsibility of the individual.

No society can function without some amount of government coercion, but it follows from Principle 1 that this should be reduced to a minimum, while individual, voluntary action should be expanded wherever possible. Whereas paternalism attempts to force people to be happy, people should be allowed to prosper or fail on their own.

*Principle 2—Solidarity: Help should be provided to the suffering, the troubled, and the disadvantaged*.

[2]Numerous authors have dealt with related issues in terms of individual freedom. Isaiah Berlin's (1969) seminal work is especially important for its distinction between positive and negative liberty. Berlin argues that the individual's negative freedom is threatened by a hyperactive, paternalist state. He calls on society to protect and reinforce individuals' negative freedom, while concurrently enhancing their positive freedom. Amartya Sen (1990, 1996) similarly considers the preservation of individual freedom to be a fundamental obligation for society.

[3]At the author's initiative, a recent Hungarian study (Csontos et al., 1996) asked: "How are you preparing for your old age?" The reply of 51 percent of the respondents was that they had not thought about it yet.

Many religions, including the Judeo-Christian and Buddhist ethics, call for compassionate solidarity, as do many labor movements and people on the left of the political spectrum. These sentiments also arise out of ordinary human goodwill, a sense of fraternity and community, and an innate altruism, without necessarily being based on any specific world view or intellectual tradition.

The solidarity principle suggests that apart from individual and collective charitable work, communities should help the suffering, troubled, and disadvantaged through a system of state redistribution. We need not explore here the criteria for receiving state assistance. Suffice it to say that the set of those in need of aid will be much narrower than the community as a whole (see Andorka et al., 1994; Atkinson and Micklewright, 1992; Milanovic, 1997; Sipos, 1994).

Implementation of the solidarity principle requires only *targeted* state assistance, not universal entitlements. This means benefits need not be awarded as a citizen's right to both the rich and the poor, the needy and the self-sufficient. Principle 2 neither requires nor excludes universal state commitments. Universal entitlements do not conflict with moral imperatives, but with economic realities. More will be said about this later, under Principles 8 and 9.

Principle 2 conflicts with political rhetoric that seeks to turn the middle class into the main beneficiary of tax policy and redistribution. The middle class, by definition, is not the social stratum in the greatest need of assistance. Under the communist system, much of the state's redistributive largesse went to the middle class, as it does in many parts of the world. Principle 2 calls for assistance only to those who are truly in need.

Principle 2 also requires that every member of a community be able to satisfy his or her basic needs. This does not imply that the state must provide for these needs, either gratis or in the form of preferential benefits for everyone. The principle of solidarity applies only to those who are incapable of supplying their basic needs through their own efforts.

In the light of Principle 2, it is worth considering the issue of uncertainty. Although one may not be dependent on others at present, one may become so in the future. According to Principle 1, the individual must prepare for such contingencies by saving and building up reserves or by purchasing a private insurance policy. Individuals should be entitled to state assistance on a solidarity basis only if they encounter problems for which they could not reasonably have been expected to prepare.

Principle 2 includes solidarity between generations, which requires an equitable intergenerational distribution of life's burdens (see also Ferge, in this volume). The present generation must show solidarity with future generations; there is no moral law that justifies making life easier today by encumbering future generations with grave debts. To do so creates an economic time-bomb that may explode in the future. An example is pension debt, which is likely to reach unsustainable levels in many countries (see Fox, in this volume). Hungary's 1994 pension debt, for instance, was equivalent to 263 percent of its gross domestic product (World Bank, 1995a:36, 1995b:127).

Principle 2 also requires that every citizen be given an opportunity for self-fulfillment. This is one argument (along with substantial external utility) underpinning state support for public education. In this connection, solidarity can justify "affirmative action," i.e., assistance that compensates the disadvantaged in order to ensure equal opportunity. It cannot, however, be used to justify any kind of crude, artificial attempt to level the great differences that exist among people.

Principle 2 must be applied in conjunction with Principle 1. Most people find "alms" demeaning. The needy must be helped primarily by being given a chance to work and undertake useful activity. The degree to which claimants are capable of helping themselves and adapting to their situation must be considered when the degree and type of help are determined.

Principles 1 and 2 must also be taken into account with respect to compulsory insurance. All citizens should be legally obliged to purchase minimum levels of pension and health insurance. Such policies could be held by decentralized insurance institutions. Although this obligation restricts the application of Principle 1 (voluntary action is preempted by a legal requirement), it should not be seen as paternalism or an attempt to impose happiness. The motive here is collective self-interest, not altruism. Humane societies will feel compelled to care for the sick who are bereft of treatment or the penniless elderly, and they will do so at the taxpayers' expense. To avoid this undesirable external effect, the law must oblige all citizens to obtain at least minimal levels of insurance coverage (Lindbeck and Weibull, 1987). Principle 2 should be brought into play only on behalf of those who are unable to afford even minimal insurance.

The differences between this proposal and the schemes presently in operation in the post-communist world are obvious. The former requires citizens to maintain minimum levels of insurance (with the possibility of adding supplementary insurance voluntarily) and targets state assistance to the needy, while the latter promises universal entitlements, with resources channeled through paternalist state redistributive institutions.

One further comment seems appropriate. This study does not embody a discussion of the ultimate values of freedom, equality, well-being, or social justice, or of the relationship between those ultimate values and particular social institutions. These are the concerns of political theory and deal with the ethical foundations of the "good" society.[4] The discussion here does not

[4]We can single out a few, especially influential works from the vast literature on the subject: Berlin (1969), Buchanan (1986), Nozick (1974), Rawls (1971), and Sen (1973, 1992). For a broad survey on the debate about the philosophical ramifications of the modern welfare state, see Culpitt (1992). Although Culpitt favors the preservation of the status quo, the survey presents a balanced exposition of the main arguments pro and con.

attempt to contribute to the analysis of these more profound issues. Principles 1 and 2 deal with what might be termed "intermediate" ethical requirements, not ultimate values. These requirements can provide a broad base that is acceptable to people with widely differing views on the nature of freedom, equality, and social justice. Still, Principle 1 will be alien, and Principle 2 may be superfluous, to those whose axiomatic point of departure is collectivist, i.e., those who would subordinate the rights of the individual to the interests of a specific community or ideology, be that a nation, race, class, or religion.

A 1992 survey conducted under the aegis of Richard Rose's "New Democracies" project (Rose and Haerpfer, 1993) yielded findings that shed light on the issue of individualism versus collectivism. On the basis of replies to four questions, analysts ranked respondents' viewpoints as approximating individualist or collectivist views of the world. The results are shown in Figure 10-1. In every country, with the exception of Bulgaria and Poland, more people were inclined to take an individualist rather than a collectivist approach, and in three countries, fully two-thirds of the population favored individualist ideas. The proportion of ambivalent positions is also significant. Although there are some differences between the definitions used in that survey and those used here, it is remarkable that ideas of individual sovereignty and responsibility play such an important role in the value systems of considerable segments of the population throughout the post-communist region.

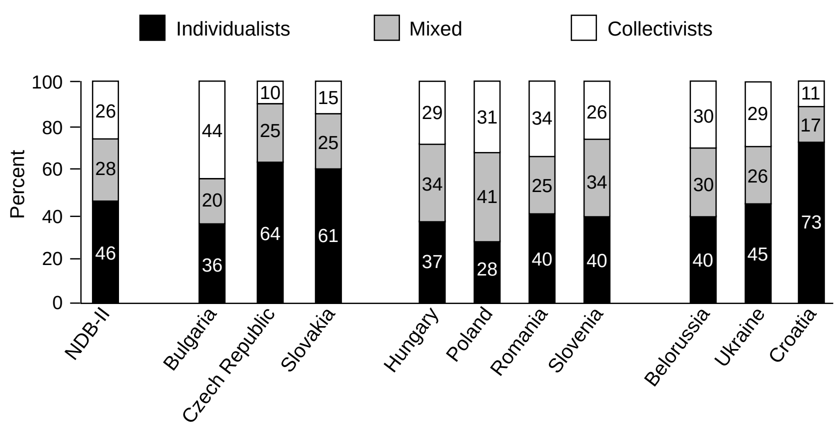


FIGURE 10-1 Individualist versus collectivist world views. NOTE: The respondents had to choose between an "individualist" and a "collectivist" alternative concerning four issues. The responses were coded as follows: individualists, three or four individualist preferences; mixed, two individualist and two collectivist preferences; collectivist, three or four collectivist preferences. SOURCE: Rose and Haerpfer (1993:71). Reprinted with permission.

## DESIRABLE ATTRIBUTES OF INSTITUTIONS AND COORDINATION MECHANISMS

Let us now turn to another plane of reform. The process of reform eliminates or alters old institutions and coordination mechanisms—the rules of the game—and establishes new ones. Principles 3 to 7 concern key attributes of these institutions and coordination mechanisms.

*Principle 3—Competition: There must be competition among different ownership forms and coordination mechanisms. The almost total monopoly of state ownership and control must cease.*

Principle 3 does not prescribe quantitative proportions between state and nonstate institutions. However, the nonstate sector must attain a critical mass before it can overcome the enervating effect of the state's dominance, which enables the producer (the welfare state) to dictate to the consumer. Although considerations of efficiency argue in favor of competition (see Principle 4), the main source from which Principle 3 is derived is Principle 1. There must be competition in order for citizens to be able to make choices. If they do not like what they receive from the state, they can go elsewhere.

The survival of the previous system in the welfare sector leaves citizens defenseless in a number of important areas, even though decisions originate with more diffuse "state authorities" rather than the politburo. Decisions as to which resources will go to medical care or what income the elderly will receive depend on the squabbling of political parties, which subordinate policy positions to their rivalry for popularity, and the relative strength of different lobbies and groups of bureaucrats, which reach compromises behind the scenes. Principle 3 seeks to place a much larger proportion of decisions on these matters in the hands of the persons directly concerned. At least for a sizable portion of these expenditures, people should decide individually what they want to spend on their health and that of their families and how they want to prepare for their old age. Such choices will become available when at least a fraction of total welfare resources ceases to be subject to state allocation, and households and individuals are able to decide on their use through market mechanisms.

Principle 3 seeks to open up all aspects of the welfare sector to private for-profit and nonprofit enterprise. It would be useful for private hospitals, clinics, laboratories, kindergartens, and retirement homes to emerge on a broad scale, through either the founding of new organizations or the privatization of those currently in the hands of the state. Commercial insurance companies and nonprofit organizations should be encouraged to expand into pension plans and medical insurance as well. The function of applying Principle 2 (solidarity) could be shared among the state, nonprofit organizations, and the for-profit segment of the welfare sector.

TABLE 10-3 The Real Value of Pensions in the Czech Republic and Hungary (as percentage of 1990 value)

| Country | 1991 | 1992 | 1993 | 1994 | 1995 |
|---|---|---|---|---|---|
| Czech Republic | 82.9 | 81.2 | 76.9 | 77.5 | 82.2 |
| Hungary | 92.4 | 87.8 | 84.6 | 86.5 | 77.4 |

SOURCE: For Czech Republic, Klimentová (1996:Chart 3); for Hungary, *Figyelõ*, July 11, 1996.

Those who insist on the complete nationalization of the welfare sector argue that the public demands security and that only the state can provide it. Yet both sophisticated analyses of uncertainty and common sense suggest a simple rule: do not put all your eggs in one basket. In investment-portfolio terms, people should diversify. Just as it would be a mistake to entrust all of one's retirement savings to a single pension fund, total reliance on the state can render an individual vulnerable. By the time a person retires, the political authorities may have revised the rules for compensation, effectively expropriating part or all of an individual's contributions.[5] Alternatively, pensions may be eroded by policy-induced inflation and by indexation rules that whittle away their real value (see Table 10-3). Thus, the most expedient proposals for pension reform are those that rest on several pillars, allowing different pension schemes to be used concurrently (see Fox, in this volume). Similar "multi-pillar" solutions will be needed to fund the health service and other elements of the welfare sector.

Principle 1 suggests that citizens should not be forced into any particular scheme; to the extent possible, they should be able to choose for themselves. A "menu" of various forms of ownership and mechanisms of control and coordination should be developed from which citizens can choose. They should be able to learn from their own and others' experience, to experiment, and to modify their points of view. This is one more reason why competition is needed in the welfare sector. In the presence of competition, selection can be made not only through the friction-ridden political process, but also directly, through the market choices of households and individuals.

*Principle 4—Incentives for efficiency: There must be incentives for forms of ownership and control that encourage efficiency.*

This principle is so self-evident that it scarcely need be argued. The only reason for including it among our declared principles is that it tends to be

[5]This applies in most post-communist countries today. The "pay-as-you-go" system and the repeated changes in pension rules, coupled with tendencies to level out pensions, have left only a very loose correlation between anticipated pension levels and pension contributions.

forgotten by politicians and academics who defend the status quo in the welfare sector.

Incentives for efficiency (and this is a substantial departure from previous practice) must be provided on the demand side as well, to the recipients of welfare services. This means that with only the rarest possible exceptions, services should not be free. Rather than state subsidies forcing prices down below market levels, state assistance should be targeted (by vouchers, for example) to those for whom it is justified (normally this would mean those in need, in line with the principle of solidarity). Even if the state or the insurer covers most of the cost, recipients should contribute a copayment so that they recognize the service is not free.

Proper incentives on the demand side include inducing efficiency among the insurers that will largely finance welfare services. This is one of several arguments against awarding monopolies to the monstrous "great wens" of central state health insurance and pension authorities. Without competition, there cannot be sufficient incentives for efficiency and thrift.

The same argument applies on the supply side, to the organizations that provide welfare services. Just as the sovereignty of the individual argues for competition, no one should be left at the mercy of a single monopolistic organization. Competition can be useful in other ways, too, by encouraging improvements in quality, the development of new technology, the discovery and introduction of new scientific advances, and the reduction of costs.[6]

Another aspect of incentives and efficiency is the most expedient form in which to accumulate and utilize "welfare reserves." Two pure cases can be distinguished. The first applied most consistently under the communist system, where all welfare services were provided on a nationalized, "pay-as-you-go" principle. Households were not expected to save for security purposes; instead they were forced to pay the taxes that financed both welfare services and investment. Total centralization led to low efficiency, both in the sphere of welfare provision and in the selection and implementation of investment projects.

The opposite case is one in which the accumulation of reserves is left entirely to households and individuals. Each decision-making unit places its reserves in a portfolio with several different components, allocating some to bank deposits or mutual funds and paying premiums to insurance companies and pension funds. The financial sector, i.e., the credit and capital markets, in turn uses this huge stock of savings to finance investment in a decentralized fashion.

[6]I realize that both for-profit and nonprofit insurers and providers may try to cut costs at the expense of recipients (the sick, or the child or old person requiring the provision). However, the same may occur with state ownership and control as well, unless money is superabundant in the state sector. Unlimited expansion of costs versus savings at the expense of those receiving the services are the horns of one of the welfare sector's gravest dilemmas. I do not feel competent to respond reassuringly to the questions this raises, and any attempt to do so would require a separate study.

These two cases demonstrate the extremes of perfectly centralized and perfectly decentralized capital allocation mechanisms. While the decentralized mechanism has many advantages, we can reasonably suppose that some public investment will still need to be financed out of taxation (e.g., for infrastructure investments or other public goods). One conclusion, however, has clearly emerged from the great historic contest between the communist and capitalist systems: a system in which decentralized investment based on private ownership and competition predominates is more efficient than one in which centralization and state ownership prevail.

The pool of savings for illness, unemployment, accident, or old age will form such a vast proportion of total savings that it should not be handed over to a state bureaucracy. The bulk of these savings should be employed in a decentralized way. Following this line of argument to its logical conclusion, Principle 4, increasing incentives for efficiency, provides a further weighty argument in favor of Principle 3, the expansion of competition and nonstate institutions.

*Principle 5—A new role for the state: The main functions of the state in the welfare sector must be to supply a legal framework, to supervise nonstate institutions, and to provide "ultimate" or last-resort insurance and aid. The state must also be responsible for ensuring that every citizen has access to basic education and health care.*

To argue about whether the state should have a large or a small role, or whether it should remain in or withdraw from the welfare sector, is to engage in a sterile debate. The essential requirement is that the state must be radically transformed. Let us briefly review the functions of a reformed state in the welfare sector:

- The state should establish the legal framework within which institutions in the welfare sector will operate. Citizens must be able to seek redress from the courts when their rights are infringed by the state, insurers, hospitals, or other service providers.
- The state should create supervisory bodies for monitoring the operation of institutions in the welfare sector. It should establish minimum standards for service providers, while claimants' and users' associations, the press, and civil society as a whole should play the role of watchdogs.
- The state should guarantee the security of savings that citizens entrust to insurance institutions or pension funds.[7]

[7]Nonstate or quasistate reinsurance institutions can be established to protect citizens' insurance investments against the failure of a particular insurer. It would suffice for the state to provide a guarantee of last resort, should the reinsurer be unable to cover the loss. The function of "ultimate insurer" will still impose a fiscal burden, but one that is much reduced.

• The state must ensure every citizen's access to basic education and health care. Declaring this to be a state responsibility still leaves open the question of how it is to be fulfilled and through what kind of institutions. It neither requires nor precludes the possibility that institutions owned or controlled by the state will take part in providing or financing these services.

• Nonstate organizations should have a role in applying the principle of solidarity. Nonetheless, there is no way the state can avoid making a substantial contribution. This should not be hidden as state assistance to those in need or subsumed under other public expenditures so the voters do not notice.[8] It needs to be stated openly.

It should be clear from what has been said that this study does not advance a purely laissez faire program. It does not seek to relieve the state of all responsibility for the welfare sector. Even if most tasks are to be performed by private (for-profit or nonprofit) enterprises, and these organizations are to be coordinated mainly by market mechanisms and spurred on by competition, this must take place under rules written by the state and under the state's (and civil society's) supervision. The state must also contribute economic resources when there is an inescapable need for it to do so. Various instances of "market failure" have been sufficiently clarified by economists. The state is justified in intervening in cases where the market has failed, provided there is no reason to fear that state activity will cause even greater failure (see Buchanan and Tullock, 1962; Niskanen, 1971; Tullock, 1965).

However, in many cases it is difficult to gauge the relative prospects for these two kinds of failure. That is one reason this study leaves open the question of how large the segment of the welfare sector that is under either state ownership or direct state control should be. If the public, through the political process, expresses the wish that part of the financial provision for old age remain within the state pension system or that certain hospitals remain in state hands, and if they are willing to pay the necessary taxes, their wishes should be respected. The latter proviso (willingness to pay the associated tax burden) leads us to the next principle.

*Principle 6—Transparency: The relation between the state's provision of welfare services and the tax burden that finances it must be made manifest to citizens. Practical reform measures must be preceded by open and informed public debate. Politicians and political parties must openly declare what their welfare-sector policies are and how they will be financed.*

[8]Most people recognize a sense of solidarity with their communities. The Hungarian poll mentioned earlier (Csontos et al., 1996) found that many childless respondents were willing to pay taxes for higher education.

This principle has three parts. The first calls attention to the fact that many citizens do not recognize that the costs of the services provided by the welfare state are borne by them, as taxpayers. Understanding of the relationship between taxes and state spending is vague or distorted all over the world, but this fiscal illusion is nowhere as pronounced as it is in post-communist societies, where people have been indoctrinated for decades with the idea that health care or education is "free."[9] Once citizens recognize that the taxpayer pays for every state service and are informed of the extent of the costs, resistance to decentralizing reforms will decrease substantially. Citizens must learn that the political process gives them a choice as to the method of payment, both for the welfare sector as a whole and for its individual components (pensions, health care, child care, and other social benefits). They can pay either through taxes (payments to the state, which then allocates money for welfare services in the budget) or through direct purchases (e.g., pay for service or insurance premiums paid by the household to the insurer who pays for the welfare service).

There is also considerable debate about the manner in which democratically elected parliaments and governments should consult public opinion in advance of introducing reforms—especially the opinion of groups directly affected by those measures. The answer will depend on several factors, one of which is whether the situation requires urgent action. Reform of the welfare sector will not be accomplished by a single, sweeping reform. It is not designed to avert economic catastrophe or respond to an acute crisis. It entails reshaping the nature of the society and the relations between individuals and the state, and it will take place over a long period of time. That is why the second part of Principle 6 calls for public debate on these weighty reform proposals and with broad dissemination of the requisite information.

This leads to the third part of Principle 6, the requirement for transparency in political debate. Political parties rarely put their ideas on welfare reform squarely before the voters, either because they have not thought their proposals through sufficiently or because they prefer to conceal their intentions. This study, in line with its normative character, does not investigate why this is so; rather it advances an ethical requirement that is addressed to the better side of every politician. It demands honesty with the voters, telling them frankly what one intends to do about pensions, health care, and other welfare services. It is also addressed to others, particularly academics researching this subject. We have no interest in gaining popularity; we are not running for elected office. We have a duty to discover and demonstrate the benefits and social costs of alternative welfare-sector proposals. Finally, this principle is addressed to

[9]The Csontos et al. (1996) survey referred to above revealed that only one-fifth of the respondents could estimate within a ±25 percent margin of error the tax burden imposed by ostensibly free state health care.

citizens. It calls upon them to discern, from the statements of politicians and the programs of political parties, their real intentions with respect to welfare reform, and to bear these in mind when voting.

It is worth acknowledging that it is frequently difficult to apprehend accurately a party's or a candidate's intentions, and that it is also difficult to decide how to vote. In casting their votes, citizens must choose between "packages" of policies. A voter may choose to vote for candidate A rather than B, even though B's welfare policies are more attractive, because he or she prefers A's economic, judicial, foreign, or other policies. Suffice it to say that it would exceed the scope of this study to discuss how far this problem might be resolved by a system of referenda on important legislation. With few exceptions, democratic constitutions permit referenda only in special circumstances.

These difficulties provide additional arguments for Principles 1, 3, and 5. There must be a reduction in the set of welfare services under the state's direct control so that these matters are less subject to the vagaries of the political process.

*Principle 7—Time: There must be sufficient time for the new institutions of the welfare sector to evolve and for citizens to adapt.*

The reformed welfare sector will contain institutions that were unknown under the communist system. Some will be entirely new, such as newly established private clinics, hospitals, and nonstate pension funds. Others will develop out of formerly state-owned organizations; for example, a team of doctors might open a surgery in a public hospital under a rental contract. In my view, the advocates of reform cannot leave these developments entirely to spontaneous processes, for many reasons. The creation of new institutions and the transformation of old ones requires the careful design of new rules, which must be enacted by legislation or as the by-laws of organizations. Some new organizations will emerge at the initiative of governmental agencies, while in other cases political pressure will be needed to set the process of change in motion. One might add that by definition, a change in the role of the welfare state can occur only with the state's involvement. In sum, while many components of the evolutionary process of institutional transformation will happen spontaneously, this study does not advocate a reform pattern that relies exclusively on spontaneous changes (Davis and North, 1971; North, 1990).

Neither does this study advocate forcing through the fastest possible reform of the welfare state at any price. There are situations of crisis in which a government is compelled to enforce a painful and unpopular economic adjustment program. Such a program may have to include measures that cause a rapid fall in state welfare spending. That is one thing, and comprehensive reform of the welfare sector is another. Comprehensive reform is not fiscal fire fighting, but a radical social transformation that must not be conducted at breakneck speed. Sufficient time must be allowed for programs to be carefully drafted and political support to be mobilized.

The issue of political support was mentioned under Principle 6. The more thoroughly the public understands both the social costs and the likely benefits of reform, the readier it will be to support the reform. If at all possible, time must be allowed for citizens to adapt to the new situation. The problem of differing degrees of adaptability was mentioned under Principle 2. Reformers must display calm insight and compassionate understanding of the fact that people have different powers of adjustment. To illustrate this, let us consider the example of transforming the pension system.

The younger generation can justifiably be called upon to accept radical changes. Their whole active working life lies before them. Let them, and their employers, pay the sums needed for retirement into individual accounts and entrust these to pension funds that will put them to good use. In due course, they will receive pensions that represent the fruits of their own efforts and savings. In line with Principle 1, there should be a close connection among earnings, propensity to save, and retirement income, spanning the whole life cycle.[10]

The same cannot be said to those who are already receiving pensions. In their case, the state must fulfill the obligations undertaken by previous governments (see Kornai, 1996). They are no longer capable of adapting to a new pension system. Apart from the fact that the state is legally required to meet these obligations, Principle 2, the principle of solidarity, dictates that society must continue to maintain the "pay-as-you-go" system, whereby the active members of the labor force pay taxes that finance state pensions.

As for the intermediate generations, I would propose that they be given a choice. They could leave their accrued pension entitlement with the state, or, if they so chose, could transfer it (after the deduction of reasonable conversion costs) to an individual account with a nonstate pension fund.

Returning to the more general plane of discussion, to the extent allowed by the state of the economy, the sufferings caused by the introduction of these changes should be mitigated, and the process of adaptation encouraged, through assistance to those who suffer severe losses as a result of reform. Long-term assistance should be given, however, only to those who are really unable to adapt. For everyone else, assistance should be granted only for a temporary period. Individuals should have a grace period, but they must recognize that they will have to adapt to the new situation once that period is over.

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[10]As explained in the discussion of Principles 3 and 5, I think it would be wrong to reject the possibility of a state "pillar," even for young people, alongside the other "pillars" of pension insurance. If the majority of the population feel this enhances their sense of security and declare their willingness to fund it through taxation, they should have it. Sooner or later, however, it will be expedient to reach the point where state pensions cover only a small part of retirement income.

## DESIRABLE PROPORTIONS OF ALLOCATION

*Principle 8—Harmonious growth: There must be harmonious proportions between the resources devoted to investments that directly promote rapid growth and those spent on the welfare sector.*

Two extreme views are often heard in the welfare debate. One places a one-sided emphasis on the losses entailed in the transition and fails to acknowledge that the best way to overcome present difficulties is by encouraging the long-term growth of the economy. However trivial this may seem to an economist, it is consistently ignored by those who favor maintaining the welfare-state status quo. They dismiss the elementary economic argument that living standards for the majority in the post-communist countries will never attain the present average level in the West until there is sufficient investment to produce lasting and sufficiently rapid growth.

At the other extreme is the view that sacrifices welfare spending in favor of investment projects. Statistical examinations covering several countries show that in the long term, the fastest growth has taken place in the Southeast Asian countries that spend least on welfare provisions. The authors either leave Eastern European readers to draw their own conclusions, or state plainly that if they want to catch up with the West, they should follow the Southeast Asian model.

To me, as a member of the older generation, this emphasis on very rapid growth sounds familiar. One of the watchwords of the Stalinist-Khrushchevite economic policy was, "Let us catch up with the West as soon as possible." This view led to a forced growth strategy and consequent distortions in the economic structure, a key result of which was that people's immediate welfare needs were ignored (Kornai, 1972). This bias created grave problems within the socialist system, the consequences of which have yet to be overcome. It would be a shame to repeat this failed strategy.

A different conclusion is reached if the international comparison is based not on the relation between aggregate welfare spending and *rate* of growth, but on that between aggregate welfare spending and *level* of economic development. As a country develops, state spending on health, education, culture, child care, and the elderly increases. The connection is not deterministic, since it is affected by other factors as well, including the political complexion of the government and cultural traditions. Still, there is a close correlation between overall economic development and government spending on welfare. This correlation is demonstrated in Figure 10-2 and Table 10-4.

Departure from the most desirable proportion between government welfare expenditure and level of development might occur in two directions: too much or too little spending. As an "overcompensation" for the excesses of

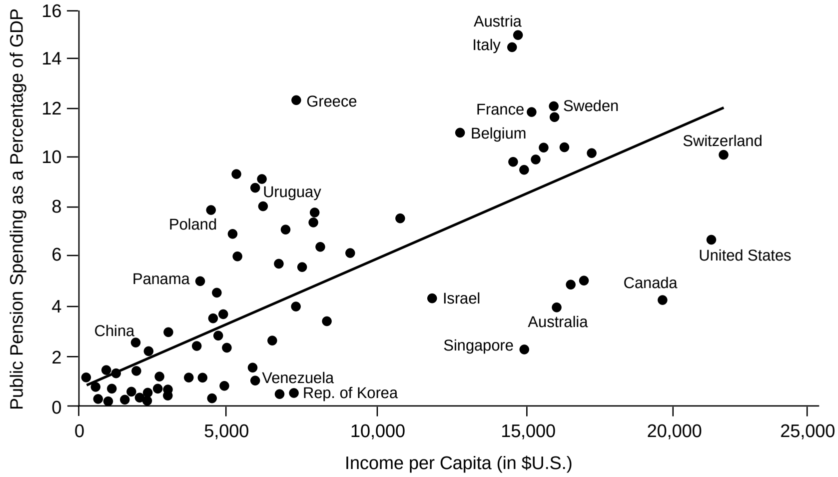


FIGURE 10-2 Relation between income per capita and public pension spending. NOTE: The sample comprises 92 countries for various years between 1986 and 1992; because of space limitations, not all data points are identified. SOURCE: World Bank (1994:42). Reprinted with permission.

the Stalinist period, some post-Stalinist countries let welfare spending run rampant. Prompted by the paternalist ideology and a desire to calm the population, the state undertook greater obligations than its resources warranted. Some Eastern European countries, especially Hungary, overreached themselves not only in state obligations, but also in the fulfillment of those obligations. That is why I termed them "premature welfare states" in an earlier study (Kornai, 1992). Hungary went the furthest in this respect (see Table 10-5).

There is a vital need to restore the proper balance by approaching the problem simultaneously from two directions: state commitments and entitlements must be reduced while economic growth is promoted.

For my part, I would not venture to advance a quantitative golden rule that would ensure harmonious proportions. It would be an exciting research task to reconsider this issue in the context of the post-communist transformation. However, although Principle 8 may not supply a method of quantification, it certainly contains a warning against allowing blatant distortions and heeding false political slogans.

Here I must refer back to Principle 1. One reason why more economic choice has to be entrusted to individuals is the well-founded doubt that central planners will make the best decisions. Is it necessary for the state to intervene in defense of health care and educational expenditures? Must households be

TABLE 10-4 Public Pension Spending

| Country | Pension Spending as Percentage of GDP | Pension Spending as Percentage of Government Expenditures |
|---|---|---|
| **Other Than Post-Communist Countries** | | |
| (national averages by income group) | | |
| Low | 0.7 (32) | 3.9 (18) |
| Lower-middle | 2.9 (29) | 10.1 (16) |
| Upper-middle | 6.7 (20) | 23.8 (13) |
| High | 8.2 (23) | 23.1 (20) |
| **Post-Communist Countries** | | |
| Albania | 6.3 | 14.4 |
| Bulgaria | 10.2 | 21.5 |
| Czech Republic | 8.3 | — |
| Slovakia | 9.3 | 18.0 |
| Hungary | 11.6 | 18.3 |
| Poland | 14.7 | 29.2 |
| Romania | 6.4 | 14.9 |
| Russia | 6.0 | — |
| Ukraine | 7.1 | 14.8 |

NOTES: In the first part of the table, the data refer to the period 1985-1992, and figures in parentheses indicate the number of countries for which data are available. The data for post-communist countries refer to 1992. The figure for Russia is an estimate.
SOURCES: For other than post-communist countries, World Bank (1994:103); for post-communist countries, United Nations Children's Fund (1994:96-97).

TABLE 10-5 Composition of Public Social Expenditures in Hungary and in Selected OECD Countries (as percentage of GDP)

| | Hungary 1992 | Germany 1990 | Spain 1989 | Sweden 1991 |
|---|---|---|---|---|
| Pensions | 10.4 | 9.6 | 7.9 | 13.2 |
| Health[a] | 5.3 | 9.1 | 6.5 | 8.8 |
| Family | 3.9 | 1.3 | 0.1 | 1.4 |
| Housing | 2.8 | 0.2 | 0.1 | 0.9 |
| Unemployment | 2.3 | 2.1 | 3.1 | 4.1 |
| Total | 24.7 | 22.3 | 16.3 | 26.4 |

NOTE: Pensions include old age, disability, and survivors. Unemployment includes all active programs and unemployment compensation.
[a]Refers to 1991 and only to public-sector expenditures on health.
SOURCE: Organization for Economic Cooperation and Development (1995:49).

prevented from investing too much on building factories, for instance? I hardly think there is a danger of that. On the contrary, one might expect that, through a myriad of individual decisions aggregated on a national level, society will spend more on health, education, and other welfare activities than central planners would. One sound argument for intervention, however, is the fear that without a certain measure of redistribution, guided by the solidarity criteria of Principle 2, an extremely decentralized decision-making process might fail to provide the lowest, most disadvantaged strata of society with basic welfare benefits.

*Principle 9—Sustainable financing: The state budget must be capable at all times of financing the state's obligations.*

While Principle 8 concerns the desirable allocation of real resources, Principle 9 draws attention to the financial aspect of this issue. However self-evident this requirement may seem, its infringement was what brought an end to the previously "untouchable" status of popular welfare programs in many parts of the world.

Many economies have substantial budget deficits; this is true for the post-communist countries almost without exception. Where a budgetary system clearly earmarks revenues for specific welfare expenditures, the financial deficits incurred by individual components of the welfare sector can be discerned, at least in part. In many countries, however, the funds required to defray welfare services are not separated from those for other expenditures. State welfare expenditures are paid out of general tax revenues, making it difficult to determine the relative role of welfare spending in the overall deficit.

This study does not address the various causes of fiscal deficits at different times and in different countries. Nonetheless, it is worth drawing attention to the fact that the welfare commitments entrenched throughout the developed world are likely to become unsustainable sooner or later, other circumstances being equal, and taking into account the most likely economic growth rates and demographic trends. In particular, state pension systems are threatened everywhere by fiscal crisis. State health services are also imperiled by increasing pressures from the demand side, and it appears that they will eventually become unsustainable as well. The severity of this crisis varies from country to country, with experts predicting that these systems will reach their financing limits at different dates and questioning whether the gap can be bridged by raising taxes.

But raising taxes generates other issues. In economic terms, higher taxes will dampen incentives and impede investment. Politically, the unpopularity of tax increases must be weighed against the unfavorable impact of reduced welfare spending. Ultimately, it appears that in most post-communist countries, the need to improve the fiscal balance will force reductions in state welfare spending.

Although I have left Principles 8 and 9 to the end of this discussion, they are no less cogent than the other principles. We must consider both the social and economic costs and benefits of welfare reform. All too often the academic debate is bifurcated, with the "defenders of the welfare state" describing in dramatic terms the sufferings of the destitute and disadvantaged while dismissing any mention of the requirements of harmonious economic growth. Those are just narrow-minded "fiscal" arguments that no compassionate person would consider. On the other side, one encounters economic arguments in which the need for a "social safety net" is relegated to an aside, and where the authors have failed to consider the social consequences of the rules they propose. Both sides usually refrain from supporting their positions with ethical considerations. It is high time for us to insist on a synthesis of outlook, in ourselves and others. Neither side has the right to espouse social criteria or economic arguments alone.

## CONCLUDING REMARKS

A review of Principles 1 through 9 leaves open several important questions whose discussion would extend beyond the bounds of this study. Further analysis is required to decide the extent to which the various pairs and ensembles of postulates are reconcilable and the extent to which they have trade-off relations. For instance, Principle 1 (individual freedom and responsibility) and Principle 5 (the responsibility of the state) are not irreconcilable, although clearly the further we take one, the less scope remains for the other. No prior theoretical consideration can preclude the need to make a specific, responsible choice in each case. As mentioned in the introduction, the principles presented here are intended to serve as *mementos*, or a checklist, so that none will be forgotten when programs, legislation, and regulations are drafted, evaluated, and enacted. Even when decision makers are obliged to make a concession on some principle, let them do so consciously, wrestling with their conscience and common sense before accepting the compromise. Those who truly espouse the principles proposed here will refrain from an extreme interpretation of any one of them if it conflicts with another.[11]

The choice of subject for this study may elicit the following counter-

[11]According to press reports (including *The New York Times*, October 15, 1996), the homeless were to be deported from Moscow, and some of them forced into accommodations reminiscent of internment camps, outside the capital. If the report is true, this would have put a roof over the heads of the homeless and eased the lives of others in an overcrowded city. On the other hand, this paternalist measure, applied in an especially brutal form, is a grave breach of Principle 1—the sovereignty of the individual and his or her fundamental human rights.

argument. The scope for reform is given in all post-communist countries; it is constrained by economic and political conditions. The latter ultimately determine what kind of reform can be implemented. If reformers really want to fight for their ideas, they will have to make concessions. They may even have to manipulate public opinion. It is not always in their interests to declare clearly and unambiguously what principles they follow, what they intend, and what consequences can be expected.

The fate of reforms is generally known to be decided in the political arena. Among the tasks of academic research, I consider it important to examine the chances of welfare reform from the angle of political economy.[12] I have tried to do this previously, taking a positive political-economy approach to the problem. However, I hope it will prove useful, as a complement to such positive research, to approach the issue from the opposite side as well. The question worth asking is not just how we can and must take the next steps, starting from where we now stand; it is also vitally important to ask where we really want to go. Particularly in the case of the welfare sector, it is worth considering the *desired terminal state*, because the answer is highly debatable and indeterminate in historical terms, and because, as I say, there is no country to serve as a real model, a pattern we might wish to follow.

The nine principles expounded in this study are not tied to any particular party, in Hungary or elsewhere in the post-communist region. They cannot be pigeon-holed in the usual way. They are neither "left-wing" nor "right-wing," or to use American terminology, they do not correspond with what the traditional "liberal" or "conservative" ideas would suggest. They are dissociated from the earlier strand of social democracy, which saw as its main task the fullest possible construction of a welfare *state*, and which bears part of the historical blame for the exorbitant lengths to which this concept was taken. They are also dissociated from the cold-hearted radicalism that would dismantle all the achievements of the welfare state, and the ideologues who are uncritically biased against the state and in favor of the market. The set of nine principles represents a specific "centrist" position, and though dissociated from the traditional left and right wings, draws noteworthy ideas and proposals from both. My motive in doing so is not to make both sides like what I say. That might well rebound, so that neither side would approve. I have drawn up these nine principles in the belief that they form an integral whole.

The perspective behind this study is akin to that of many other authors, in political and in academic life alike. Perhaps it is not too soon to claim that this constitutes an international trend, which has not yet found an appropriate

[12]On the political economy of reforming the welfare state and/or cutting governmental social transfers, see Lindbeck et al. (1994) and Lindbeck (1996), who discuss the Swedish experience, and Nelson (1992), who analyzes the problems in selected countries in Latin America, Asia, and Africa.

name for its view of the world. It has both feet firmly planted in capitalism. It does not seek a third road. However, it does seek, not just with empty wishes, but by building up appropriate institutions, to ensure that capitalism has something more than a human face: a human heart and mind as well. It seeks to build much more firmly on individual responsibility, the market, competition, private ownership, and the profit motive, and it rejects much more strongly the proliferation of bureaucracy and centralization than old-style social democracy used to do. On the other hand, it does not accept any of the Eastern European variants of ultraconservatism. It seeks to apply the principle of solidarity not simply through individual charitable action; within certain bounds, it is prepared to countenance state redistribution for this purpose. It has no illusions about the market, and it does not reject all state intervention out of hand.

The historical experiences of the future will decide what effect this emerging intellectual and political trend will have on the transformation of the welfare sector.

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# 11

# Social Policy Challenges and Dilemmas in Ex-Socialist Systems

*Zsuzsa Ferge*

## THE NEED FOR SOCIAL POLICY REFORMS: THE GLOBAL SCENE

The reform of social policy is on the agenda everywhere, in the industrialized West, the developing countries, and the transition economies of Central and Eastern Europe and the former Soviet Union. The reasons and arguments for this are manifold. However, it should be recognized that there is also a neoliberal agenda that, in its extreme form, would like to put an end to the welfare state that evolved in Western Europe in the twentieth century (e.g., Marsland, 1996). A milder and more widespread variant of this agenda continues to emphasize the role of the individual, accepting the state's responsibility only with regard to care for the destitute.

Beliefs and values, like tastes, are difficult to dispute. In one of his many contributions to this debate, Barr (1994) helps us distinguish between values and rational reasoning by suggesting that we separate the issue of the scale from that of the structure of welfare spending. He argues that the scale of spending—the quantity spent—will depend not only on the resources available, but also on the values endorsed by a society, such as the weight accorded to social solidarity. In contrast, the structure of spending—the relative shares between the state and the market—should be seen as a technical issue that turns on questions of efficiency. Where markets are efficient, they should allocate resources, whereas in instances of grave market failure, state interven-

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tion may be justified. Barr's argument is useful, but the dividing line between scale and structure is not always clear, as illustrated, for instance, by the case of top-up vouchers (Glennerster, 1996). The argument also fails to deal with issues such as the techniques used in providing social benefits, which may matter a great deal.

Of course, changing conditions demand social-sector reform everywhere. Although the reasons for this may seem self-evident, they should be recapitulated briefly here because of their relevance to transition countries:

- **Globalization.** Globalization demands (1) open and competitive economies, which can initiate an upward spiral in efficiency and a downward spiral in labor costs, and (2) basic changes in labor markets, the effects of which range from deindustrialization to large-scale, long-term unemployment. In countries undergoing transformation, the challenges posed by globalization are especially great, because they are undertaken in conditions of sharply reduced gross domestic products (GDPs) and abrupt increases in prices, unemployment, and black market activity (Standing, 1996).
- **Demographic trends.** Demographic trends include (1) increasing longevity; (2) declines in fertility; and (3) changing family patterns, particularly the multiplication of single-parent families. In many transition countries, these problems are being aggravated by a general health crisis, including increasing mortality and the spread of infectious diseases (Cornia et al., 1996; Nauck and Joos, 1995).
- **Tendencies that weaken solidarity and increase individualism.** Many of the relatively better off now espouse "postmodern" attitudes toward former social policy arrangements. They demand better value for their money, including more individually tailored services and more choices. They are also less willing to share the collective costs of change. All these phenomena are appearing in transition countries, perhaps in an accentuated form as a sociopsychological reaction to the sudden lifting of former oppressive controls.

The modern welfare state has not coped well with the consequences of these trends, even in the West. Hence we have seen the emergence, even in many of the most developed and relatively affluent societies, of social fragmentation and threats of massive social exclusion and disaffiliation.

These developments may not be inevitable, however. Resources in developed countries remain plentiful; it is only their distribution that has become more unequal (World Bank, 1996a; Atkinson et al., 1995). Many analysts are searching for new insights, arguments, and instruments to address these trends. In an interesting sign of this new thinking, the eminent capitalist and financier George Soros (1997) recently warned about the potentially dangerous social consequences of unconstrained market domination.

Civil society's increasing resistance to attempts to scale back the welfare state—as indicated by demonstrations in several Western European countries in the spring of 1997—provides important evidence of democratic efforts to rebuff attempts at curtailing the welfare state. Many supranational agencies have also adopted new or stronger stances in opposition to this trend. The Council of Europe, in its recent revision of the European Social Charter, attempted to strengthen the safeguards for fundamental economic and social rights, while the United Nations declared the coming decade, 1997-2006, the International Decade for the Eradication of Poverty. The European Commission's "Comité des Sages," established in 1995, emphasized the importance of the social dimension in an integrated Europe. The committee's chair stated that "civic rights and social rights are becoming interdependent. . . . In the European tradition they are inseparable. . . . 'Freedom and the conditions of freedom' are the mirror image of 'democracy and development'" (European Commission, 1996:5).

There are, of course, additional reasons for welfare reform in the formerly state socialist countries of Central and Eastern Europe. Over and above what might be considered aggravated forms of the general Western problems enumerated above, there are the endemic flaws of the former welfare system to be corrected. Profound social transformation also has produced new problems that require new solutions.

The most basic flaw in the former welfare system is not that it was somehow premature or overly lavish, as some have suggested. The main defect of social policy in these states was that it was permeated with the totalitarian logic of the former political system. To mention just a few corollaries, because the legal system was arbitrarily dominated by politics, (1) rights remained illusory; (2) social policy, like everything else, was ideologically loaded; and (3) all measures were developed without citizens' participation or control or any attempts at consensus building. As but one example, inconvenient facts, such as poverty or unemployment, that did not correspond with official ideology were ignored and went unaddressed. Because of the domination of politics, all subsystems were deprived of autonomy. Instead of an interplay and compromise between social and economic rationality, the distinction was blurred in a fusion that was detrimental to both.

It is interesting to note that the current reform discourse seldom addresses the need for the democratization of (central) state welfare policy. Many recommend efforts to enhance the development of civil society and the nongovernmental organization (NGO) movement, but they seldom recognize that civil society plays a dual function: a service function and a "voice" function. In the former, as a provider of welfare services, civil society can play a useful role, although it can not replace the state. Yet it is in the "voice" function—acting as an advocate for society's needs—that civil society plays its paramount democratizing role. Civil society may change state institutions through citizen participation, criticism, and supervision, although this contribution is rarely evaluated positively by elites unused to criticism and countervailing pressures.

Another shortcoming of the reform debate is that whereas the existence of an autonomous economic logic is generally acknowledged, such recognition is denied to social processes and policy. This means social policy is once again subordinated to external requisites, this time to the logic of the economy, that is, the market.

With regard to new problems requiring new solutions, many of these—such as increasing poverty and the gap between world prices and local wages—are discussed in the next section. However, one factor connected with globalization deserves consideration here. Global pressures for adjustment to the newly emerging international community, and particularly to the "new economic order," have become very strong. This undoubtedly plays a greater role in the post-communist states and in Latin America than it does in the West, but no region is immune. Pressures for adjustment curtail the margin of freedom within which new democracies can develop relatively autonomously. While these pressures are very different from the political dictates of the former Soviet Union, which operated through duress and command, they preclude genuine national independence. Although less direct and less threatening, the new pressures coming from multinational organizations and supranational agencies also require compliance with rules and institutions that may be at odds with more organic trends in these countries, as well as with popular expectations, preferences, and values.

In response to this array of new and old problems, most countries in the region have begun the process of reforming their social policies. To summarize what might be called the changes in instruments, universalism has practically disappeared, while the risks covered by insurance have been both expanded (e.g., unemployment) and restricted (e.g., child benefits and death grants). Conditions relating to access are generally becoming more stringent, while standards are becoming lower, and targeted social assistance is gaining ground.

The changes in the number of actors involved in the provision of social services have meant rapid pluralization. This entails less responsibility in the hands of central state authorities (and state enterprises) and an increasing role for local authorities, civil society, families, and the market. This pluralization of social functions is important, but there may also be unforeseen drawbacks. The withdrawal of the state may escalate more rapidly in the post-communist states than in the West given the general weakness of civil society, and the consequences may prove to be more detrimental as a result of the prevailing atmosphere of economic and moral crisis.

## CHALLENGES AND DILEMMAS FOR THE FUTURE

It is difficult to reflect on the future without distinguishing between the short and the long run, although the two can never be completely separated. In the formerly state socialist states, past fiascos cause everyone to shy away from attempts to plan the future. In no country is there any sort of project or outline for the society that is being created. Similarly, there have been few attempts to build consensus, even on partial issues such as whether there should be more or less integration, more or less inequality, or more or less social fragmentation. Slogans of “market” and “democracy,” with no specification of their content, cannot fill this void. As there is no consensus about the future, there are no long-term commitments that can bind future governments. Reforms introduced by one government today can easily be revoked by the next tomorrow. We can only speculate about the future, taking the present as a starting point. This section examines, if only briefly the following issues:

- The possible long-term consequences of the current mismatch between needs and resources
- The possible impact of nation building based on full citizenship, if and when the social is individualized
- Increased investment in human resources as the best means to ensure individual and collective “salvation,” and the probability of this course of action
- The controversial issue of existential security: a test case for democracy?

### The Possible Long-Term Consequences of the Current Mismatch Between Needs and Resources

Needs are clearly escalating. Poverty in all its forms (absolute and relative, total and partial, lasting and temporary, objective and subjective) has increased throughout the region as a result of mass unemployment, the need to pay world prices for consumer goods, the increasing gap between foreign and domestic wage levels, increasing inequalities in income and wealth, deteriorating health services; and what many see as a deliberate decline in the real value of most social transfers.[1]

There is, of course, a great deal of variation in current trends in the region. In some countries (e.g., the Czech Republic and Slovenia), the increase in

[1]The figures may be debated at length. For instance, the most recent World Development Report gives data about income inequality in the transition countries that are at variance both with other data in the same volume and with the results of other surveys. But there is agreement on the main trends.

poverty has probably ceased (although projected price increases may produce unknown results). In others, poverty continues to escalate or deepen or both. Countervailing trends, such as a reduction in poverty, have yet to be evidenced even in countries such as Poland, where economic growth has resumed.

Meanwhile the redistributive capacity of these states is diminishing. States have fewer resources because of the overall decline in production and GDP; the privatization of the most profitable industries and activities first, with control of the "losing propositions" being retained; the declining capacity of the state to collect taxes and contributions; frequent reductions in taxes in order not to discourage capital, especially foreign capital; the growth of the black economy; incestuous relations between new economic and political elites; and the fact that people are less willing to pay taxes or make contributions for deteriorating services. In countries that are heavily indebted, the burden of debt servicing intensifies these difficulties.

The potential consequences of this gap between needs and means are unclear and varied. Until late 1993 or 1994, the inertia of prior commitments, especially pensions, and the pressure of new needs pushed states to continue transfers at relatively high levels. As a result, the share of social transfers in declining GDPs actually increased. However, such figures are seriously misleading. On the one hand, a higher proportion of a shrinking GDP could still mean lower levels in absolute terms. On the other hand, if the unregistered black economy is indeed producing 15 to 40 percent of GDP and going unrecorded, the real figures for the share of social outlays will be considerably reduced.

More radical measures to lower family benefits, pensions, and sick pay have been initiated since 1993, and the results are already visible, both in terms of diminishing the proportion of social transfers relative to overall GDP and their real value (see Table 11-1 for Hungary). It should be recognized, however, that stringent measures in some fields increase the need for social assistance.

It seems almost impossible to devise a system of social assistance that will be both efficient and effective. This is because there is insufficient money to fund a decent safety net and insufficient administrative capacity to target the truly needy. This issue is so crucial that it merits a slightly more systematic discussion. The main difficulties hampering the implementation of an efficient and effective social assistance scheme are discussed below.

The average official wage is so low that recipients barely manage to stay above even a modest poverty line. If the poverty line is maintained at a decent level, there will be substantial disincentives to work. This clearly presents an unemployment trap, one that may be impossible to overcome as long as wages remain low.

It is impossible to determine the truly needy because of both the widespread resort to subsistence agricultural production and the prevalence of the black economy. Production and incomes from household plots are difficult to calculate, while the black market is ubiquitous. The well-to-do use it to avoid taxes and perpetrate various fraudulent practices (for example, the self-employed and small-scale ventures can declare incomes that are sufficiently low to qualify for means-tested benefits). The poor use the black market to survive by accepting risky, dangerous, unprotected, and low-paid jobs (old forms of exploitation are indeed coming back). They also apply for assistance on the basis of their official, low incomes. However, the fraudulent poor are more visible than the cheating rich and invite closer scrutiny. As local authorities take on a greater role, the applications of the poor may be more frequently rejected, not only because of greater local knowledge, but also because discretion favors those who are closer to the administrators making the decisions.

There is an increasing reliance on workfare—making assistance after the expiration of unemployment insurance conditional on work (e.g., 5 days of communal work paid at the minimum wage or less). The poor may not take this “opportunity.” After all, the wage is less than they can earn in the black economy, and if they take time off from their unofficial work to qualify for government assistance, they may lose their black employment. No one should count on the poor’s undertaking complex calculations of the long-term opportunity costs of this behavior. Rather, it should be anticipated that large numbers will lose their entitlements.

It is also worth noting that a culture of social rights is generally lacking in Central and Eastern Europe. Such a culture scarcely existed under the former system. It is interesting to note, however, that the “clients” are learning about claim rights more rapidly than the administrators. The latter love their discretionary power and are afraid of being accused of squandering money by helping those who are not “truly needy.” This has led to a strong resistance to right-based assistance. The administrators also prefer behavior tests and home visits, which make them feel more secure in their decisions. Such intrusive measures, however, are detrimental to the development of a self-assured citizenry.

There is also a general lack of administrative capacity and know-how: social policy and social work became acknowledged disciplines only after the transition; budget cuts have hit local authorities hard, and they are unable to engage enough qualified people to administer complex assistance schemes. This has meant the emergence of extremely debatable solutions, such as contracting out home visits. Administrators also sometimes appeal to the populace to denounce frauds and encourage anonymous informants.

There are also widespread shortages of funds at the local level. Responsibility for some types of assistance may be shared with central authorities, but very often the locality is solely responsible, and its activities are funded by a block grant. Since there are many competing claims for these funds, the locality may not be able to provide for all the needy. According to some evidence (World Bank, 1996b; Ferge et al., 1995), as many as 50 to 60 percent of the eligible poor are not receiving assistance, and many are refused assistance because of a lack of local funds. Of course, this is not meant as an indictment of local autonomy. The regaining of local autonomy after decades of stifling overcentralization is a fundamental achievement, and it is revitalizing localities. However, its success is contingent on adequate funding.

In sum, because of a whole series of problems, the level of poverty assistance is generally too low, and the procedures being developed for administering it are too often demeaning. The proud shy away from applying. Both client awareness of opportunities and the authorities' willingness to offer genuine help may be deficient. In the old system, poverty was taboo and therefore unaddressed; now it is seen as "natural" and perennial, making efforts to eradicate it seem futile. As a result, few if any officials, at the level of either discourse or institution building, are paying attention to issues of poverty or exclusion, albeit there were some positive changes in 1997..

This does not mean there are no efforts to discover alternatives. Many NGOs, particularly Western foundations, are dedicated to finding innovative solutions that will abolish long-term unemployment and reduce the worst aspects of workfare. However, these efforts reach only a tiny minority. The dominant political tendency is described by Standing (1996)—harsh workfare with many disincentives.

The foreseeable if not necessary or inevitable consequence of the gap between means and needs is lasting poverty and various forms of disaffiliation or exclusion. Although this may not necessarily produce a distinct underclass, the processes outlined above deeply harm social integration. In countries with a large deprived minority, such as the Romanis in Hungary or Slovakia, exclusion is already well advanced, strengthening racial prejudices.

### The Possible Impact of Nation Building Based on Full Citizenship, If and When the Social Is Individualized

One objective of the European welfare states was to forge a more integrated society, to induce a general sense of belonging based on full citizenship, and to recognize the equal dignity of all. The reduction of inequalities in individuals' physical and social life chances was also an objective. Hence importance was attached not only to negative (freedom from), but also to positive (freedom to) freedoms, that is, to civil, political, economic, and social rights (Sen, 1990; Dasgupta, 1995). Public instruments to accomplish these goals included such nondiscriminatory transfers as social insurance and universal health benefits. These objectives were never fully attained anywhere, but headway was certainly made. It is also worth emphasizing that this project was started in relatively poor countries (Sweden in the early 1930s, Britain after World War II), with the intent of overcoming deep social cleavages.

The importance of nation building or community building is not out of place in this discussion of trends in the "new democracies." People in these countries have undergone the alienating and atomizing experience of totalitarianism.[2] In addition, current societal processes are producing a number of divisive tendencies, such as the spontaneous emergence of new social classes and groups with divergent or opposed interests, increases in inequalities of wealth and income, and the great divide between those with a job and the unemployed. Although social policy will never eliminate these new cleavages, appropriate measures can soften the edges. However, current trends in social policy reform neither endorse nor promote such efforts. Some of the reforms may accelerate these divisive processes, and it appears likely that a two-tier health and educational system will emerge in the post-communist states.

A particularly divisive strategy seems to be the rejection of the former unwritten contract between generations. While many deny the legitimacy or rationale for such a contract, which they largely deem fictive, there are many rational reasons to maintain it (Kohli, 1993; Walker, 1996). Judging from a recent Eurobarometer survey, the majority of citizens in Western countries have no intention of reneging on this obligation. When asked whether they agreed with the statement "Those in employment have a duty to ensure, through contributions or taxes, that older people have a decent standard of living," 85 percent of the respondents in 12 countries agreed, either strongly or slightly. Only 15 percent disagreed slightly or strongly (reproduced in Walker, 1996:4).

In the Central and Eastern European countries, however, changes in family benefit schemes and pension reforms (both those that have been adopted and those still under consideration) tend to undermine the intergenerational contract. This contract implies a continuity between generations and a common stake in the process of social reproduction. The abolition of universal family benefits has already damaged one side of this contract. Providing help only to the truly needy involves an institutionalized differentiation among children. It also makes it clear that the community does not see all children as potentially equal future social actors.[3]

The other side of the contract is even more problematic. Space here does not permit discussion of the intricacies of the two- and three-pillar schemes that are now on the agenda everywhere (one of the most elaborate versions is to be found in World Bank, 1994). The relative merits and demerits of pay-as-you-go versus funded schemes are also not particularly relevant from the

[2]There has been relatively little attention to how adversely totalitarianism affected spontaneous microsolidarities and how it atomized society by confining freedom to the narrowest private sphere (if it was permitted at all).

[3]Not all forms of lowering family benefits would have harmed the generational contract (see World Bank, 1996b, proposals for group targeting and benefit taxing).

perspective of social integration, since even funded schemes may include elements of solidarity.

It is the so-called mandatory privately managed pillar that embodies the most disturbing elements. Optionally elected private saving contracts represent a positive development and enhance individuals' free choice in determining the use of their savings. This picture changes, however, when these contracts become mandatory and an integral part of retirement security, as is currently being proposed not only by the private banking and insurance sector, but by many supranational agencies as well. There are problems associated with money markets, and these are exacerbated in countries with fragile and inflation-prone economies, as well as underdeveloped banking systems. Slow economic growth and public commitments to those already on pensions may make the transition extremely expensive for both taxpayers and pensioners.

Summarizing the experiences with privately funded schemes, it is often observed that they have low potential coverage (never more than two-thirds of the population and often less); that the risk of noncoverage is particularly high for the chronically sick and disabled, as well as the long-term unemployed; and that, especially in the take-off period, but even beyond, they are much more costly than public schemes (Townsend and Walker, 1996; Myers, 1995; Kritzer, 1996). From the perspective of solidarity and integration, certain further elements should be mentioned. First, the benefit that will be received, particularly if it takes the form of an annuity, may suffer from the absence of solidarity. Annuities are actuarially calculated. Hence, women and men with exactly the same working careers will receive different benefits. A further divisive characteristic is the fact that the benefits one receives can potentially be related to prices, but they can never be related to wages. Thus the gap between the incomes of active and retired people may fluctuate or increase depending on prevailing economic trends.

Many different means are being used to bring home to people the message that the intergenerational contract should be abolished. The potential for conflict between the old and the young was noted by the demographer Samuel Preston over a decade ago when he suggested that "the social security system was becoming increasingly generous to the elderly while adopting a more severe attitude towards . . . welfare payments for children." He was, however, "careful in his address to avoid any explicit suggestion that children and the elderly were direct competitors for a fixed sum of public resources" (see Johnson and Falkingham, 1992:131-132).

In quite a few Organization for Economic Cooperation and Development (OECD) countries, at least some pensioners have indeed fared comparatively well recently because of relatively generous earnings related to pensions, but some of these advantages may not be sustainable over the long run. The poverty of children may have increased recently as well as a result of increased unemployment and parsimonious child benefits. Increasingly, the idea is being advanced that there could be a trade-off in the competition for scarce resources between the two groups—a proposition that is less than self-evident. This logic would hold that the elderly must be worse off for children to be better off, or that the problem is not that children are doing too badly, but that the aged are treated too well. A second disturbing aspect of this argument is that it has returned 10 years later, in the debate in the transition countries. Commenting on the poverty of children in Central and Eastern Europe, a World Bank expert declared: "I tell people in Eastern Europe that their pension policy is impoverishing their children. The demands of pensioners are taking food out of the mouths of working people's children" (Murphy, 1995:50).

No doubt the situation of children is deteriorating, partly because of the destruction of the former family benefit system. However, the data must be analyzed in more detail. In the less turbulent countries of Central and Eastern Europe, pensioners are better off, in terms of equivalent income, than households where the head is unemployed; however, they are worse off than families where the head is an active earner. The gap is large (15-35%) if there are no children. The income difference is lower if there are children: the equivalent income of pensioners is about 20 percent less, even if there are children. In other words, pensioners may not be among the main losers, but they are among the losers. The majority of pensioners are on the verge of poverty, and they are largely unrepresented in the top quintile of the population (see Table 11-1, and Ferge et al., 1995).[4]

Evidence abounds regarding the hardships faced by the majority of pensioners. The solution so often recommended—to lower pensions further or to target the relatively higher pensions for reductions—not only undermines the relative security of those involved, but also damages the contractual element that was enforced through earnings-related contributions. These recommendations also ignore the fact that citizens in Central and Eastern Europe are still very much in favor of maintaining solidarity with the elderly, as is clear from many surveys.

The foreseeable, if not necessary or inevitable, consequences of the individualization of the social are manifold. Differentiated and divisive health, pension, and other social systems may evolve. The poverty of children or discrimination against them may increase (even the positive discrimination entailed by sharpened targeting is divisive in that it accentuates the differences among children.) The coverage of the elderly by social insurance may easily shrink if access to pensions becomes much more restrictive. This in turn may entail large inequalities among the elderly and the poverty of all those with

[4]The survey furnishing these data was carried out as part of the Social Costs of Economic Transformation in Central Europe (SOCO) project, initiated and coordinated by the Institute for Human Studies, Vienna. The countries covered were the Czech Republic, former East Germany, Hungary, Poland, and Slovakia. The initial results are presented in Ferge et al. (1995).

TABLE 11-1 State Expenditures On Social Welfare-Social Policy, 1989-1996 (in percent of GDP and in real value, 1989 = 100)

| Policy | In percent of GDP | | | | | 1996/1989 in Real Value |
|---|---|---|---|---|---|---|
| | 1989 | 1991 | 1993 | 1995 | 1996 | |
| Price subsidies | 2.6 | 1.8 | 0.6 | 0.6 | 0.7 | 23% |
| Health | 5.7 | 7.6 | 7.6 | 6.4 | 5.3 | 81% |
| Education,culure | 7.0 | 9.3 | 9.3 | 8.5 | 7.7 | 96% |
| Housing subsidies | 3.5 | 2.5 | 1.1 | 1.2 | 0.9 | 22% |
| Unemployment | 0.0 | 0.7 | 1.7 | 0.9 | 0.7 | — |
| Pensions | 9.1 | 11.3 | 10.5 | 9.5 | 9.1 | 87% |
| Social assistance | 0.3 | 0.9 | 1.8 | 1.7 | 1.6 | 464% |
| Family benefits | 4.0 | 4.6 | 4.1 | 2.7 | 2.2 | 48% |
| Sick pay | 1.2 | 1.3 | 1.0 | 0.7 | 0.5 | 36% |
| Total, in percent of GDP | 33.4 | 39.9 | 37.6 | 32.2 | 28.6 | 75% |
| Total, in real value, 1989 = 100 | 100 | 103 | 92 | 83 | 75 | — |

SOURCE: TÁRKI (1997).

atypical careers. Women may be particularly hard hit. Other forms of social solidarity—between generations and between the employed and unemployed—may be further weakened.

### Increased Investment in Human Resources as a Means of Individual and Collective "Salvation"

It is widely recognized that the educational legacy of the countries of Central and Eastern Europe is largely positive. They had well-developed preschool networks and nearly universal and relatively good-quality basic educational institutions, and their students exhibited high levels of achievement in many fields. The weaknesses in this inheritance flow from the same source as do the weaknesses in social policy and the economy in general: the system was antidemocratic; overcentralized; overregulated; rife with inefficiencies; and, as a result of demands to meet the immediate "needs" of the economy, overspecialized (Barr, 1994).

The importance of education and training, both in promoting wealth formation on the national level and in improving each individual's opportunities, is too well known to be addressed here. In fact, some of the most rapidly developing countries (e.g., Singapore) achieved their amazing economic records by investing almost disproportionately in education.

The evidence regarding the current situation in education in the region is somewhat controversial. On the one hand, the share of GDP spent on public education is by and large on a par with expenditures in Western countries (between 3 and 7 percent, averaging around 5 percent). In some countries, Hungary for instance, this share even increased between 1986 and 1996—from 7.0 to 7.7 percent (see Table 11-1). This increased share is somewhat misleading, however. The real value of educational expenditures has declined everywhere, although the decrease may not have been proportional to the decline in GDP as a whole. On the other hand, many indicators show that similar shares of GDP may be yielding very different results, largely because the absolute levels may be much lower. Thus the secondary and tertiary enrollment ratios lag behind those of the OECD countries, although they remain very high if compared with those of the developing countries (Esping-Andersen, 1996:12; World Bank, 1996a:201).

Adult education and training are considered part of the package of social investment policies being used against unemployment, but they do not correspond very well to the needs of economic restructuring. Rates of enrollment appear not to be significantly different than those in the West, but if they are compared with the needs for retraining that flow from the previously distorted structure of skills, they are rather low.

Among recent developments in the field of education, some merit special attention:

- In most countries, there has been a huge decline in preschool facilities, nurseries, and kindergartens. This is detrimental to both the current well-being and the future opportunities of children from the most deprived strata. It also constrains women's opportunities to pursue gainful occupations, albeit many (probably the culturally better endowed) have found ways of combining household responsibilities with work by initiating or participating in home-based ventures.
- Scarce resources and the decentralization of financing have made it difficult to maintain the existing stock of educational institutions, and have rendered new investments or the expansion of the existing infrastructure practically impossible.
- The wages of those working in the care-giving and teaching professions—doctors and nurses, teachers, and professors—were always low, but not dramatically lower than other wages. Over the course of the transition, significant differentiations have occurred between the private and public spheres and within the public sphere among various sectors. Those working in the care-giving and teaching professions in the public sector are now among the worst paid. Low wages and the threat of becoming redundant have driven many professionals out of these fields. The resulting brain drain has lowered standards and dampened the enthusiasm of those remaining.

- The introduction of relatively high fees for school meals and so-called extracurricular activities with a high educational value (e.g., second languages and sports), as well as the extraordinary price increases for schoolbooks and other school equipment, may entail one of two consequences for public education (at the elementary and secondary levels): either children will be deprived of access to certain facilities, or they will have to receive means-tested help. Since children know everything about their peers, it will be difficult for those receiving assistance to overcome its stigmatizing effects. A more serious consequence may be increasing drop-out rates for the most deprived children, such as Romany children in Hungary. The increasing need for the money these children can earn—the opportunity cost to parents of keeping their children in school—will only aggravate this problem.
- The introduction of fees in higher education, combined with price increases for all school-related equipment and facilities, will most probably increase the already existing inequalities in access.
- Private or nonstate educational institutions and training courses are cropping up relatively quickly at all levels. A temporary problem stems from the lack of methods and institutions for accreditation: many of these courses represent quick profit-making ventures that provide no real benefit to their clients. However, the issue of increasing inequality of educational opportunity represents a much more serious and probably lasting problem. For-profit schools may offer better opportunities for success in later life.

To prepare for the future, these countries must not only overcome the inherited backwardness of their populations' skills, but also encourage new abilities and innovative thinking among the next generation of students. This is a must if the growing economic and social gaps among different parts of Europe are to be overcome. The basis for acceptably high growth—particularly in countries with scant natural resources—is a healthy and well-educated work force. Hence the soundest possible investments are in education, training, and health.[5] It is perhaps understandable that the urgency of immediate needs pushed this concern into the background at the beginning of the transition. That is no longer the case. If there is continued deterioration in public education (which is likely to remain dominant even if the private tier grows rapidly), the deleterious effects may be incalculable. The opportunities missed now will be very difficult to overcome later.

There are foreseeable, if not necessary or inevitable, consequences of the increased costs to the individual of procuring a quality education, the neglect

[5] Both the education and health systems are discussed in detail in several chapters in this volume. From the perspective of the future, the two have similar implications. I have singled out education because it has more direct connections with both the immediate plight of children and the structuring forces of the future.

of the public educational system, and the emergence of a two-tier educational system. One of the consequences on the macro level is that the full potential of the children of the less well off will remain untapped and therefore effectively be wasted. At the individual level, the consequence will be the further differentiation of opportunities.

## The Controversial Issue of Existential Security: A Test-Case for Democracy?

According to Marris (1996), uncertainty is a fundamental condition of human life. But uncertainty also breeds anxiety, which can produce real suffering (Ferge, 1996a, 1996b). Some anxious feelings can be termed "essential anxieties" in that they arise from our biological or mortal nature, while others can be considered "existential anxieties" since they stem from social conditions. Both, it should be noted, are, in Freud's terms, "real" anxieties, not pathological or neurotic symptoms. One of the consequences of anxiety may be a paralysis of action. If one cannot be sure of being able to make the payments on one's home or tuition fees for one's children, one may forego attempting to maintain the home or to encourage the children to study.

Another consequence of anxiety may be actions to reduce it. When (with the advent of capitalism) risks multiplied and the former agents of existential security weakened, new institutions emerged. The most important of these were insurance companies. The market failures of the insurance market (Barr, 1994), coupled with the financial weakness of individuals and small communities, made imperative the creation of larger institutions, in which the state assumed some role in defraying the risks. Indeed, social insurance has been an appropriate societal response to the anxieties associated with industrialization and an increasingly dominant market.

These new institutions, collectively called social security, developed to a rather high level in the West European welfare states. They also made important headway in the totalitarian state socialist systems of the post-communist states, which started to implement these systems early in the twentieth century. Inasmuch as the former system of social security is still valued, this is precisely because of the existential security it offered to its "subjects" (they were not genuine citizens as they were deprived of civil rights) *without stigma*. People value their new freedoms, particularly the liberation from political oppression. But if they are unable to build up their defenses against uncertainty, they will not be able to enjoy or fully utilize these new freedoms.

When the transition was first initiated, freedom (which previously had been jeopardized or curtailed) was deemed at least as important as existential securities. Since then, however, freedom seems to have become an accepted part of social reality, and according to the SOCO results, people now feel it is securely established. In sharp contrast, there is a pervasive sentiment in all these countries that basic securities—concerning income, employment, housing, and children's futures—are being threatened or undermined. In fact, the SOCO results show a significant deficit in desired securities. This deficit is most pronounced with regard to public safety, but is also strong with regard to incomes and children's futures (see Table 11-2).

The "security gap" is visible with respect to the full range of securities. When the difference between the importance attached to freedoms and to securities is calculated for each individual, it turns out that security is never treated lightly: it is of utmost importance even to those who value freedom above all. It also appears that the high value attached to existential security is not confined to Central and Eastern Europe; it is pervasive throughout Europe.

It may be surmised that the need for existential security is historically and culturally constructed and may therefore be "deconstructed," that is, that people can be resocialized to accord greater value to self-reliance and the absence of state intervention (see Green, 1993; Marsland, 1996). However, the success of such a project is doubtful. We can use the case of freedom as an analogy. Societies endured peacefully for millennia with individuals not experiencing freedom in its modern sense, but once freedom was discovered and tasted, people's desire for it could not be eradicated.

If this analogy is valid, the debate over existential security becomes a matter of form, not of content; the debate can only be about how it will be ensured. One school of thought contends that collectivist solutions that rely on a substantial measure of state responsibility should be maintained, with the proviso that they be better adjusted to the new economic and social environment. Many reform plans for existing public pay-as-you-go schemes fall into

TABLE 11-2 Degree to Which Security in Various Areas is Assured, Five SOCO Countries (scale of implementation of security/importance of security; importance of security = 100)

| Area of Security | Hungary | Slovakia | Czech R. | Poland | Germany[a] | Five Countries |
|---|---|---|---|---|---|---|
| Family | 90 | 88 | 81 | 88 | 82 | 87 |
| Housing | 86 | 84 | 75 | 79 | 71 | 78 |
| Health | 81 | 75 | 70 | 70 | 78 | 75 |
| Politics | 62 | 68 | 80 | 65 | 58 | 64 |
| Job | 72 | 73 | 64 | 70 | 54 | 67 |
| Income | 51 | 54 | 63 | 53 | 63 | 58 |
| Children's future | 56 | 59 | 60 | 56 | 58 | 57 |
| Public safety | 44 | 50 | 41 | 51 | 42 | 45 |
| Country mean | 69 | 69 | 66 | 66 | 64 | 67 |

NOTE: In the case of freedoms, all similar percentages are close to 100 percent (Ferge et al., 1995).

[a]Only former East Germany.

this category (Townsend and Walker, 1995; Augusztinovics, 1993), as do numerous proposals by the Hungarian Autonomous Pension Insurance Fund and the revived interest in basic income schemes in France, Germany, England, and elsewhere (Caillé and Laville, 1996; Mückenberger, 1994; Offe, 1994; Jordan, 1994). It should be added that at the beginning of the transition, Atkinson (1991) suggested that a basic income scheme in the Central and Eastern European countries would help overcome the major difficulties of social dislocation, prevent the worst forms of poverty, and facilitate small-scale entrepreneurship. Others reject these arguments, advocating individualized and privatized solutions.

All parties to the debate recognize that security is important, but the question remains whether it will be available to all or only to those who can afford it. A different question concerns the most appropriate role for the state in providing or ensuring security.

One would expect that people in the region, having experienced hated and oppressive party-states for decades, would reject any hint of state interference. It seems, however, that while people hated the party-state, they are willing to empower a democratic state. The SOCO data suggest that in all five countries, people would turn more willingly to public authorities when in need than to churches, nongovernmental organizations, or charitable institutions (see Figure 11-1). Undoubtedly, the populations of different countries and those within each country will differ in their expectations, and the anticipated role for the state will vary depending on the issue involved. Yet in all five countries, the populations expect the state to be least involved in the provision of day care for preschool children, the defraying of expenses associated with child rearing and with secondary and tertiary education, and the purchase of first homes. Similarly, in all of these countries a major role is accorded the state with respect to care for the handicapped, pensions, health care, primary education, and jobs, with pensions and care for the handicapped almost invariably ranking highest (see Table 11-3).

Citizens in Western Europe also accord great importance to the state's role in the provision of health, education, and pensions. This enthusiasm is maintained even where people are fully aware that they must pay more to receive better services or benefits. Recent evidence from Hungary demonstrates that despite very high rates of taxation, only a minority would opt for decreasing taxation at the expense of declining services. This proportion is higher than one would find today in England, but approximates figures obtained in Britain a decade ago.

Table 11-4 shows that there is very strong support, in both Eastern and Western Europe, for a substantial public role in protecting the population against major risks. Some condemn this as evidence of a "dependency culture" that undermines people's moral fiber (Marsland, 1996) or breeds "learned

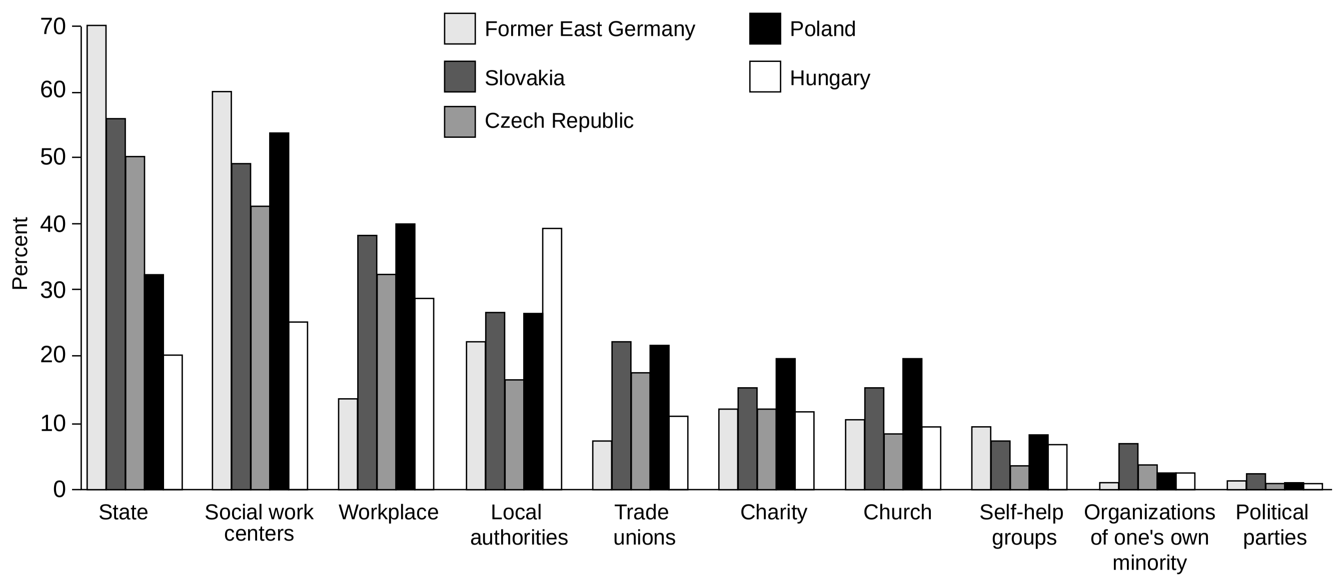


FIGURE 11-1 Where people would turn when in need, five SOCO countries; see fn 4. NOTE: The countries are arranged in order of expressed preference for assistance.

TABLE 11-3 Ranking of Items of State Responsibility (total of all five SOCO countries)

| Item | Percentage of households Giving the Following Scores: 1 and 2 | 3 | 4 and 5 | Total | Average, 5 countries |
|---|---|---|---|---|---|
| Cost of children (6) | 21 | 37 | 42 | 100 | 3.36 |
| Care for children under age 6 (2) | 21 | 30 | 49 | 100 | 3.48 |
| Higher education (5) | 16 | 29 | 55 | 100 | 3.66 |
| First home (8) | 14 | 29 | 57 | 100 | 3.72 |
| Secondary education (4) | 6 | 23 | 71 | 100 | 4.09 |
| Jobs (9) | 5 | 16 | 79 | 100 | 4.33 |
| Health care (1) | 2 | 12 | 86 | 100 | 4.50 |
| Primary education (3) | 3 | 11 | 86 | 100 | 4.50 |
| Support for handicapped (10) | 1 | 8 | 91 | 100 | 4.50 |
| Decent pensions (7) | 2 | 7 | 91 | 100 | 4.63 |

NOTE: The items are ranked according to the overall regional mean.

helplessness" (Marody, 1992). Some see it as nostalgia for the past, while others deem it "conservative": "The vast popular majorities in favor of the welfare state that opinion polls and election results regularly identify are essentially conservative ones because they rely on, and wish to perpetuate, a benefit structure that was put in place more than a generation ago" (Esping-Andersen, 1996:267). This attachment to security may have been created over time, in part through purposive state action, but it has probably become by now an almost unshakable emotional and psychological need for modern men and women.

The weakening of public responsibility in ensuring existential securities may have many negative effects. The foreseeable if not necessary or inevitable consequences in the transition countries, where there is already a tremen-

TABLE 11-4 Preferences on Taxes and State Spending: England and Hungary

| Preference | 1983 | 1994 | Hungary 1996 |
|---|---|---|---|
| Decrease taxes and spend less on health, education, and social security | 9 | 4 | 16 |
| Keep taxes and spending at current levels | 57 | 35 | 56 |
| Increase taxes and spend more on health, education, and social security | 34 | 61 | 28 |

NOTE: Figures shown are the percentage of valid answers.
SOURCES: For England, Taylor-Gooby (1995a); for Hungary, Hungarian Panel Study 1996, questions sponsored by the grant of OTKA (Orszagos Tudomanyos Kutatasi Alap—the Hungarian National Scientific Research Fund).

dous amount of unpredictability, include the further deterioration of mental and physical health as a result of stress and anxiety. Since overwhelming majorities believe certain basic securities should be the concern of the community and not left entirely to the individual, consensus building around this issue may well become a major test case for democracy. If governments ignore popular expectations, tensions may increase, and left- or right-wing populism may gain ground. Populism has rarely proved a fertile soil for democracy or for the strengthening of active citizenship.

## CONCLUSION

Social policy reform is badly needed in Central and Eastern Europe and the New Independent States, not only to ensure the relative independence of the market, but also to safeguard democracy, genuine citizens' rights, state accountability, transparency, and adequate welfare arrangements. If the current level of resources does not permit the state to provide adequately for all needs, it is still possible for it to build a consensus in favor of short-term stringency measures. To achieve this consensus, the burdens of societal transformation should be shared more equitably, and people should be assured that any withdrawal from public responsibility does not represent a long-term strategy, but a response to overwhelming short-term necessity. They should further be assured that social rights and benefits will improve with increasing resources.

The costs of societal transformation have proven to be more formidable than was originally anticipated, and have fallen disproportionately on the shoulders of those who are the least able to bear them. It is neither new nor unusual that the most vulnerable bear the brunt of the costs of economic and social change. However, in the case of the transition in the formerly state socialist countries, these costs appear to have been unusually high.

If governments continue to neglect the short- and long-term consequences of present trends in impoverishment and diminished security, large-scale poverty, social disintegration, marginalization, and social exclusion may result. Such consequences would threaten both economic modernization and democratization. Governments' freedom of action may be restricted by economic scarcity, but there are always alternative places to make the necessary cuts. It should be remembered that social policies play a positive role in safeguarding the cohesion of societies experiencing transition, can assist in avoiding or minimizing the potential negative consequences enumerated above, and may thereby offer a more solid basis for long-term economic growth.

Our objectives should not be limited to finding better ways to meet various short-term needs or attempting to compensate for market failures. The elaboration and implementation of effective social policy must entail the cooperation between the state and an increasingly strong civil society. Both improved policies and increased state-civil society cooepration will promote the mutifaceted process of transformation, by developing human resources and strengthening the institutions that promote social integration.

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# 12

# Health Reform in Russia and Central Asia

*Jeni Klugman and George Schieber with Timothy Heleniak and Vivian Hon*

## INTRODUCTION

The impressive achievements in health status that set the former Soviet Union apart from its neighbors of comparable income are under pressure. Stresses at the individual and household levels associated with the collapse of the inherited economic system have been compounded by sharply reduced funding for health services.

Improvements in health status in Russia and Central Asia will depend on a number of factors. Income growth and its distribution are probably the most important determinants in the long run. Maintaining educational achievements, especially of women, is also important. Health programs will play a critical role, in particular through the development of cost-effective interventions, health promotion, and improvements in water and sanitation.

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This paper surveys health-care reform in Russia and Central Asia in the context of the socioeconomic, epidemiological, and institutional realities facing these countries. Following this introduction, the next section examines demographic and epidemiological trends in the region. The third section evaluates current health systems, highlighting their primary strengths and weaknesses. The reform agenda facing health policymakers is investigated in the fourth section. The final section contains concluding observations.

The goals of health-sector reform can be stated in fairly noncontroversial terms: to improve the health status of the population, ensure equity and access, improve efficiency, improve clinical effectiveness, and ensure quality and consumer satisfaction. Reaching those goals, however, is a far less tractable task. This paper attempts to provide an empirical as well as conceptual overview of these issues. While there are important distinctions among the countries, some generalizations are possible. Indeed, the problems of financing and delivering health services in an efficient and equitable way present a difficult challenge for all countries, rich and poor.

It should be noted that macroeconomic performance is a critical element in the analysis of health outcomes and policy reform. The average level of national income per capita is clearly important. Increased income allows individuals and households to buy better living and housing conditions and more health care. Similarly, economic growth expands government revenue possibilities, and thus the opportunities to provide preventive and curative health services, safe water and sanitation systems, better-quality and safer food, and education, for example. Because rising average incomes tend to reduce poverty, there is generally a strong link between incomes and health status. World Bank analysis suggests that more than 75 percent of the difference in child mortality across countries is associated with income differences, and that the relation is causal rather than merely associative: in a sample of 58 developing countries, a 10 percent increase in income per capita, all else being equal, reduced infant and child mortality rates by between 2.0 and 3.5 percent (World Bank, 1993c).

## HEALTH STATUS: DEMOGRAPHIC AND EPIDEMIOLOGICAL TRENDS

People living in Russia and Central Asia enjoy relatively good human development outcomes, especially relative to income levels. High rates of literacy, coupled with relatively high life expectancy, mean that the United Nations' human development ranking of each country at independence was higher than if it had been based on income alone, especially for the poorer countries (Klugman and Schieber, 1996:Table 1). This section explores the demographic and epidemiological trends underlying health status in Russia and Central Asia, focusing on the period since 1991.

## Demographic Trends

Recent demographic trends provide a useful basis from which to evaluate the performance of the health systems and needed reforms in Central Asia and Russia. In summary, the population of Central Asia is young, and likely to become younger in some countries. Even though fertility rates have recently declined, population growth remains high. In contrast, the Russian population is aging and has experienced an extraordinary drop in both crude birth rate and fertility, while significant return migration has had an even larger absolute impact on the population. Since 1989, mortality rates have tended to increase, and life expectancy has declined dramatically throughout the region (Klugman and Schieber, 1996). Most of Central Asia experienced significant population increases between 1989 and 1995, while all the Central Asian countries except Turkmenistan had a combination of high natural increase with outmigration.

It is clear, however, that these developments in Central Asia and Russia represent a rapid acceleration of trends that have been evident for several decades. Birth rates have been declining slowly since the 1960s. The flow of Russians and other nationalities into Central Asia began to reverse direction in the mid-1970s. Stagnation and then declines in life expectancy in Russia began in 1965.

Fertility, as measured by either the crude birth rate or the total fertility rate, has generally declined since 1989 (see Table 12-1). Total fertility rates in Central Asia are nonetheless still high relative to Russia (1.4) and Organization for Economic Cooperation and Development (OECD) countries (averaging 1.9). In 2015, Tajikistan, Turkmenistan, and Uzbekistan are still expected to have roughly the same skewed age structures they have today, with more than 40 percent of their populations below age 16 and less than one in ten people above working age.

The outmigration of Russians and other Slavic and European nationalities from Central Asia has had, and will continue to have, an enormous impact on the demographics of the region. The Russian population is older and more urbanized, with birth rates between one-third and one-half those of the titular nationalities and higher death rates, resulting in much lower rates of natural increase. This trend of differential natural growth rates is long-standing, but has become even more marked in recent years. In terms of nationality composition, the Central Asian countries can be classified into two groups: Kazakstan and Kyrgyz Republic with their much larger Russian populations (38 and 22 percent, respectively, in 1989) on the one hand, and the remaining three countries, each less than 10 percent Russian, on the other. Outmigration has played a much more important role in the former group. In Russia, with an overall positive inflow of people from other parts of the former Soviet Union, internal migration and the direction of flows of return migrants have affected the regional distribution of the population; in particular, there have been signifi-

TABLE 12-1 Selected Demographic and Health Characteristics of Russia and the Central Asian States, 1989-1994

| Country | Crude Birth Rate (per 1,000) | Crude Death Rate (per 1,000) | Rate of Natural Increase (per 1,000) | Total Fertility Rate[a] | Infant Mortality Rate (per 1,000 births) | Maternal Mortality Rate (per 100,000 live births)[b] | Life Expectancy (years)[c] |
|---|---|---|---|---|---|---|---|
| *1989* | | | | | | | |
| Russia | 14.7 | 10.7 | 3.9 | 2.0 | 17.8 | 47.4 | 69.6 |
| Kazakstan | 23.0 | 7.6 | 15.4 | 2.9 | 26.0 | 53.1 | 68.7 |
| Kyrgyz Republic | 30.4 | 7.2 | 23.2 | 3.9 | 32.4 | 42.6 | 68.5 |
| Tajikistan | 38.7 | 6.5 | 32.2 | 5.2 | 43.3 | 38.9 | 69.4 |
| Turkmenistan | 35.0 | 7.7 | 27.3 | 4.4 | 54.8 | 55.2 | 65.2 |
| Uzbekistan | 33.3 | 6.3 | 27.0 | 4.2 | 38.1 | 42.8 | 69.2 |
| *1994*[b] | | | | | | | |
| Russia | 9.4 | 15.6 | –6.2 | 1.4 | 18.6 | 51.6 | 64 |
| Kazakstan | 18.2 | 9.6 | 8.6 | 2.3 | 27.4 | 49.6 | 65.8 |
| Kyrgyz Republic | 24.6 | 8.3 | 16.3 | 3.3 | 29.6 | 44.5 | 65.4 |
| Tajikistan | 28.2 | 7.0 | 21.2 | 4.3 | 45.9 | 74.0 | 67.7 |
| Turkmenistan | 32.0 | 7.9 | 24.1 | 4.0 | 42.9 | 44.4 | 63.9 |
| Uzbekistan | 29.4 | 6.6 | 22.8 | 3.8 | 32.7 | 24.1 | 67.9 |
| *Percent change, 1989-1994* | | | | | | | |
| Russia | –35.4 | 44.4 | –259 | –30.0 | 2.8 | 6.7 | –7.9 |
| Kazakstan | –20.9 | 26.3 | –44.2 | –20.1 | 5.4 | –6.6 | –4.2 |
| Kyrgyz Republic | –19.1 | 15.3 | –29.7 | –15.6 | –8.6 | 4.5 | –4.5 |
| Tajikistan | –27.1 | 7.7 | –34.2 | –17.7 | 6.0 | 90.2 | –2.4 |
| Turkmenistan | –8.6 | 2.6 | –11.7 | –9.1 | –21.7 | –19.6 | –1.8 |
| Uzbekistan | –11.7 | 4.8 | –15.6 | –9.1 | –14.2 | –43.5 | –2.0 |

[a]The total fertility rate (TFR) is a synthetic measure of the number of children a woman would have if she passed through her childbearing years at the current age-specific fertility rates. Figures are for 1993.

[b]Figures for total fertility rate and maternal mortality rate are for 1993; figures for life expectancy are for 1994 except Tajikstan (1992) and Uzbekistan (1993).

[c]Figures are for 1994, except Tajikistan (1992) and Uzbekistan (1993).

SOURCES: Commonwealth of Independent States Statistical Committee, national statistical offices; World Health Organization Health-for-All Global Indicators Data Base.

cant net reductions in the numbers of people living in outlying regions of the North, East Siberia, and the Far East (Klugman and Schieber, 1996).

Crude death rates have increased in each country, most dramatically in Russia, Kazakstan, and the Kyrgyz Republic. The crude death rate in Russia now significantly exceeds that in Central Asia. Life expectancies have declined in all the countries since 1989, most seriously in Russia.[1] The male-

[1]There is evidence that life expectancies are overstated in the former Soviet states, especially in some Central Asian states, as a result of statistical and registration problems (Anderson and Silver, 1995).

female life expectancy gap has widened in all the countries except Turkmenistan, but again most dramatically in Russia. The infant mortality rate has worsened in Russia, Kazakstan, and Tajikistan, but improved elsewhere.

Age-specific mortality trends reveal distinct patterns. In Central Asia, those with the largest increases in death rates have tended to be younger, aged 10-30. In Russia, the largest increases in mortality during the transition period have been among those aged 35-44, especially males. External causes explain the largest portion of rising death rates for both men and women, and may be linked to the stress and uncertainty associated with the transition (Nell and Stewart, 1994). Moreover, while age-adjusted mortality rates from cardiovascular disease have tended to decline in Western Europe (by 35 to 50 percent between 1960 and 1985), they have risen dramatically in the Soviet Union over the past three decades (Chernichovsky et al., 1996; Klugman and Schieber, 1996:Table 4; Murray and Bobadilla, 1994; Shkolnikov et al., 1994).

### Epidemiological Situation

The epidemiological situation of a population is a clear indicator of its health needs and demands. International historical experience suggests that changes in the pattern of disease among a population proceed in two steps: the first is the demographic transition, when mortality from infectious diseases declines, and, partly as a result, fertility decreases as well; the second is the epidemiological transition, when the population becomes older, and noninfectious diseases become the main causes of mortality (World Bank, 1993).

Russia appears largely to have passed through the demographic transition, although reports of infectious disease outbreaks have been fairly frequent in recent years. In Central Asia, however, pre-epidemiological transition conditions, such as a high prevalence of infectious diseases and high infant mortality, coexist alongside health problems such as ischemic heart disease, emphysema, and motor traffic accidents, which are typical in richer industrial countries (Phillips et al., 1992). Moreover, some previously eradicated disorders have seen a resurgence. In some Central Asian countries, such as Turkmenistan and Tajikistan, classic pre-demographic transitional disorders such as acute respiratory infections and diarrheal diseases cause high infant mortality, indicating that they have never been completely controlled in these areas. High mortality (and morbidity) from other disorders surrounding childbirth continue. Russia's infant mortality rate is significantly lower than the rates in Central Asia.

Maternal mortality rates were high in all the countries prior to independence; since then, experiences have diverged (Table 12-1). Maternal mortality rates in Uzbekistan are now reported to be only about half the regional average as a result of declines in fertility and infant mortality rates of 9 and 14 percent, respectively. A comprehensive program aimed at women of childbearing age was launched in 1991, including special preventive and treatment centers and the promotion of birth spacing, although these initiatives may be too recent to have had such striking results.

Infectious diseases have generally not been important in determining the health of the general population, with the possible exceptions of tuberculosis and diphtheria. While the incidence of tuberculosis may be underreported, the official incidence of diphtheria has risen sharply across the region. In the Kyrgyz Republic and Tajikistan, the rates rose in both countries from about 0.2 per 100,000 in 1990 to 6.8 and 33.4, respectively, in 1994. Rates in Russia rose from 0.8 to 27 over the same period. Available evidence suggests that the rates of sexually transmitted diseases (STDs) have also risen rapidly—in Russia, from 32.2 cases per 100,000 in 1990 to 127.3 in 1994—even though rates are still likely to be underreported. Very few AIDS cases, fewer than 100, have been reported in the entire region.

## THE INHERITED HEALTH SYSTEMS

This section describes and evaluates the basic health systems of Russia and Central Asia in terms of expenditures and the availability and use of services. The systems are discussed in the context of the goals of health system reform: improving health status, ensuring access and equity, achieving microeconomic and macroeconomic efficiency, improving clinical effectiveness, and ensuring quality and consumer satisfaction.

The systems in Russia and Central Asia are based on the centrally planned national health service model of the former Soviet Union. The characteristics of this system were, and largely remain, as follows:

- **Eligibility—**The entire population is eligible for services.
- **Benefits**—The state provides all necessary health services at no charge.
- **Financing—**The public system is financed from the general state budget (e.g., national general revenues), enterprise budgets, and extrabudgetary funds. Private payments in the past were limited to a few nonessential services and some unofficial payments to public providers for preferential treatment.
- **Payment of Medical Care Providers—**Virtually all facilities were owned by the state, and all health-care personnel were state employees. Polyclinics and hospitals were reimbursed on the basis of 18 category line item budgets. Physicians and other health personnel were salaried employees. Provision and financing were combined (the public financing authority owned, budgeted, and managed facilities).
- **Service Delivery System**—The system was conceptually a well-integrated hierarchical structure of feldsher stations; health posts; polyclinics; and local-, regional-, and national-level hospitals. The human and physical capital

infrastructure of the system was based on planning norms used to allocate facilities and personnel across geographic areas. Quality of care was enforced through a hierarchical review process based on reprimanding inappropriate behavior. Public health programs were targeted to maternal and child health and communicable diseases.

While there were significant differences across the countries of the former Soviet Union, these centrally planned systems generally performed well prior to the breakup in terms of equity, access, and the achievement of relatively good overall health outcomes for the amounts spent.[2] On the other hand, the systems tended to be underfunded by Western standards (as social sectors were given low priority in the planning process), were inefficient, provided low-quality care, allowed little consumer choice, and were prone to informal payments for preferential treatment. Moreover, the systems were unable to cope with the epidemiological transition (Chernichovsky et al., 1996; Field, 1995; Knaus, 1981).

The disruptions associated with the breakup of the Soviet Union exacerbated these problems (Table 12-2). As a result, there is a broad range of problems in the health-care financing and delivery systems in all these countries:

- Declining health status of the population due to environmental risk factors and socioeconomic trends that have drastically increased mortality from heart disease, violence, injuries, and suicides
- Poorly structured or nonexistent public health programs for health promotion, disease prevention, family planning, adult health, occupational health, and environmental health
- Chronic underfunding (as an "unproductive" service sector) relative to the systems in Western countries, with low wages for physicians, nurses, and other health-care workers
- A rigid 18-category budgeting system for paying polyclinics, physicians, and hospitals, which provides few incentives for economic efficiency and tends to encourage inpatient over outpatient treatment, as well as care at the highest, most expensive levels of the system
- Too many physicians, too many specialists, and a lack of professionalism among physicians resulting from the state-enforced breakup of professional associations
- Poorly trained primary-care physicians, limited inpatient and outpatient diagnostic capacity, too many hospital beds, excessive utilization of services (particularly inpatient care), and the obsolete and poor condition of the capital stock

[2] The small Communist Party elite and nomenclatura, however, always had access to superior services.

TABLE 12-2 Key Macroeconomic Indicators During the Transition

| Country | 1995 GDP as a Percent of GDP 1990[a] | Average Inflation (percent) | | Registered Unemployment[b] | | Real Wage 1995 as a percent of Real Wage 1990 (1990 = 100) |
|---|---|---|---|---|---|---|
| | | 1993 | 1995 | 1994 | 1995 | |
| Kazakstan | 46 | 1,660 | 180 | 1.0 | 2.1 | 27 |
| Kyrgyz Rep. | 50 | 1,210 | 50 | 0.6 | 3.0 | 20 |
| Russia | 62 | 895 | 189.2 | 6.1 | 7.8 | 35 |
| Tajikistan | 47 | 2,140 | 400 | — | 1.8 | 4 |
| Turkmenistan | 58 | 1,630 | 1,005 | — | — | 29[c] |
| Uzbekistan | 82 | 1,230 | 320 | 0.7 | 0.3 | 52 |

[a]GDP = gross domestic product; figures for Tajikistan and Turkmenistan refer to net material product.
[b]Registered unemployment, except for Russia, the figures for which are based on the (broader) International Labor Organization definition.
[c]1994 real wage.
SOURCE: Goskomstat SSSR.

- Outdated treatment norms that promote ineffective medical practice, inefficient facility configurations, and staffing norms that restrict facility managers from making rational staffing decisions
- A lack of modern quality assurance systems
- Inefficient and outmoded production, procurement, distribution, and management systems for pharmaceuticals; outmoded lists of essential drugs; and coverage/reimbursement policies that encourage individuals to be hospitalized to receive free drugs
- Little or no consumer choice
- No accountability on the part of consumers or medical care providers for the consequences of their decisions
- Confusion about roles and responsibilities at the national level as responsibility for financing and delivering health care has been decentralized
- Hospitalization used as a safety net to compensate for inadequate referral systems, poor transportation and housing, the high costs of food and pharmaceuticals, and the health sector's generally being relied on by governments as an employment maintenance mechanism

These problems are fundamental and affect almost every aspect of health care at all levels. Nonetheless, the system retains substantial elements of success. These include an extensive and well-integrated hierarchical system of feldshers, health stations, polyclinics, and local, regional, and national hospitals; access to care for all as a right—and the associated equitable distribution of health resources in terms of household income and location; and, at least until recently, relatively good health outcomes for the limited moneys spent.

## Expenditures and Availability and Use of Services

Available evidence on financial indicators and the availability and use of services in Russia and Central Asia reveal certain differences among the countries. However, both the levels and trends over time for most measures are markedly similar.

### Expenditures

Table 12-3 and Figures 12-1 and 12-2 provide information on health expenditures measured in a variety of ways for 1990-1994: as a share of gross domestic product (GDP), on a real per capita basis, and per capita in U.S. dollars. Unfortunately, because of a lack of information on private spending, only public spending on health is presented. Even these figures may not be strictly comparable, since countries may spend different amounts through enterprises and extrabudgetary funds that may not be captured. Furthermore, one must be cautious in interpreting health expenditure-to-GDP ratios, as there are serious GDP valuation issues concerning whether certain commodities (e.g., oil and gas) are valued at local or world market prices. Similar problems occur in developing real health expenditure trends, which are extremely sensitive to the price deflators chosen. In Russia, and probably Central Asia as well, the GDP deflator probably significantly understates health-sector inflation resulting from price liberalization and elimination of import subsidies for pharmaceuticals. Thus, the reported levels of expenditure are overstated, perhaps significantly (King and Proskuryakova, 1996).

In all the countries except Russia and Tajikistan, the (public) health expenditure-to-GDP ratio (the percentage of national income going into the health sector) has declined since 1990, prior to the breakup of the Soviet Union (Figure 12-1). Although the health expenditure-to-GDP ratio is the most commonly used measure of expenditure performance, one must also analyze real per capita health spending to get a complete picture. For comparisons of the absolute levels of spending across countries, spending must be converted into one numeraire currency, as in Table 12-3.

The health sector appears to have been somewhat protected, at least in terms of its share of a declining economy, in Russia, Tajikistan, and Uzbekistan. The elasticities of health spending relative to GDP (that is, the annual percentage change in health spending relative to the annual percentage change in GDP) for all six countries are clustered between 0.87 and 1.07. An elasticity of 0.87 means that a 10 percent change in GDP was accompanied by

TABLE 12-3 Public Health Expenditures, 1990-1994

| Country and Indicator | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|
| Russia | | | | | |
| Health Expenditure-to-GDP Ratio | 2.5 | 2.4 | 2.5 | 3.3 | 4.1 |
| Real per Capita Health Spending as % of 1990 | 100 | 92 | 81 | 99 | 107 |
| Per Capita Health Spending ($US [PPPs[a]]) | 206 | 198 | 134 | 166 | 183 |
| Kazakstan | | | | | |
| Health Expenditure to GDP Ratio | 3.3 | 4.2 | 2.1 | 2.5 | 2.0 |
| Real per Capita Health Spending as % of 1990 | 100 | 118 | 54 | 56 | 37 |
| Per Capita Health Spending ($US [PPPs]) | 183 | 203 | 86 | 86 | 56 |
| Kyrgyz Republic | | | | | |
| Health Expenditure to GDP Ratio | 4.1 | 3.6 | 3.2 | 2.6 | 3.2 |
| Real per Capita Health Spending as % of 1990 | 100 | 77 | 57 | 39 | 36 |
| Per Capita Health Spending ($US [PPPs]) | 136 | 124 | 83 | 56 | 62 |
| Tajikistan | | | | | |
| Health Expenditure to GDP Ratio | 4.8 | 4.5 | 5.2 | 5.4 | 6.4 |
| Real per Capita Health Spending as % of 1990 | 100 | 84 | 75 | 51 | 46 |
| Per Capita Health Spending ($US [PPPs]) | 117 | 101 | 87 | 63 | 60 |
| Turkmenistan | | | | | |
| Health Expenditure to GDP Ratio | 3.7 | 3.7 | 2.0 | 1.8 | 1.2[b] |
| Real per Capita Health Spending as % of 1990 | 100 | 92 | 47 | 34 | 17 |
| Per Capita Health Spending ($US [PPPs]) | — | — | — | — | — |
| Uzbekistan | | | | | |
| Health Expenditure to GDP Ratio | 4.6 | 4.6 | 4.7 | 4.1 | 4.0 |
| Real per Capita Health Spending as % of 1990 | 100 | 96 | 87 | 72 | 66 |
| Per Capita Health Spending ($US [PPPs]) | 131 | 135 | 124 | 103 | 95 |

NOTE: Health expenditures are deflated by the GDP deflator.

[a]PPP = Purchasing Power Parity.

[b]If Turkmenistan's reported GDP is not adjusted for world market prices for its exports, the 1994 health expenditure to GDP ratio is 2.7. Such adjustments have little or no effect in the preceding years.

SOURCE: Klugman and Schieber (1996) and World Bank data.

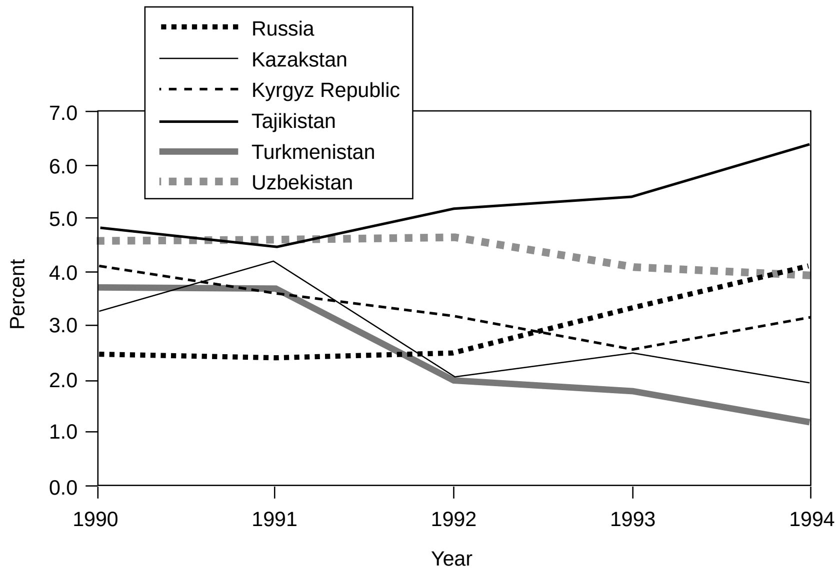


FIGURE 12-1 Public health expenditures as percentage of GDP, 1990-1994. SOURCE: Adapted from Klugman and Schlieber (1966:18).

an 8.7 percent change in health spending.[3] In other words, in countries with elasticities below 1.0, health expenditures increased less rapidly than GDP (which, in inflation-adjusted terms, declined significantly in all countries, as shown in Table 12-2).

Real GDP has fallen substantially throughout the region since 1990 (Table 12-2), in several countries by 50 percent or more. Reductions in real health spending have largely paralleled these trends. Real public health spending in 1994 also fell throughout the region, by half or more in all the countries except Russia and Uzbekistan. Given the large increases in population in Central Asia, real per capita health spending suffered even larger declines over the period 1990-1994. In 1994, it was just 17 percent of the 1990 level in Turkmenistan and 66 percent in Uzbekistan (Figure 12-2). General declines of these magnitudes have led to a serious deterioration of the health infrastructure. With the attendant general declines in income and socioeconomic conditions, these trends are contributing to the increased morbidity and mortality and worsening health status of the population.

There is little information on private-sector spending. Survey data from Russia indicate that, although private health expenditures average less than 2

[3]The elasticities are 0.98 for Uzbekistan, 0.93 for Kazakstan, 0.94 for Kyrgyz Republic, 1.07 for Russia, 1.05 for Tajikistan, and 0.87 for Turkmenistan.

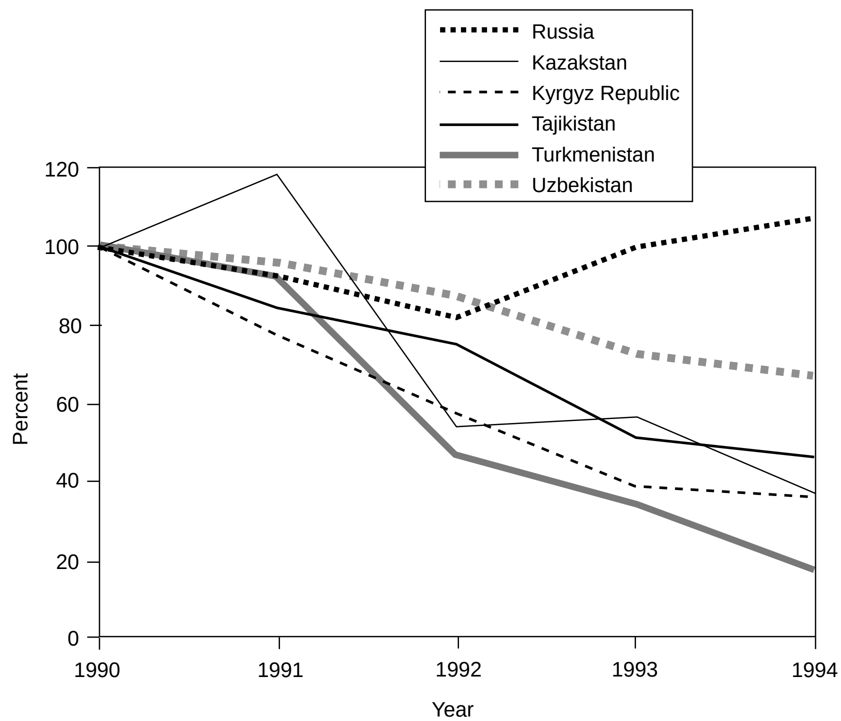


FIGURE 12-2 Real per capita public health expenditures, 1990-1994 (with 1990 set at 100 percent). SOURCE: Adapted from Klugman and Schlieber (1966:20).

percent of all household expenditures, they are higher for the poor than for the nonpoor, and the poor tend to use preventive services less often. About 28 percent of those unable to obtain prescribed medications cited insufficient money as the cause (Klugman, 1996; Zahoori et al., 1996). However, other survey data from the Kyrgyz Republic and Kazakstan indicate that out-of-pocket payments by individuals for pharmaceuticals, as well as for many normally publicly covered inpatient services, are quite high. Household survey evidence from the Kyrgyz Republic shows that between 1993 and 1994, formal charging for medical consultations increased significantly, from 11 to 25 percent of the population. Informal payments to medical staff are also widespread and likely to be increasing—reported by about one in four inpatients. By far the most significant item of private medical expenditure is drugs (Abel-Smith and Falkingham, 1996; Klugman and Schieber, 1996). An October 1994 survey in a South Kazakstan oblast found that over 35 percent of users of pharmaceuticals and hospital services were making large out-of-pocket payments for these services (Langenbrunner et al., 1996).

One legacy of the Soviet period was the widespread ownership, provision, and/or financing of social services by enterprises and collective farms, which extended to health facilities. Russia's Ministry of Economy estimates that enterprises owned and maintained 8 percent of all outpatient clinics and 6 percent of all hospitals in the country overall, though the shares were much higher in certain regions (Mikhailev, 1996). Evidence suggests that the enterprise facilities are of significantly higher quality than those of government authorities (World Bank, 1997). The transition has led many enterprises to close or divest social facilities, although not without problems. Uzbekistan is an outlier in that the Ministry of Health, up to 1996, was explicitly encouraging greater employer provision of health care. As these enterprises are increasingly privatized and state subsidies are withdrawn, any health services they continue to provide should be regarded as private, not public, health expenditures.

In absolute U.S. dollar terms, using purchasing power parities to convert (i.e., a special exchange rate that takes into account cost-of-living differences across countries), per capita health spending ranges from $56 in Kazakstan to $183 in Russia. This compares with health expenditures of $149 in Egypt, $185 in Turkey, and $374 in Jordan, for example (World Bank, 1997). Spending is well below the 8.1 percent health expenditure-to-GDP ratio and $1500 per capita expenditures for OECD countries (of which 75 percent is public) (Schieber et al., 1994). Perhaps more pertinent is whether these countries can maintain the vast health infrastructures that were developed when more budget resources were available.

## Availability and Use of Services

As shown in Table 12-4, Russia and Central Asia (like all countries of the former Soviet Union) are characterized by large quantities of inputs and high rates of hospital use. Central planning norms led to large numbers of hospital beds and physicians, while the system for paying hospitals provided strong incentives to keep beds filled. Poorly paid health personnel at the lower levels of the system, often lacking appropriate equipment, supplies, and medications, had incentives simply to refer individuals up the system rather than treat them. Since higher levels had better physicians, equipment, and supplies, individuals also had incentives to bypass lower levels of the system.

All these factors are reflected in the basic statistical profiles of the delivery systems in Russia and Central Asia. In terms of physicians, in 1994 the physician/population ratios varied from 2.1 physicians per 1000 population in Tajikistan to 3.8 in Russia, with a six-country average of 3.3. This compares with an OECD average of 2.5. Since 1990, these ratios have fallen slightly in all six countries except Uzbekistan. Nonetheless, the ratios throughout, except for that in Tajikistan, are still well above the OECD average.

TABLE 12-4 Availability and Use of Services, 1990-1994

| Indicator | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|
| Russia | | | | | |
| Physicians per 1,000 population | 4.1 | 4.1 | 3.9 | 3.9 | 3.8 |
| Hospital beds per 1,000 population | 13.1 | 12.7 | 12.2 | 12.1 | 11.9 |
| Admission rate (% of population) | 22.8 | 21.8 | 21.0 | 21.6 | 21.6 |
| Hospital days per capita | 3.8 | 3.6 | 3.6 | 3.6 | 3.6 |
| Average length of stay (days) | 16.6 | 16.7 | 17.0 | 16.8 | 16.8 |
| Occupancy rate (%) | 79 | 79 | 80 | 82 | 84 |
| Kazakstan | | | | | |
| Physicians per 1,000 population | 4.0 | 3.8 | 3.9 | 3.8 | 3.6 |
| Hospital beds per 1,000 population | 13.7 | 13.7 | 13.5 | 13.2 | 12.1 |
| Admission rate (% of population) | 22.9 | 22.6 | 21.3 | 20.2 | 17.6 |
| Hospital days per capita | 3.7 | 3.6 | 3.5 | 3.3 | 3.0 |
| Average length of stay (days) | 16.0 | 16.0 | 16.3 | 16.3 | 16.8 |
| Occupancy rate (%) | 79 | 79 | 78 | 76 | 74 |
| Kyrgyz Republic | | | | | |
| Physicians per 1,000 population | 3.4 | 3.4 | 3.3 | 3.1 | 3.1 |
| Hospital beds per 1,000 population | 12.0 | 12.1 | 11.9 | 10.7 | 9.6 |
| Admission rate (% of population) | 23.0 | 22.5 | 21.7 | 19.9 | 17.0 |
| Hospital days per capita | 3.4 | 3.4 | 3.3 | 3.0 | 2.6 |
| Average length of stay (days) | 14.9 | 14.9 | 15.3 | 15.3 | 15.4 |
| Occupancy rate (%) | 80 | 78 | 78 | 80 | 78 |
| Tajikistan | | | | | |
| Physicians per 1,000 population | 2.6 | 2.4 | 2.3 | 2.2 | 2.1 |
| Hospital beds per 1,000 population | 10.7 | 10.7 | 11.2 | 10.6 | 8.8 |
| Admission rate (% of population) | 21.0 | 20.5 | 16.3 | — | — |
| Hospital days per capita | 3.0 | 3.0 | 2.4 | — | — |
| Average length of stay (days) | 14.3 | 14.6 | 14.5 | — | — |
| Occupancy rate (%) | 94 | 88 | — | — | — |
| Turkmenistan | | | | | |
| Physicians per 1,000 population | 3.6 | 3.7 | 3.6 | 3.6 | 3.5 |
| Hospital beds per 1,000 population | 11.5 | 11.6 | 11.4 | 11.7 | 11.5 |
| Admission rate (% of population) | 19.8 | 19.4 | 18.4 | 18.4 | 16.6 |
| Hospital days per capita | 3.1 | 2.9 | 2.7 | 2.7 | 2.5 |
| Average length of stay (days) | 15.6 | 15.2 | 14.7 | 14.9 | 15.1 |
| Occupancy rate (%) | 73 | 72 | 69 | 70 | 64 |
| Uzbekistan | | | | | |
| Physicians per 1,000 population | 3.4 | 3.4 | 3.3 | 3.3 | 3.4 |
| Hospital beds per 1,000 population | 12.5 | 10.9 | 10.8 | 9.4 | 8.8 |
| Admission rate (% of population) | 24.6 | 24.5 | 23.6 | 22.0 | 19.3 |
| Hospital days per capita | 3.6 | 3.6 | 3.5 | 3.2 | 2.8 |
| Average length of stay (days) | 14.8 | 14.8 | 15.0 | 14.5 | 14.3 |
| Occupancy rate (%) | 83 | 82 | 85 | 88 | 87 |

SOURCE: World Health Organization, Health-for-All Global Indicators Data Base; Church and Koutanev (1995).

Available evidence reveals widespread reductions in the number of beds, hospital admission rates, and lengths of stay since 1990 (Table 12-4). Nonetheless, the levels remain high and exceed those in OECD countries, which have substantially larger elderly populations. Since 1990, the ratio of hospital beds to population has declined significantly in most of the countries, but the levels are still well above the OECD average (8.4 compared with the regional average of 10.5). Hospital admission rates (percentage of the population admitted to a hospital each year) average 18.1 percent in the region, and in all six countries remain above the OECD average of 16.2 percent. Since 1990, admission rates have declined in all six countries. Hospital occupancy rates average 79 percent in the six countries of the region, slightly above the OECD average. Since 1990, occupancy rates have declined in all the countries except Uzbekistan and Russia. The average length of a hospital stay varies from 14.3 days in Uzbekistan to 16.8 in Russia and Kazakstan, with a six-country average of 15.5 days. Given the young population structure in most of Central Asia, these lengths of stay are high as compared with the 14.4 day average in OECD countries. Average lengths of stay have increased in four of the six countries. The number of hospital days per person per year ranges from 2.4 in Tajikistan to 3.6 in Russia, with a six-country average of 2.8, which again exceeds the OECD average of 2.5. Since 1990, the number of bed days per capita has declined in all six countries.

The foregoing evaluation reveals striking health-sector trends. Public funding has been substantially reduced, yet the health infrastructure in terms of personnel and facilities remains extensive, inefficient, and not fully adjusted to reduced funding levels. Health outcomes, except in Russia, are still good relative to those of other countries with comparable incomes; overall, however, mortality rates have increased, life expectancy has declined, and certain infectious diseases appear to be on the rise. It is evident that basic public health programs and treatment norms are not well targeted to dealing with the population's underlying health needs, especially given sharply reduced funding. The reforms being initiated now, at different stages in all six countries, address these problems.

## HEALTH POLICY REFORM AGENDA

Policymakers in each of the six countries of the region have developed a clear consensus on the need for a reorientation of spending priorities—toward more effective public and environmental health programs, an emphasis on primary care, less hospital-based tertiary care, and the provision of appropriate financial incentives. This section addresses the health reform agendas of the six countries and examines how these countries could implement such reforms, as well as the factors likely to influence their effectiveness.

All six countries have either initiated or are contemplating reforms to address the underlying financing and delivery problems facing their health systems.[4] The generic policies being pursued by virtually all these countries are similar:

- Obtain additional financing through nonbudgetary sources, such as earmarked payroll taxes on employers; voluntary insurance; and other private financing, including patient cost sharing.
- Reduce pressure on the national budget by decentralizing the financing of health care to the regional and local levels.
- Get better value for the money spent by separating financing from provision and having money follow patients.
- Improve system efficiency by introducing incentive-based provider payment mechanisms.
- Improve the service delivery system by restructuring it to favor primary care, promoting general and family medical practice, and eliminating unneeded hospital capacity.
- Institute major reforms in pharmaceutical regulation, management, essential drug lists, procurement, management, distribution, and pricing.

Reforms in health-care financing have been implemented in Russia and several Central Asian countries and are being developed in others. The basic principles of the Russian reforms in terms of use of insurance funds and decentralization of financing and delivery are generally being emulated by the Central Asian countries. Russia passed health insurance legislation in 1991, which was modified before being implemented in late 1993. Since Russia has progressed the furthest to date, much of the following discussion pertains to the Russian experience.

The basic goal of Russia's health insurance legislation was to infuse new nonbudgetary revenues into the system and introduce efficiency by separating financing from provision (Chernichovsky et al., 1996; Sheiman, 1994). Ownership of most health-care facilities was turned over to oblast, municipal, and rayon governments. New revenues would be obtained through a 3.6 percent payroll tax on enterprises to pay for the health care of their workers. Local governments would make contributions for the nonworking population. Contributions from firms and local governments would go to Territorial Health Insurance Funds (THIFs) in each of the 89 oblasts (regions). These THIFs would enter into contracts with noncommercial insurance companies, which would contract with health-care providers. Consumers would choose their insurance companies. A small percentage of the payroll tax, 0.2 of the 3.6 percent, would go to the Federal Mandatory Health Insurance Fund (FMHIF),

[4] See the World Bank reports on all six countries cited on the list of references (1996a-f).

which would use these funds for fiscal equalization in health spending and general administrative purposes.

The new system started functioning in late 1993, when payroll tax contributions began to flow to THIFs. THIFs first made payments to insurers, and to providers in those areas without insurance companies, in 1994. Implementation has proceeded unevenly throughout Russia's 89 oblasts and has been fraught with major problems—bureaucratic, financial, and operational—as well as fraud. With the decentralization of financing and delivery responsibility to each of the 89 oblasts (some 90 percent of all health financing is now being raised locally), the Russian Ministry of Health (MOH) has had little to do with implementing the new system. Some oblasts have not implemented the system at all; others have implemented it in only some rayons; many have implemented it without insurance companies since insurers did not exist and/or did not find it profitable to enter the market.[5] Major bureaucratic turf battles have occurred between the Oblast Health Authorities, which are reluctant to give up their control over the health system, and the THIFs. There have been allegations and investigations of fraudulent use of funds by some THIFs and their managers, and MOH has been attempting to gain control over the health insurance funds.

Given the vagueness of certain aspects of the enacted legislation, such as the benefit package and the contribution levels of local governments for the nonworking population, as well as the significant economic difficulties described above, the system in many oblasts faces severe financial problems. It would appear that rather than adding funds to the system through the payroll tax, local governments have simply reduced their previous levels of public financing for the health sector. Thus, it does not appear that the goal of infusing significant amounts of new funding through payroll tax contributions has succeeded.

On the other hand, THIFs are operating in most oblasts. Since the lack of funding has deterred insurance companies from entering the market, THIFs have often entered directly into incentive-based arrangements with health-care providers. In many cases, these arrangements may be superior in efficiency and productivity to the previous 18-category line item budgeting system. Thus, the system has to some degree succeeded in separating financing from provision and instilling incentive-based provider payment mechanisms. Yet given the availability and use patterns shown in Table 12-4, there does not appear to have been much change in health-sector performance. Moreover, the limited participation of insurance companies and the highly vertically integrated nature of the state-owned monopolistic service delivery system have resulted in

[5]According to Chernichovsky et al. (1996:82), full insurance of the entire population has been implemented in 7 regions, while full insurance of the working population has been implemented in 17 regions.

little additional consumer choice and competition among providers. In fact, placing insurance companies between the consumer and the THIF has often been criticized as adding an unnecessary layer that simply increases administrative costs.

With the Russian elections over and a renewed government interest in social policies, the partially implemented health insurance system is under close scrutiny, and major changes are being actively considered. These developments are being watched closely by the Central Asian countries as they grapple with many of the same problems resulting from their common legacy. Reforms in Central Asia are thus focusing on health insurance funds as a source of new nonbudgetary revenues, decentralization and separation of financing and provision, and measures to encourage efficiency through the use of new incentive-based health-care provider payment mechanisms.

After Russia, Kazakstan and the Kyrgyz Republic have progressed the furthest in introducing legislation to establish health insurance funds based on contributions from employers for the working population and from government for the nonworking population. Both countries have also experimented with health insurance and provider payment reforms based on general practitioner fund-holding mechanisms[6] in selected regions. Turkmenistan has established a publicly run voluntary insurance system to pay for outpatient pharmaceuticals and provide for priority use of publicly covered services. There is also a focus on improving both primary care and the effectiveness of public health systems. The intent to focus scarce resources on the most cost-effective interventions is reflected in burden-of-disease and cost-effectiveness studies undertaken in several countries. Other important objectives include developing lists of essential drugs and reforming the procurement, regulation, management, and distribution of pharmaceuticals. Decentralization of financing and use of capitation-based transfers from national to local governments are under way in a number of countries, including Uzbekistan.

Nationwide implementation of health insurance legislation in Kazakstan and the Kyrgyz Republic was delayed and has only recently begun because of depressed economic conditions and the limited ability of employers to make the requisite contributions. Turkmenistan's voluntary insurance program faces major financial difficulties due to premium collection problems, larger-than-foreseen pharmaceutical demand, and the lack of an actuarially sound contribution base. Uzbekistan is also in the process of developing legislation to establish insurance funds based on employer contributions, and is considering provider payment changes, as well as basic benefit packages predicated on cost-effectiveness criteria. Several countries are also considering explicit

[6]General practitioner fund-holding mechanisms are those in which a general practitioner is given a fixed amount of money to take care of all, or a defined set, of services to meet a patient's health needs.

privatization of certain services. Tajikistan is in a somewhat earlier stage of designing its reforms.

In general health policy terms, the reforms focus on the five major areas of health-care financing and delivery: financing (i.e., sources of revenue), eligibility, benefits, payment of health-care providers, and the delivery system. Each of these areas is discussed in turn below.

## Financing

Most of the focus in current reform debates has been on financing—raising revenues available for health care. Given the large declines in national income and budget revenue described earlier, policymakers are seeking additional financing through extrabudgetary sources and private contributions. There has also been a tendency to decentralize financing responsibilities to local governments, as described in the preceding section. A number of key issues have arisen:

- Adequacy of financing from both state and employer sources under the various health insurance approaches
- Ability of regional and local governments to finance their shares
- Administrative costs of such approaches
- Roles and responsibilities of national and subnational health authorities and insurance funds

Depressed economic activity in the region has effectively precluded raising additional revenues from both public and private sources. The extensive infrastructures that existed before the economic decline have become unaffordable. Regional and local governments are often unable to afford the increased health-care responsibilities being placed upon them. Enterprises are having serious economic problems, cannot afford to pay additional taxes, and are attempting to divest themselves of their social-service infrastructures and responsibilities. As Russia and the countries of Central Asia struggle with their economic and social priorities, the key task may be learning to develop more efficient systems that are far less extensive than in the past.

The advantages and costs of establishing and running health insurance funds of the types legislated in Russia, Kazakstan, and the Kyrgyz Republic must be considered. Basing insurance coverage on employment means individuals lose their coverage when they are unemployed, and either become uninsured or are insured at the expense of the state. Moreover, there are administrative costs associated with establishing and operating such funds. Multiple funds have higher administrative costs than single funds (Poullier, 1992). Similarly, voluntary insurance approaches, such as the one adopted in Turkmenistan, unless carefully designed, can be fiscally unsound as a result of favorable selection by sick individuals, as well as lack of a sound actuarial base for premiums.

Changing the source of financing does not enhance the efficiency of the delivery system. Countries such as Canada and the United Kingdom have maintained their general revenue funding bases while successfully implementing payment mechanisms to encourage efficiency. Furthermore, general revenue-based approaches tend to pool risks more equitably than social insurance-based models, as evidenced by the difficulties experienced by both Germany and Japan in pooling risks among multiple sickness funds and government programs. All these issues should be carefully weighed, along with the effects of increased payroll taxes on labor demand and on enterprise viability and competitiveness. Whatever approach is chosen, the financing base must be actuarially sound; that is, the revenues from the designated sources must be sufficient to pay for the individuals and benefits that are covered under the program.

There is a need to clarify the roles of the various levels of government, health-care providers, health insurance funds, and health insurance companies. The relationships and responsibilities of the various agencies involved in health care have been problematic in a number of countries implementing reforms. There is often a preoccupation with financing issues to the detriment of basic public health, policy development, and rational system management—especially in Russia, where confusion and turf battles between financing and health authorities at all levels have been frequent.

## Eligibility

One of the great strengths of the previous system was universal entitlement—all citizens were covered. If reform efforts in the region follow the normative tenet applied in most Western market countries that all individuals should have *access* to care based on need and *pay* for care on the basis of their ability to do so, insurance reforms and privatization strategies will need to be carefully designed. This will be especially so if private financing is pursued for certain groups and employer and state responsibility for others, to ensure that some individuals do not fall through the cracks and lose eligibility. Moreover, multiple systems are more complicated to administer, have greater difficulty in controlling costs, and, as discussed above, may have more difficulty in distributing risks equitably.

## Benefits

People in Russia and Central Asia are accustomed to a system that, at least in theory, provided individuals with all their necessary care free of direct expenditures. Costs did not escalate out of control because of budget caps and supply constraints—constraints that may be less effective as these systems become more open-ended and private. In any financing system, whether based on general revenue or insurance contributions, it is essential that the contribution levels for employers and the state be set to cover the costs of the benefits package covered under the system.[7] This has not been the case in Russia or Central Asia. Part of the problem is political—the perception of taking away the "unlimited" benefits people used to have.

The other part of the benefit issue is financial: the payroll taxes on enterprises and the required (and not specified) government contributions for those not in the labor force must be sufficient to pay for the individuals and benefits covered under the system. Most former Soviet governments have refused to face this issue directly. Authorities do not want to admit that they cannot afford to cover the services that have been promised. Rational policy would suggest that the state establish realistic expectations on the part of the population and then meet its commitments to finance that level of services. Even in systems still based on public general revenue financing, governments need to consider ways of limiting the package of services available free of charge.

Despite the principle of access to free health care, the situation in practice is very different. Individuals always made informal payments to providers for preferential treatment, and, as discussed earlier, many now pay for certain services out of pocket. For example, survey evidence from the Kyrgyz Republic indicates that the ability to pay is a major problem: the total costs of one episode of ill-health exceeded the monthly income of the entire household in 20 percent of cases, while nearly half of all patients reported severe difficulty finding money to pay for their hospitalization. Moreover, as overall health service utilization rates have fallen in the Kyrgyz Republic, the poorest are least likely to seek medical assistance. In 1994, about two-thirds of households in the top income quintile sought medical help outside the home, compared with only 41 percent of those in the bottom quintile (Abel-Smith and Falkingham, 1996). A similar situation was found in a South Kazakstan oblast (Langenbrunner et al., 1996). The challenge for policymakers in all these countries is to design formal benefit and cost-sharing structures that will capture these largely informal payments in a way that enhances the revenue position of the government while not impeding access to care, especially for the poor.

[7] In establishing an insurance system with particular contribution levels required of different entities in a severely budget-constrained environment, it is important to specify what will be covered. In the case of Russia and Central Asia, it is important to be realistic about what can be provided and then put systems in place to ensure the necessary revenues for actuarial soundness. Indeed, once these countries get past their current financial crises and start funding their systems at higher levels, the lessening of supply-side constraints in the absence of a defined benefit package would likely have disastrous financial consequences.

A related policy concern is determining which services will be provided to the entire population as basic public health services (e.g., immunizations, vector control) and which personal health services should be provided through the insurance benefit package and/or private payments. Such decisions can be assisted by burden-of-disease/cost-effectiveness studies (Godinho, 1996). Such studies enable ranking of health interventions on cost-effectiveness grounds, and provide an empirical basis for deciding which services are to be covered for the entire population as basic public health services, which are to be included in the publicly funded insurance benefit package, and which will not be covered by public programs because they are not affordable and/or of low priority (World Bank, 1993). This is especially important for Russia because of the large declines in male and female life expectancy, and for Central Asia because of the large burden of pretransitional diseases.

## Payment of Health-Care Providers

The methods used to pay hospitals, polyclinics, and physicians have important effects on access to care, economic efficiency, clinical effectiveness, quality of care, and consumer satisfaction (Barnum and Saxenian, 1995; Jencks and Schieber, 1991; Langenbrunner et al., 1996). As discussed above, the 18-category normatively based line item budgeting system and salary reimbursement of health-care personnel provide few incentives for efficiency. Health systems in the former Soviet Union have a large quantity of generally low-quality inputs that are not used efficiently. Disproportionate levels of financing and care are rendered at the highest and most costly levels of the system as a result of budget norms, greater availability of supplies and equipment, free pharmaceuticals, and the best physicians being in higher-level hospitals, as well as poor referral and transportation networks and a lack of penalties for consumers or physicians for bypassing lower levels of the system. The deteriorating economic situation also inhibits health authorities from eliminating redundant personnel for fear of exacerbating the unemployment situation.

Virtually all former socialist economies, middle-income Latin American countries, and Western industrial OECD countries are separating provision from financing, having money follow patients in the context of an overall global budget, and adopting incentive-based payment mechanisms for health-care providers (Schieber, 1995). Experiences in Eastern European countries, Russia, the Kyrgyz Republic, and Kazakstan suggest that the incentive-based systems initially developed and implemented in the OECD countries can work just as effectively in the former socialist economies.

Numerous experiments with new provider systems in Russia date back to the late 1980s, when certain Russian oblasts and republics were allowed to experiment with innovative systems under the New Economic Mechanisms being put in place. Further experiments in provider payment reforms have taken place over the past several years through the U.S. Agency for International Development's ZDRAV Reform program in Siberia and Central Russia. Both sets of experiments have focused on risk-sharing approaches, case payments, and managed care, and indicate the viability of implementing such approaches in Russia as long as up-front development work is done carefully, and the systems deal effectively with inherent tradeoffs among costs, quality, and access. The general practitioner capitation/fund-holding experiments in Siberia, for example, led to large reductions in inpatient spending, decreases in hospital days, and significant increases in outpatient visits (Langenbrunner et al., 1996).

In Central Asia, the most extensive demonstrations of new provider payment systems are evident in Kazakstan, while the Kyrgyz Republic is undertaking a major demonstration project in general practitioner fund holding (Langenbrunner et al., 1996). In Kazakstan, the most detailed evaluation took place in Dzheskasgan, where a territorial medical organization (TMO) representing local providers and facilities restructured the financing, organization, and payment of health care along several dimensions. The restructured system implemented a new financing mechanism (health insurance fund) for the employed through a payroll tax and capitation payments from the state budget for those not working; established primary-care groups as fundholders who received capitated budgets for their services, including bonus payments to adjust salaries based on economic performance; gave hospitals a case-mix-adjusted flat payment per diem based on historical costs; and instituted contracts between all facilities and the TMO, which then signed a contract with the health insurance fund.

The results of the experiment were generally consistent with expectations: primary-care visits increased, the ratio of general-practice physicians to specialists in polyclinics increased, hospital admissions declined by over 25 percent, and the number of hospital beds decreased from 14.7 to 10.7 per 1000 population. Other, less positive results included a significant number of inappropriate in-patient admissions, continued high referral rates from polyclinics to hospitals, little increase in hospital efficiency, and no increase in the use of preventive services.

Unintended negative effects from health-care reforms in other former socialist economies have included the nonprovision of services, large volume increases, and rising shares of inpatient expenditures. These problems occurred because the new payment systems contained design flaws, including a lack of global budgets in physician fee-for-service and hospital case-based payment systems; open-ended payments for hospitals, coupled with reduced budgets and payments to lower levels of the system, resulting in increased inpatient hospital shares; no monitoring of necessary referrals and quality in capitation-based systems; and inadequate training and/or involvement of relevant stakeholders in the design and implementation phases.

There are a number of issues of particular importance in Russia and Central Asia as a result of the interest of policymakers in general practitioner fund holding, capitation, and case-based payments for hospitals. First, it is essential to define the package of services to be covered under either a general practitioner fund-holding or full-capitation approach. Second, it is important to set the average payment at a level that covers the costs of providing that set of services efficiently. Third, it is important for the capitation rate to be risk-adjusted so that health-care providers will accept sicker patients. The difficulties of doing this should not be underestimated, as there is ample evidence from the United States of insurers and managed-care organizations accepting only healthier patients, leaving the sicker and more costly cases to the public sector (Hadley and Langwell, 1991; Miller and Luft, 1994). Fourth, access, quality, costs, and referrals to other provider levels must be carefully monitored. To work as planned, these systems will require major restructuring and retraining/reorganization of physicians so that cases can be appropriately treated at lower, less costly, ambulatory levels of the system, which currently lack the diagnostic capacity, supplies, and equipment to function in this manner.

The design of provider payment systems is one of the keys to efficiency and long-run financial sustainability. It is also one of the most complex areas of reform in Russia and Central Asia, as these reforms must be accompanied by appropriate management information and quality assurance systems, as well as training of managers at all levels of the system. On the other hand, even simple changes, such as providing facility managers with global instead of line item budgets and eliminating outmoded staffing norms, would result in efficiency improvements. Delaying reforms in this area because of a lack of financing is a shortsighted response. Without reform, both rich and poor countries will continue to get poor value for the money expended.

## Delivery System Reforms

There is a recognized need in Russia and Central Asia for restructuring service delivery systems, reducing and retraining health staff, adopting modern medical treatment protocols, better targeting public and environmental health programs, and rationalizing the pharmaceutical sector. Reductions of beds are taking place as a matter of economic necessity. However, it is necessary to develop a strategic approach to hospital rationalization. Such an approach would address, among other things, the need to reduce the excessive specialization and duplication in the hospital system; to promote outpatient care by developing the necessary diagnostic and treatment capacity, including ambulatory surgery centers; and to ensure adequate supplies and pharmaceuticals. There is also a need to retrain physicians in general and family practice, while increasing the ratio of nurses to physicians (Hensher, 1996). Russia is expending considerable effort to train physicians in the “new” specialties of general and family practice. Making providers autonomous entities is a first step in this direction. Several Russian oblasts and the Kyrgyz Republic are actively moving ahead to restructure their delivery systems, assisted by World Bank projects. Provider payment systems being implemented in Russia, the Kyrgyz Republic, and Kazakstan provide the financial incentives to reinforce delivery system changes. Whether governments will be able to take the difficult step of eliminating surplus employees, given the economic climate, remains to be seen.

In the area of basic health services, all the countries recognize the need to adopt new treatment protocols, which in many cases reflect ambulatory-based treatment regimens and shorter lengths of hospitalization. Burden-of-disease/cost-effectiveness studies show that the Central Asian countries have a high disease burden both from pre-epidemiological transition diseases affecting women and children and from noncommunicable diseases such as cancer, heart disease, and stroke. A significant part of this disease burden is attributable to social factors such as diet, smoking, alcohol abuse, and violence. Better public and environmental health programs, as well as the availability of appropriate equipment and supplies at the primary-care/feldsher levels targeted at acute respiratory infections and diarrheal diseases, could have a cost-effective impact on improving the health status of mothers and children. Similarly, adult prevention programs focused on lifestyles and substance abuse could help reduce current and future costs associated with treating chronic conditions. This is especially important in Russia and Central Asia given recent declines in life expectancy.

Quality of care could also be significantly improved by adopting modern quality assurance systems rather than the current systems, which rely on sanctions. The former systems are necessary concomitants of provider payment changes and have accompanied the provider payment reforms currently being developed and implemented in Russia, the Kyrgyz Republic, and Kazakstan.

Another area of importance is the development of policymaking and management capacity at the national and local levels and of necessary data for decision making, both economic and epidemiological. Effective and integrated management structures at the central, regional, local, and individual facility levels are essential. As the health systems undergo reform, it is essential to ensure that the data needed for management of the system are collected and transmitted to appropriate decision makers at all levels, including consumers.

It is important as well that national governments not abrogate their public health, staff training, environmental health, and quality assurance functions as the transition to insurance-based and decentralized systems pervades the reforms in these countries. All these countries need to develop national health accounts so they will know the total level of resources committed to the health sector by source of payment and type of service. Russia is currently in the process of developing such accounts under a World Bank project.

The pharmaceutical sector is also a major area for reform in all six countries. Many of the problems with pharmaceutical production, management, distribution, and pricing stem from inherent structural weaknesses of the old planned production and distribution system, as well as the disruptions associated with the transition to a market economy. As a low-priority sector under Soviet planning norms, the pharmaceutical industry was subject to low overall investment, capacity, technology, and quality. There were little advanced Western production technology and very limited investment in research, and no plants met international Good Manufacturing Practice (GMP) quality standards. Distribution was through a state monopoly, and there was little relationship between production and demand. Moreover, the integrated production structure of the Eastern Bloc led to a focus on heavy industrial investment in Russia, while much of the light industry that produced the final pharmaceutical products was located in other Soviet republics and Eastern Europe. This production and distribution chain was severely disrupted by the breakup, and the prices of raw materials and finished products have escalated. Similarly, there were major problems in the management of pharmaceuticals, including essential drug lists and treatment protocols for the rational use of drugs.

Each of the governments in Russia and Central Asia is seeking ways to reduce budgetary expenditures on pharmaceuticals. Privatization of the pharmaceutical sector and the consequent diversification of sources of financing may allow financial responsibility to shift from state budgets to households by enabling better-off patients to buy pharmaceuticals privately. The resulting savings are likely to be relatively small, however, given the very modest purchasing power of most of the population at present. Reducing costs by increasing efficiency in the sector will depend on several interrelated reforms that face governments around the world, including (1) defining a list of essential drugs; (2) training physicians, pharmacists, and consumers in the rational use of drugs; (3) shifting from brand-name to generic drugs; (4) improving procurement methods (e.g., international competitive bidding) and drug management; and (5) developing sound pharmaceutical pricing policies (e.g., competition policy). Further thought should also be given to redefining the population groups that receive subsidies for drug purchases.

## CONCLUSION

The challenge to Russia and the Central Asian countries is to improve the health status of their populations at a time of economic decline while maintaining the strengths of the old system in terms of equity and access. Countries need to maximize the efficiency and effectiveness of their systems, subject to the limited funding available. Since 1990, six countries have faced major economic declines, and they cannot afford the extensive and inefficient systems of the past. Doing more with less is the name of the game in the short run.

Perhaps most important in terms of direct improvements in health status is the need to restructure current public health activities. This includes maternal and child health programs, family planning, school health, occupational health, environmental health, adult health promotion and disease prevention, substance abuse, and road safety. Given serious overall fiscal pressures in the short term, additional resources to foster these efforts can be obtained only by making efficiency improvements in the current system and formalizing the current official and unofficial systems of user charges. Efficiency improvements can be achieved by restructuring the inefficient health delivery systems, which still have too many staff and too many beds, as well as providing financial incentives for consumers and providers to behave efficiently and introducing modern management and quality assurance systems. The current system of official and unofficial "user charges" should be formalized so the additional revenues will flow to responsible health authorities and can be used for appropriate priority health activities. Such formal user charges should be designed to provide incentives for consumers to use services efficiently while at the same time exempting vulnerable populations, such as the poor, from excessive out-of-pocket payments.

Major reforms are also needed in staff training and medical education. Norms of all kinds—clinical treatment protocols, facility structural characteristics, and staffing—must be eliminated or modernized both to improve health outcomes and to enable facility managers to manage their facilities efficiently. Pharmaceutical sectors need to be reformed in terms of procurement, distribution, management, pricing, rational use of drugs, quality, essential drug lists, and generic substitution. Policymakers will need to address all these difficult issues as the health-care systems in these countries adjust to changing needs and economic realities. Effective reforms now will provide the basis for improved health status, adjustment to the epidemiological transition, improved quality and consumer satisfaction, and long-run financial sustainability.

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# 13

# Vulnerable Populations in Central Europe

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## INTRODUCTION

This chapter examines economic changes at the household level in Central Europe during the economic transition. Between 1988 and 1993, the gross domestic product (GDP) per capita in the Czech Republic, Hungary, and Poland fell 20, 15, and 12 percent, respectively. Real income change as measured by household budget surveys dropped 10, 24, and 18 percent, respectively (Milanovic, 1996b). These changes made some households much more economically vulnerable than they had been in the past, while others became less vulnerable.

The countries examined are the Czech Republic, Hungary, and Poland. National household surveys from each country have been standardized to facilitate comparisons over time and across countries. The chapter addresses the changes in relative poverty and income inequality in the five year period. It also focusses on the vulnerable populations (e.g., the young, pensioners, women, and rural populations) who were disproportionately affected during the earliest phase of the transition.

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## HOUSEHOLD INCOME DATA

The analysis in this chapter is based on household survey data collected in the Czech Republic, Hungary, and Poland between 1987 and 1992 and on the analyses of these data performed by Vecernik et al. (1995), Sik et al. (1995), and Gorecki et al. (1995). This section reviews these data sources and describes the Luxembourg Income Study database, which has standardized many of these data sets and made them comparable both among themselves and with those of other Organization for Economic Cooperation and Development (OECD) countries.

### Central European Household Surveys

The Central European countries have a long tradition of using large, detailed household surveys to collect a broad range of demographic, income, and consumption data similar to those collected in Western European and U.S. surveys. The availability of survey data from 1987 and 1988 provides a baseline from which to measure subsequent change. Each survey is a nationally representative sample with a large sample size and detailed questions pertaining to household characteristics (Garner et al., 1991). The following surveys are used in this chapter:

- The Czechoslovak Microcensus (1988) and the Czech Republic Microcensus (1992)
- The Hungarian Household Panel Survey (1992, 1993, 1994) and the Hungarian Household Income Survey (1983, 1987)
- The Polish Household Budget Survey (1987, 1990, 1992)

Selected characteristics of each survey are presented in Annex Table 13-1.

### Luxembourg Income Study

The Luxembourg Income Study has standardized the income variables and demographic definitions used in the most recent of the Central European surveys so that comparisons among countries can be made. Disposable income is the income concept used for comparison. This concept includes government benefits net of taxes. The Central European surveys collected data on a number of different sources of income, such as earned income and public and private transfers.

Households are characterized not only by the age and gender of the household head, but also by size. Household income is adjusted for the size of the household, using an equivalence scale similar to that used by the OECD in its most recent publications (e.g., Förster, 1993). Using this scale instead of employing straight per capita income adjustments significantly affects evaluations of household welfare in countries where families have many children. These effects are discussed in more detail in the following section on poverty estimates.

Despite the standardization of the Central European household surveys by the Luxembourg Income Study, biases remain in each survey. The sample population in each is the noninstitutionalized population. However, the Czech and Hungarian surveys exclude the military and police, while the Polish survey excludes the nonagricultural self-employed, who are a small but growing population.

Another source of bias is the growing nonresponse rate of households that are surveyed. Under communist governments, the nonresponse rates were generally under 10 percent. Currently, the rate is increasing and is between 15 and 30 percent without sophisticated sampling of the nonresponding households; however, the effect of the bias is unknown. The most important bias in the surveys is likely to be the uneven inclusion of incomes from the informal economy. Estimates of the size and distribution of informal income in Hungary and the bias thereby introduced are discussed later in the section on income distribution.

The strong statistical tradition in Central Europe provides some confidence that the current household survey data can be useful despite the above biases. But because the net effect of the various biases is unknown, the income given here should be interpreted with caution. The statistical offices collecting the data are aware of the increasing biases in their data and will be addressing the problem for future surveys.

## DID LEVELS OF RELATIVE POVERTY INCREASE DURING THE INITIAL PERIOD OF ECONOMIC TRANSITION?

Before 1989, each Central European country had its own nationally defined minimum income level, which changed over time relative to the average income within each country. Also, the definition of "minimum income" differed among the countries, so that their "national poverty rates" were incomparable. To make more accurate comparisons of relative poverty over time and across countries, this chapter uses a consistent definition of poverty to measure both trends within countries and relative levels of poverty among them.

The definition we use is the common European Union and OECD definition: persons in households with incomes less than 50 percent of adjusted median income. A relative rather than an absolute definition of poverty is used because of the impracticality of translating different currencies into a single absolute standard over time. Purchasing power parities are used to convert currencies to a single standard. But the results are not consistent from one time period to another. Therefore, in examining income trends over time, a relative measure of poverty provides the best consistent definition and a readily understandable concept.

The equivalence scale used is 1.0 for the first adult, .66 for additional adults, and .33 for each child. Adjusted (or equivalent) income (*EI*) is defined as disposable income (*DPI*) divided by family size (*S*), raised to an exponent (*E*) to capture economies of scale ($EI = DPI/S^E$). An *E*-value of .60 is similar to the values used in recent OECD studies of .55 (Förster, 1993) and .50 (Atkinson et al., 1995). It should be noted that estimates of appropriate economies of scale vary by country and lifestyle. In Central Europe, where housing and energy costs are still relatively low, the economies of scale of several people living together are closer to 1 (or per capita) than in countries where housing and energy are more expensive. While there is no single "right" estimate for economies of scale, it is an important value judgment in estimating relative poverty. For comparison, we also use household incomes unadjusted for size.

Prior to 1989, only a small percentage of the population in these three Central European countries fell below 50 percent of median income or the poverty line. While the percentage of persons classified as poor on the basis of our measure of equivalent income increased from the mid-1980s to the early 1990s in all three countries, this percentage remained quite small by international standards in 1992 (Table 13-1, column 1, figures for all persons, equivalent income) and closely approximated relative income poverty rates in the European Community (e.g., Gottschalk and Smeeding, 1995).

Far more people have between 50 and 75 percent of equivalent median income than fall below 50 percent (Table 13-1, column 2). While the percentage of people falling below 75 percent of adjusted median income (column 3) was much higher than the percentage falling below 50 percent, the change in the percentage of people falling below the 75 percent level in all three countries was very small between the 1980s and the 1990s. There were only modest increases in Hungary and Czechoslovakia, there was no change in the territory that became the Czech Republic, and there was only a slight increase in Poland between 1987 and 1992. Relative measures were quite stable given the declines in the macro economy.

The percentage of households with household income falling below 50 percent of unadjusted median income decreased in the Czech Republic and Poland and remained constant in Hungary (Table 13-1, column 1). If we use 75 percent of unadjusted median income level as our poverty line, we find that the percentage of households classified as poor remained constant in Hungary and fell in the Czech Republic and Poland (albeit by a small amount). In all three countries, the rate of relative poverty was consistently higher at the household than at the individual level, partly because the poor households are disproportionately small and therefore have fewer income earners. Household units appear to have absorbed the economic shocks of the transition better than individuals as measured by the change in relative poverty rates. Changes in household composition were very small, and therefore are unlikely to explain the differences between the changes in individual and household poverty rates.

In summary, the relative poverty rates in all three countries increased for individuals whose income fell below 50 percent of the median equivalent income and increased by a smaller percentage if poverty is defined as those receiving less than 75 percent of median income. On an unadjusted basis, relative household poverty rates in the three countries decreased or remained stable over the period.

## DID INCOME INEQUALITY INCREASE SIGNIFICANTLY DURING THE TRANSITION?

Before 1989, there was generally less per capita income inequality in Central Europe than in Western countries (Atkinson and Mickelwright, 1992). And as in Western countries, the Gini coefficients for person-weighted equivalent income distributions were consistently lower than those based on unadjusted household income. Prior to 1989, income inequality among individuals was the smallest in Czechoslovakia among the three countries. Poland ranked next in the late 1980s (Table 13-2).

Per capita income inequality increased during the early phase of the economic transition by 10 percent in the Czech Republic (1988 to 1992) and by 12 percent in Poland (1987 to 1992) as measured by the Gini coefficient (Table 13-2). Income inequality measured in terms of households increased by 11 percent in the Czech Republic, but it remained remarkably stable in Poland over this period. In Poland, the household Gini coefficient jumped in 1990, the year in which real GDP declined 12 percent, but 2 years later it had returned nearly to the pretransition level.

The Atkinson measure of income inequality allows comparison of distributional preferences. In this measure, the parameter $e$ represents the weight attached by society to inequality in the income distribution. This parameter ranges from zero, or indifference, to infinity, where society is concerned only with the relative position of the lowest-income group (Atkinson, 1975). The value of the Atkinson measure can be interpreted as the proportion of total income that would be required to achieve the current level of social welfare if all incomes were equally distributed. The lower the Atkinson value, the greater the welfare of those in the lowest-income groups.

We have selected Atkinson measures with $e = 1$ and $e = 2$, the latter giving greater weight to changes in the income distribution among those with the lowest incomes. Because the Atkinson measure is more responsive to changes in the lower tail of the distribution than is the Gini coefficient, disproportionate increases in the former measure would mean that the poor have suffered

TABLE 13-1 Distribution of All Households and Persons into Brackets Defined by Percentage of Median Income

| Median Income | 0-50% (1) | 50-75% (2) | 0-75% (3=1+2) | 75-100% (4) | 100-125% (5) | 125-150% (6) | 75-150% (7=4+5+6) | 150-200% (8) | 200% and More (9) | All (10) |
|---|---|---|---|---|---|---|---|---|---|---|
| **Czechoslovakia 1980, 1988, 1991[a] and the Czech Republic 1988, 1992** | | | | | | | | | | |
| All Households, Unadjusted Income | | | | | | | | | | |
| Czechoslovakia | | | | | | | | | | |
| 1980 | 21.2 | 13.2 | 34.4 | 15.7 | 19.9 | 15.2 | 50.8 | 11.7 | 3.1 | 100 |
| 1988 | 19.8 | 14.6 | 34.4 | 15.7 | 19.8 | 15.3 | 50.8 | 11.9 | 3.0 | 100 |
| 1991 | 12.3 | 14.2 | 26.5 | 27.4 | 15.8 | 9.3 | 52.5 | 9.8 | 11.1 | 100 |
| Czech Republic | | | | | | | | | | |
| 1988 | 19.7 | 15.0 | 34.7 | 15.3 | 19.4 | 15.5 | 50.2 | 12.3 | 2.8 | 100 |
| 1992 | 16.7 | 13.8 | 30.5 | 19.5 | 16.5 | 13.6 | 49.6 | 13.4 | 6.4 | 100 |
| All Persons, Equivalent Income[b] | | | | | | | | | | |
| Czechoslovakia | | | | | | | | | | |
| 1980 | 5.4 | 13.4 | 18.8 | 31.1 | 31.1 | 13.0 | 75.2 | 5.4 | 0.6 | 100 |
| 1988 | 3.5 | 14.3 | 17.8 | 32.2 | 31.2 | 13.1 | 76.5 | 5.2 | 0.5 | 100 |
| 1991 | 5.7 | 17.5 | 23.2 | 29.9 | 17.3 | 10.3 | 57.5 | 9.7 | 9.6 | 100 |
| Czech Republic | | | | | | | | | | |
| 1988 | 3.1 | 13.3 | 16.4 | 29.9 | 31.9 | 14.8 | 76.6 | 6.3 | 0.7 | 100 |
| 1992 | 6.9 | 9.5 | 16.4 | 17.7 | 19.3 | 17.9 | 54.9 | 19.1 | 9.7 | 100 |

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Hungary 1987, 1992[a]** | | | | | | | | | | |
| All Households, Unadjusted Income | | | | | | | | | | |
| 1987 | 17.7 | 15.9 | 33.6 | 16.4 | 15.2 | 11.3 | 42.9 | 12.9 | 10.6 | 100 |
| 1992 | 17.9 | 14.5 | 32.4 | 16.7 | 13.9 | 10.4 | 41.0 | 13.3 | 12.4 | 100 |
| All Persons, Equivalent Income[b] | | | | | | | | | | |
| 1987 | 3.6 | 18.4 | 22.0 | 28.0 | 20.3 | 11.3 | 59.6 | 10.9 | 7.5 | 100 |
| 1992 | 7.8 | 19.8 | 27.6 | 22.4 | 19.1 | 11.2 | 52.7 | 11.0 | 8.6 | 100 |
| **Poland 1987, 1990, 1992** | | | | | | | | | | |
| All Households, Unadjusted Income | | | | | | | | | | |
| 1987 | 17.5 | 16.3 | 33.8 | 16.2 | 16.4 | 13.7 | 46.3 | 14.2 | 5.8 | 100 |
| 1990 | 17.3 | 16.7 | 34.0 | 15.9 | 14.8 | 12.0 | 42.7 | 14.1 | 9.1 | 100 |
| 1992 | 15.2 | 16.3 | 31.5 | 18.5 | 16.2 | 11.8 | 46.5 | 14.2 | 7.9 | 100 |
| All Persons, Equivalent Income[b] | | | | | | | | | | |
| 1987 | 4.3 | 20.2 | 24.5 | 25.5 | 21.8 | 13.9 | 61.2 | 11.2 | 3.1 | 100 |
| 1990 | 5.9 | 20.2 | 26.1 | 23.9 | 19.8 | 13.4 | 57.1 | 11.6 | 5.2 | 100 |
| 1992 | 6.3 | 19.0 | 25.3 | 24.7 | 20.2 | 13.4 | 58.3 | 11.3 | 5.2 | 100 |

[a]The 1991 Czechoslovakian and 1987 Hungarian surveys differ from the 1980 and 1988 Czechoslovakian and 1992 Hungarian surveys. Thus, trends should be interpreted with caution.

[b]Uses 1.00, .66, .33 equivalence scale and person weights.

SOURCES: Czechoslovakia: 1980, 1988 Microcensus; 1991 Survey of Economic Expectations and Attitudes, Institute of Sociology. Czech Republic: 1988, 1992 Microcensus. Hungary: 1987 Household Income Survey; 1992 Hungarian Household Panel Survey. Poland: 1987, 1990, 1992 Household Budget Survey.

TABLE 13-2 Comparisons of Gini and Atkinson Measures of Income Inequality for Households (Unadjusted Income) and for Persons (Equivalent Income)[a]

| Country and Year | Gini Coefficient | | Atkinson Measure | | | |
|---|---|---|---|---|---|---|
| | Household | Person[a] | Household $e = 1$[b] | Household $e = 2$ | Person[a] $e = 1$ | Person[a] $e = 2$ |
| Czechoslovakia | | | | | | |
| 1980 | .278 | .168 | .145 | .314 | .048 | .102 |
| 1988 | .290 | .158 | .134 | .284 | .041 | .086 |
| Czech Republic | | | | | | |
| 1988 | .291 | .192 | .150 | .310 | .061 | .131 |
| 1992 | .320 | .210 | .161 | .312 | .078 | .140 |
| Hungary | | | | | | |
| 1989 | .312 | .237 | n.a. | n.a. | n.a. | n.a. |
| 1992 | .361 | .295 | n.a. | n.a. | n.a. | n.a. |
| Poland | | | | | | |
| 1987 | .294 | .217 | .144 | .290 | .074 | .145 |
| 1990 | .325 | .248 | .170 | .327 | .101 | .186 |
| 1992 | .299 | .243 | .147 | .284 | .095 | .177 |

[a]Uses 1.00, .66, .33 equivalence scale and person weights.

[b]The parameter $e$ represents the weight attached by society to inequality in the income distribution (see text).

n.a. = not available

SOURCES: Czechoslovakia: 1980, 1988 Microcensus; Czech Republic: 1992 Microcensus. Hungary: 1987 Hungarian Income Survey; 1992 Hungarian Household Panel Survey. Poland: 1987, 1990, 1992 Household Budget Survey.

the largest changes in inequality. However, changes in the Atkinson measure for the Czech Republic and Poland mirror the changes noted above in the Gini coefficient, thus assuring us that changes in the income of the lower-income groups do not differ greatly from those observed among the rest of the population.

The increase in income inequality observed during the first phase of the transition was accompanied by a decrease in the percentage of people in the middle-income classes (75-150 percent of median equivalent income) (Table 13-1, column 7). Between 1988 and 1992, the decrease was largest in the Czech Republic, from 76.6 to 54.9 percent, followed by Hungary, from 59.6 to 52.7 percent. The change in the percentage of persons in these groups was lowest in Poland, dropping from 61 to 58 percent. The large decline in the middle-income groups in the Czech Republic is correlated with increases in higher-income groups (Table 13-1, columns 8 and 9); in Hungary and Poland, increases in higher- and lower-income groups are correlated with declines in the middle-income groups.

While individual income distribution changed considerably, household income distribution did not. The change in the fraction of households in the 75 to 150 percent range was negligible in both the Czech Republic and Poland and very small in Hungary.

Estimates for the most recent year available in the Luxembourg Income Study suggest that the level of current income inequality for individuals in the Czech Republic is most similar to that found in the Scandinavian economies, while levels in Hungary and Poland are most similar to those in Canada, Australia, and the United Kingdom.

It should be noted that, as mentioned earlier, a potential source of bias in our estimates of poverty and income distribution is the underreporting of the informal economy in each country. Every communist Central European country had an unreported "second economy." Estimates of the size and distribution of this second economy suggest that it represented approximately 10 percent of national income, a level similar to that found in Italy. While every income decile received some unreported income, Hungarian analysts have suggested that it went disproportionately to those in the upper-income classes in that country (Eleto and Vita, 1989). Since the collapse of the communist economies, the second economy has been replaced by a range of unreported, informal economic activities. Endre Sik (1994, 1995), a noted Hungarian researcher, estimates the size of these activities in Hungary as a percentage of GDP to be larger (12 to 33 percent of the formal economy) than that of the second economy under communism. The current informal economy is also estimated to provide income to a broader distribution of income groups than did the previous second economy. Sik estimates that those in the lowest quintile receive about 20 percent of the total income generated by the unreported, informal economy, while the highest quintile receives approximately 50 percent; the remainder, approximately 30 percent, is distributed among the other three quintiles (Sik, 1994, 1995).

Table 13-3 shows how the inclusion of income from the unreported, informal economy might have affected the 1992 reported Hungarian income distribution. We assume that the informal economy not reported in the household surveys represented 15 percent of total disposable income. That amount of income was then distributed among income quintiles in accordance with Sik's estimated distribution.

Persons were ranked by deciles of equivalent disposable income. The incomes of those in the bottom two deciles were increased proportionately by 3 percent (20 percent of the informal economy, which was assumed to be 15 percent of total disposable income). On the same basis, the top two deciles received 50 percent of the income from the informal economy, which increased their incomes 7.5 percent. The remaining 30 percent of the informal economy, 4.5 percent of current disposable income, was added proportionately to the incomes of the middle 60 percent of the population. This exercise was repeated for the theoretical case of the informal economy's being 25

TABLE 13-3 Simulated Effects of the Informal Economy on Hungarian Incomes[a] in 1992

| | | Atkinson | | Decile Points[b] | | |
|---|---|---|---|---|---|---|
| Estimate | Gini | $e = 1$[c] | $e = 2$ | $P_{10}$ | $P_{90}$ | Decile Ratio[d] |
| Reported equivalent disposable income[a] | .282 | .133 | .272 | 54.4 | 182.6 | 3.37 |
| Simulated equivalent disposable income from informal economy = 15 percent[e] | .276 | .118 | .210 | 65.8 | 207.5 | 3.15 |
| Simulated equivalent disposable income from informal economy = 25 percent[f] | .274 | .115 | .196 | 72.5 | 222.0 | 3.06 |

[a]All income measures use 1.00, .67, .33 equivalence scale and person weights.

[b]The decile points are the ratio of the 10th percentile person's income to the median ($P_{10}$), multiplied by 100, and the 90th percentile person's income ($P_{90}$) to the median, multiplied by 100.

[c]The parameter *e* represents the weight attached by society to inequality in the income distribution (see text).

[d]The decile ratio is the ratio of $P_{90}$ to $P_{10}$.

[e]Assumes income from the informal economy is 15 percent of total disposable income; see text for simulation details.

[f]Assumes income from the informal economy is 25 percent of total disposable income; see text for simulation details.

percent of total disposable income, using the same distribution, but higher values. Persons were then reranked (e.g., a person at the 19th percentile of disposable income could have received a sufficiently high fraction of the informal economy to "pass" a person at the 21st percentile), and the Gini and Atkinson measures were recomputed. We also calculated the percentile points of the distribution (incomes at the 10th and 90th percentiles as a percentage of median income) and the decile ratio (the ratio of the 90th to the 10th percentile income) (Table 13-3).

When these estimates of the informal economy were added to the reported survey estimates, the lowest-decile income ratio, the $P_{10}$ ratio, rose from 54.4 to 72.5 (a 33 percent increase). But the highest-decile ratio, the $P_{90}$ ratio, also rose, from 182.6 to 222.0 (a 22 percent increase). Thus, both the bottom and the top of the Hungarian distribution improved their positions compared with the middle-income groups, while the Gini coefficient changed hardly at all.

Estimates of the distribution of informal income among income quintiles do not yet exist for other Central European countries. These illustrative estimates on the Hungarian income distribution suggest that if the distribution of informal income for the latter countries is similar, the reported income on their household surveys may be underestimating the total incomes of both the lowest- and highest-income quintiles.

## WERE VULNERABLE POPULATIONS DISPROPORTIONATELY AFFECTED DURING THE EARLIEST PHASE OF THE TRANSITION?

Vulnerable populations tend to be those with fewer labor market skills or less mobility, such as children, the elderly, women, and those in single-parent families. A comparison of income adjusted for household size shows that in all three countries, children lived in households that had approximately the median income (Table 13-4, column 9), while the elderly received only 72 to 77 percent of the median (Table 13-4, column 10). When the income status of these two groups during the early years of the transition is compared, it becomes evident that the economic status of children improved in Hungary and stayed about the same in Poland and the Czech Republic. The relative income status of the elderly also improved relative to the median in both Poland and the Czech Republic, where pensions were explicitly adjusted to protect them from hyperinflation in the first phase of the transition. This resulted in an improvement in the incomes of pensioners relative to those in other groups, including children, whose real incomes fell with the real wages of their households' wage earners.

The attempt to measure the income of vulnerable populations is particularly sensitive to the equivalence scales used to adjust for family size. The former communist countries used a per capita equivalence scale that ignored the economies of scale of the household as an economic unit. The per capita equivalence scale tended to overadjust for the presence of children in the family, thereby making households with children appear poorer than they would have if the equivalence scale described here had been used. The Central European countries that employ per capita income scales estimate large rates of poverty, especially among children, while those using equivalence scales, such as the ones used here, estimate lower poverty rates, particularly among children (Szulc, 1995).

Single-parent families constitute the only vulnerable household group that does not include aged members. This group is less well off than almost any other household type, with the possible exception of single women living alone in Western countries (Rainwater and Smeeding, 1995). In contrast with Western countries, however, single-parent families comprise only 3 to 4 percent of all households in the three countries under analysis here. In Central Europe, very few single-parent families live in separate households. They are much more likely to be found in extended families that are counted as "other households with children," particularly in rural areas. These "other" house-

TABLE 13-4 Ratio of Group Median Equivalent Income to National Median

| | Czech Republic | | | Hungary | | | Poland | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Income Ratio[a] | | Change in Ratio | Income Ratio[a] | | Change in Ratio | Income Ratio[a] | | | Change in Ratio |
| Household Type | 1988 | 1992 | 1988-1992 | 1987 | 1992 | 1987-1992 | 1987 | 1990 | 1992 | 1987-1992 |
| Households with Head Under Age 60 | | | | | | | | | | |
| One-person household | 1.05 | 0.98 | –7 | 1.08 | 0.87 | –21 | 0.96 | 0.95 | 1.17 | 22 |
| Couples without children | 1.22 | 1.13 | –9 | 1.18 | 0.94 | –24 | 1.22 | 1.15 | 1.32 | 17 |
| Couples with children | 1.01 | 1.03 | 2 | 1.06 | 1.25 | 19 | 0.99 | 0.96 | 1.01 | 5 |
| One-parent families | 0.86 | 0.88 | 2 | * | * | * | 0.77 | 0.80 | 0.85 | 5 |
| Other households with children | 1.08 | 1.03 | –5 | 0.98 | 1.00 | 2 | n.a. | n.a. | 0.92 | n.a. |
| Other households without children | 1.16 | 1.12 | –4 | 1.08 | 0.91 | –17 | 1.17 | 1.16 | 1.10 | –6 |
| Households with Head over Age 60 | | | | | | | | | | |
| One-person household | 0.58 | 0.75 | 17 | 0.72 | 0.60 | –12 | 0.72[b] | 0.72[b] | 0.88[b] | 16 |
| Two-person household | 0.80 | 0.87 | 7 | n.a. | 0.75 | n.a. | | | | |
| Other | 1.03 | 0.98 | –5 | 0.79 | 0.85 | 6 | 0.79 | 0.94 | 0.89 | –5 |
| Individuals | | | | | | | | | | |
| Children under 18 | 0.98 | 1.01 | 3 | 1.00 | 1.18 | 18 | 0.98[c] | 0.99[c] | 0.94 | –4 |
| Elderly over 60 | 0.72 | 0.85 | 13 | 0.81 | 0.74 | –7 | 0.77 | 0.75 | 0.94 | 17 |

[a]Ratio of median equivalent income of group to national median equivalent income.
[b]Polish estimates are for one- or two-person households with a head age 60 or over.
[c]Children were defined as 16 and under in Poland in 1987 and 1990.
* = Too few in sample.
n.a. = not available
SOURCE: Data from Luxembourg Income Study.

holds comprise 13 percent of all households in the Czech Republic and Poland and 20 percent in Hungary.

The income status of other household types relative to the national median income changed very little in the Czech Republic during this period (Table 13-4). In Hungary, the relative income of households without children declined, while in Poland it improved. No obvious pattern of vulnerability among different household types is evident across the countries. In fact, the more disaggregated the data become, the more unique the household transition in each country appears.

Because women receive lower wages than men in both Western and Central Europe, they are also considered more vulnerable than male workers during economic transitions. Registered unemployment rates are higher for women than for men in the Czech Republic and Poland, but they are lower in Hungary (Employment Observatory, 1994). In all three countries, labor force participation rates for both men and women have fallen, but further for women than for men. Elderly women in single-person households are perhaps the most vulnerable group, receiving only approximately two-thirds the income of their male peers. But these households constitute only approximately 4 percent of the households in the three countries.

Living together continues both as a result of tradition (predominantly in rural areas) and out of necessity (single mothers, older women), but it does not appear to be increasing. Because of the slow deregulation of utility prices and the abandonment of rights to flats by previous “state” owners, housing costs have remained at reasonable levels in these countries, not rising above 15 to 20 percent of total expenses (Struyk, 1995).

It is also clear that urban populations are experiencing a relative income advantage during the current transition. The most recent survey data indicate that in all three countries, the income status of both the young and the old was in most cases better in the capital city and the region surrounding it than outside the capital region. The variance in income between the capital region and all other regions was at its lowest level in the Czech Republic (no difference for children and 11 percent higher in the capital for the elderly) and at its highest between Budapest and Eastern Hungary (36 percent larger for children and 26 percent larger for the elderly in the capital). Regional differences in Poland were less severe than those in Hungary (26 percent higher for children and 17 percent higher for the elderly in Warsaw compared with the South Eastern Region). One reason for this differential between urban and rural areas is consistently lower unemployment rates in the capital city than in the country as a whole (Milanovic, 1996a).

In fact, one of the outcomes of the initial period of economic transition has been a decline in the importance of demographic variables (such as age and gender) as explanatory variables in income distribution. Education and financial capital are increasingly important in explaining earnings and income differentials (Vecernik, 1994). Under the communist economies, wage income was strongly correlated with age and household size (because of policies related to equal wages per worker and very high labor force participation rates) and only weakly related to education. But with the breakdown of the command economy, a much higher premium has been placed on secondary and university education and on the ownership of capital.

Between 1989 and 1993, food and housing costs rose slightly as a share of total expenditures in Central Europe. In Poland, however, other real consumption increases suggest that the substantial import liberalization had the desired effect of lowering the dollar costs of consumer durables. Since 1989, consumption of consumer durable goods has increased in every country, and in some instances these changes have been far from trivial (Gorecki et al., 1995). In Poland, the percentage of households owning cars has increased by one-third or more. While many of the cars are second-hand, they still represent a substantial purchase. The number of Polish worker households with video cassette recorders has also increased substantially, from almost nil in 1989 to over 50 percent of households with nonfarm workers by 1992. Similar increases can be noted among Polish mixed (farmer-worker) households, and to a lesser extent among farmer households. Much of the same pattern emerges in Slovakia, with most of the changes occurring between 1991 and 1994 (Bednarik et al., 1995).

Although smaller consumption increases were seen in the Czech Republic and Hungary between 1989 and 1991, the consumption of nearly all consumer durables increased there as well (Vecernik et al., 1995; Sik et al., 1995). Central European consumers also increased their purchases of other luxury durables, such as color rather than black-and-white televisions, during the transition.

In Hungary, the number of consumer durables purchased by households without members in the labor force (a group dominated by pensioners) actually increased over the period. With the increases in their real benefit levels, Polish and Slovak pensioners were also able to increase substantially their consumption of cars, washing machines, and freezers. Czech consumption data, when disaggregated by income, show that while those in the lowest-income population groups consumed less than the average in the country (especially families with children), pensioner households tended to increase their consumption of non-necessities, such as leisure goods (Garner, 1995). Thus, even the most vulnerable populations have found the means to take advantage of the increased availability of consumer goods since the transition began.

## DISCUSSION

The above analyses suggest that as the national economies of the Czech Republic, Hungary, and Poland declined, the poverty rate and income inequality of individuals increased. The changes in the relative income of two vulnerable groups, the young and the old, were mixed. There was improvement for both groups in the Czech Republic, improvement for children in Hungary, and improvement for the elderly in Poland. But given their considerable limitations, the data can only be suggestive of income changes; by themselves they cannot be used conclusively.

The sources of bias in the survey data have been mentioned above. The surveys exclude a small but important segment of the population—the institutionalized, the military, and the police. Since 1989, the surveys also have had an increasing nonresponse rate. The effect of this increasing trend on the data is not yet known. Most important, the full effect of the informal economy is not captured in any of the Central European surveys; as income from this economy grows, its exclusion from the surveys will become increasingly important. Without more research, the magnitude of these biases cannot be accurately estimated.

Adding to the known biases of the income survey data is the incompleteness of the concept of income for measuring welfare (van de Walle, 1996). While income is an important factor in welfare, other concepts, such as the measurement of time allocation, life expectancy, and the subjective sense of personal well-being, are very important. Private transfers of time and resources among social and family networks may also be very important in the transition period.

The governments of Central Europe need reliable household income data to help target social safety net transfers to the most vulnerable individuals and households. In both the Czech Republic and Poland, social safety net programs have been used explicitly to minimize the adverse effects of the economic transition on pensioners (Blanchard et al., 1994). The sustainability of current pension levels is, however, in doubt (Sachs, 1995). If social safety nets decline in the future, the need for reliable household income data to guide the allocation of shrinking resources will become even more important.

The Central European countries studied in this chapter have had a long tradition of taking sophisticated household income surveys. The economic transition, however, has made the quality and quantity of the data an issue. More work needs to be done to improve the quality of the data, and more resources will be needed to improve the quantity and timeliness of the surveys. Future research should also focus on the many indicators of well-being that are not captured by income measures, no matter how accurate they may be.

The current data raise a number of intriguing questions. For instance, how closely linked are the economic transitions of the macro, national economies and the micro household economies? What adjustments do households make to insulate themselves from major declines in the macro economies? Do households pool their resources, and if so, how does this happen? Are the same populations vulnerable at the beginning of economic decline and over the long term, or does vulnerability shift with the movement to a more market economy? Are there lessons from the economic transition among households in Central Europe that will eventually be applicable to households in other parts of the world? How good is income as an indicator of well-being during major economic transitions? The data in this chapter have raised more questions than they have answered, and therefore leave a substantial challenge for subsequent research.

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ANNEX TABLE 13-1 Selected Characteristics of Central and Eastern European Household Surveys

| Country | Czechoslovakia/Czech (CR) and Slovak (SR) Republics | Hungary | Hungary | Poland |
|---|---|---|---|---|
| Name of survey | Microcensus | Household Income Survey | Household Panel Survey | Household Budget Survey |
| Year of survey examined | 1980, 1984, 1988 Czechoslovakia; 1992 CR and SR, separately | 1983, 1987 | 1992 | 1987, 1990, 1992 |
| Frequency | every 3 to 5 years | every 5 years | annually | quarterly/annually |
| Household sample size | 102,637 Czechoslovakia; 15,677 CR; 15,221 SR | 14,790 | 2,059 | 10,800 |
| Population coverage | Noninstitutional population living in households; persons absent for longer than 6 months excluded in 1992 | Noninstitutional populations living in private households, including self-employed | All individuals with a noninstitutional address | Noninstitutional population, excluding nonfarm self-employed, police, military, Communist Party administration |
| Sample design | Two-stage stratified sample from the population census, stratified by size of locality and by number of flats within the census tract | Drawn from "uniform system of household surveys," a disproportionate random sample of 1980 census tracts | Four-stage stratification from 1990 census, with additional sub-sample for Budapest. | Two-stage, two-phase rotation sampling |

| | | | | |
|---|---|---|---|---|
| Reference person | Head of household, defined as male if complete family, parent if incomplete | Head of household | Head of household, defined as oldest active male; if no active members, head is oldest male | Head of household, defined as person whose income is major source of livelihood for household |
| Primary unit of collection | Economic/consumer household is observational unit, while address is sample unit; all households at address included in sample; persons are asked to declare whether they are members of a common household. | Economic/consumer household is observational unit, while address is sample unit; all households at address included in sample; households are all persons living together who share a common budget. | Economic/consumer household is observational unit, while address is sample unit; household is defined to be all persons living under the same roof, sharing income and expenditures. | Economic/consumer unit (identified as a household); if not a single person, then a group of persons living together who share a household budget. |
| Non-response rates | In 1993, nonresponse rate was 15.7 percent in CR, 7 percent in SR. | Total nonresponse rate was 3 percent. | Nonresponse rate was 17 percent. | Nonresponse rate was 30.9 percent of households selected to participate for the first time in 1992. |

# 14

# Pension Reform in the Post-Communist Transition Economies

*Louise Fox*

## INTRODUCTION

One of the main social and economic features of the transition in Central and Eastern Europe and the New Independent States has been a crisis in pension systems. The crisis is most acute in Central and Eastern Europe, where the demographic transition has proceeded more rapidly, and the dependency burden weighs more heavily on the working-age population. However, even in the younger countries, pension financing crises have erupted.

These crises have been economically, politically, and socially painful. From an economic perspective, high and often growing pension expenditures have frustrated stabilization efforts and crowded out other needed government expenditures, such as new social and economic infrastructure (Barbone and Marchetti, 1994). The payroll tax financing of these expenditures provides incentives for informalization of the labor force and lowers labor demand. Politically, the demands of pensioners (and soon-to-be pensioners)—that the government keep its entitlement promises—have proven very difficult to resist, despite the economic cost. Socially, the insecurity associated with declining pension payments for those who have already withdrawn from the labor force has been a major hardship, especially for the small minority of pensioners who have no other source of income or assets. At the same time, the burden of financing these payments has lowered real wages, probably contributing to the growing poverty of households with children (see also Ferge, in this volume).

Most analysts agree that the entitlements promised under the central planning system are not affordable in demographically mature countries. Nor are they desirable in market economies, since their purpose was to reduce labor supply and create dependency. From an economic perspective, there are a number of feasible options. The political and social dimensions of the reform are what has prevented countries from resolving the issues.

The future social safety net of the transition economies will need to be anchored by an old-age security system. Fixing the old-age security system involves, first and foremost, a strong effort to convince the population of the need for reform. This effort must be combined with plans for a new, economically viable system that is affordable and equitable and promotes growth. Experience from other countries, both members of the Organization for Economic Cooperation and Development (OECD) and middle-income countries in other parts of the world, indicates that a successful pension system will have more than one pillar, with a significant role for privately managed savings and insurance programs (see also Kornai, in this volume). For the post-communist states of Central and Eastern Europe and the New Independent States, this means scaling back the public system while building up the funded, privately managed one to take the pressure off the pay-as-you-go system.

As in other key areas of the transition, innovation and risk taking will be necessary. The new Latvian system is an example of just such action. It involves a whole new approach to providing pensions in the public system, while adopting some of the successful features of recent Latin American reformers in building a funded system. Three features of the package seem key to its political success. First, it offers something for all key stakeholders, even if not as much as they originally sought. Second, the new public system—a “notional” defined contribution one—has fundamentally changed the tone of the debate. By making explicit much of what is normally hidden in a traditional, defined-benefit pension system, it has revealed the cost of providing guarantees and special benefits, thereby reducing antireform political pressure. Third, the new system is flexible, allowing a high degree of individual choice and automatically adjusting to significant demographic and economic changes.

This chapter examines the legacy of central planning as regards pension systems in the post-communist states, the prospects for change, and the new Latvian system as an example of the potential for reform.

## THE LEGACY OF CENTRAL PLANNING

Under central planning, the command economy promised cradle-to-grave income security, including pensions replacing roughly 80 percent of wages. These systems have been viewed as compensation for relatively modest wages during the working years. By Western standards, they were quite generous. Retirement ages were set very low: in every country except Poland, the statutory retirement age was 55 for women and 60 for men. There were also generous special provisions for disabilities and selected occupations, which reduced the average effective retirement age to about 57 for men and 53 for women (Fox, 1994). In most of these countries, this continues to be the case.

The main economic effect of this generous system was to inflate artificially the dependency burden on the working population. Indeed, this is the root cause of the pension problem facing these countries today (Fox, 1994). Under central planning, the high value of nonmarket time to the household (e.g., of having a nonworking family member available for queuing and child care) may have corrected for this dependency in terms of overall income to the household. High payroll taxes and the resulting low wages were also not such a problem, when the shops were mostly empty anyway. Younger families pooled resources with pensioners in order to survive, with each contributing resources to the common household budget. In this situation, the pension system appeared sustainable. However, the combination of declining gross domestic product (GDP) and market-determined wages and prices made the system unsustainable as the transition progressed. The true cost of the system to the working generation also became clear.[1]

Despite recent declines in health indicators, the average postretirement life span in most post-communist countries still exceeds that in most OECD countries. In other words, the post-communist states of Central and Eastern Europe and the New Independent States, with much lower incomes and tax collection capabilities, have promised higher benefits (in relation to their resources) than some of the richest countries in the world, many of which are now finding their generous welfare systems unaffordable. As Table 14-1 shows, while demography accounts for some of the high pension spending, many Western countries—with the same share of their population over 60 and longer life expectancies—spend less on pensions as a share of GDP than do the post-communist states, owing largely to the higher age of eligibility. The size of the prematurely retired group makes the situation of the latter countries unique in the world, and complicates any solution. Moreover, health indicators are expected to rebound over the next decade, exacerbating the problem further. This situation has both economic and social costs.

## The Economic Cost

In most of the post-communist states, pensions as a share of GDP increased in the initial years of the transition. Today in Eastern Europe, pension expenditures are frequently the largest single item in the government budget, accounting for about 15 percent of GDP in Poland and Slovenia and 10 per-

[1]Disney (1996) discusses the inevitability of generational conflict in countries with pay-as-you-go pension systems as societies age.

TABLE 14-1 Pension Spending as a Share of GDP

| Country | Share of Population over Age 60 (%) | Pension Share of GDP 1990 | Pension Share of GDP 1993/1994 | 92 Country Sample |
|---|---|---|---|---|
| Poland | 14.8 | 8.80 | 15.0 | 3.479802 |
| Czech Republic | 16.9 | 8.00 | 8.0 | 3.881087 |
| Slovak Republic | 16.2 | 7.40 | 9.4 | 3.747325 |
| Ukraine | 18.7 | 9.60 | 9.0 | 4.225045 |
| Bulgaria | 19.7 | 7.80 | 8.8 | 4.416133 |
| Hungary | 19.3 | 9.10 | 10.3 | 4.339698 |
| Israel | 12.1 | — | 4.3 | — |
| Portugal | 18.7 | — | 7.7 | — |
| Uruguay | 16.4 | — | 8.8 | — |
| Japan | 17.3 | — | 5.0 | — |
| United States | 16.6 | 6.50 | — | — |
| Germany | 20.3 | — | 10.8 | — |
| Canada | 15.6 | — | 4.2 | — |
| Latvia | 17.9 | 5.60 | 10.2 | 4.072175 |
| Estonia | 17.2 | 5.6 | 6.4 | 3.938413 |
| Lithuania | 16.2 | 6.77 | 5.2 | 3.747325 |

cent in Hungary, Bulgaria, Latvia, and Slovakia. Two factors account for most of the increases.[2]

- *Pensioners held on better*. As with all other incomes, pensions fell in real terms during the initial period of price decontrol and inflation. However, as prices stabilized, pensions recovered some of their lost ground. In many countries, pensioners managed to recover more of the purchasing power lost during inflationary periods than did wage earners—the aging were able to capture a larger share of the falling GDP.
- *Eligibility expanded*. The policy measures taken by many of the post-communist states to cope with the social costs of transition have significantly worsened the financial position of the public pension system. In hopes of reducing unemployment, countries allowed workers to retire up to 5 years earlier and receive a full pension. Disability criteria were also applied less stringently. Today in Poland and the Czech Republic, for example, more than two-thirds of pensioners are under age 60.

Countries increased payroll tax rates dramatically to finance these expenditures—up to 40 to 60 percent of employees' gross wages (Andrews and Rashid, 1996). Nevertheless, most systems experienced financing crises, requiring additional financing from other sources of revenue or resulting in pension arrears. In many parts of the New Independent States, benefits have

[2]See Andrews and Rashid (1996) for a country-by-country analysis of these trends.

come late (if at all) for a long period of time. Weak tax collection systems contributed to the financing crises. However, the eligibility expansion also hurt public finances. This well-intentioned move swelled the ranks of those claiming benefits while reducing the ranks of those paying taxes. Since pension benefits are often reduced if the pensioner continues to work, many pensioners quit the formal sector, but continued to work in the informal sector. Today, an estimated 50 to 70 percent of pensioners continue to work during the first decade of their "retirement," but most are now outside of the tax net (Fox, 1994). At the same time, many in the working-age population have escaped taxation by moving out of the formal sector, leaving the burden of paying for pension benefits to those left in the public sector, who cannot evade taxes.

### The Social Cost

At a high fiscal cost, the pension systems of the post-communist states of Central and Eastern Europe and the New Independent States have kept most pensioners out of poverty. For the most part, the available evidence suggests that the social cost of the transition has not fallen disproportionately on pensioners. While almost all analyses of household income show an increase in poverty during the transition (World Bank, 1996), none find pensioners overrepresented among the poor. Given that pensions are now quite low in absolute terms in many countries, how do pensioners stay above the poverty line? First, most continue to work, especially in the first decade after receiving their pension. This is especially true in rural areas. Second, most pensioners still have access to relatively cheap housing. Many also started the transition with more consumer durables than did younger households. Finally, most pensioners do not live alone, so are being sustained by intrahousehold transfers.

While many pensioners may be better off than the average citizen, anecdotal evidence suggests that there are pockets of very vulnerable old people. In Estonia, it was found that the pensioners most likely to be in poverty were those who lived in pensioner-only households with no outside income. Other studies have identified pensioners living alone as vulnerable. In all surveys, pensioners have reported a high degree of psychological stress, which is normal given their fixed incomes and uncertain inflation.

Families with children constitute the growing poverty group in the post-communist states (World Bank, 1996). Many of these families are poor because the two incomes coming into the household are simply not enough. Part of the reason these incomes are low is the high tax burden. Although not the only cause, the generous pensions systems bequeathed by central planning are now compromising the living standards of pensioners' children and grandchildren. The former economic system left a set of rules and expectations that is very difficult for the current generation to honor, but is also very difficult for the working generation to abrogate. This may be the greatest social cost of the central planning pension legacy.

## PROSPECTS FOR CHANGE

Almost without exception, the debate about pension reform in the post-communist states is about what kind of system should be put in place for the pensioners of the twenty-first century—today's workers. Most countries envision leaving the pensions already granted to current pensioners as is (with some form of purchasing power guarantee, either partial or full), as the politics of taking away a benefit already granted are almost insurmountable.

In demographically mature countries, old-age security systems should achieve the following goals:

- Prevent poverty in old age.
- Assist with income smoothing by supporting savings and insuring against the risk of long life.
- Equitably support economic growth and development.

While the systems of the post-communist states have been effective in preventing old-age poverty during the transition, they have done so at a cost, as discussed above, and thus have not contributed to the third goal above. The high and growing number of the aging relative to workers means that this cost will only continue to rise. By relying on pay-as-you-go funding, these systems have also not encouraged savings.

Based on an analysis of pension systems around the world, the World Bank (1994) recommends a combination of pay-as-you-go and funded pension systems.[3] Achieving such an arrangement involves setting up a multipillar system that includes the following elements:

- *Pillar 1*—a mandatory pay-as-you-go public pension system designed to provide an income floor for all elderly persons
- *Pillar 2*—a mandatory funded and privately managed pension system—one whose current reserves are equal to or greater than the present value of all future pension payment liabilities, based on personal accounts (the Latin American approach) or occupational plans (the OECD approach)
- *Pillar 3*—a voluntary system (also funded and privately managed), with strong government regulation, to provide for additional savings and insurance.

Reform of pension systems to bring them closer to the World Bank's recommendations implies (1) longer working lives and (2) less income re-

[3] Similar recommendations are offered in Disney (1996). For a critique of these recommendations, see Beattie and McGillivray (1995). James (1996) offers a response.

placement from tax-funded pay-as-you-go systems. The post-communist states need to place greater reliance on prefunding of pension obligations (with private management of reserves) to (1) smooth out contribution rates as the "baby boomers" retire, and (2) deepen capital markets, and thus enhance growth, through the development of a contractual savings industry. The main difficulty in applying these recommendations in transition economies is that prefinancing in a mature pay-as-you-go system implies that the members of one generation must bear an additional burden—saving for their own retirement while simultaneously paying for that of their parents.[4] This is affordable only if the current transfers can be gradually reduced through a major reform.

In the typical post-communist system, governments can reduce future entitlements by the following means:

- Raising the effective retirement age (eliminating early retirement and raising the normal retirement age)
- Changing the formula to lower the average benefit
- Reducing indexation provisions (to, for example, the lower of wage or price increases)

Prefunding can be achieved in the public system only by building up a reserve fund. The World Bank (1994) recommends that these reserves be allocated to individual accounts (the Latin American approach), as this reduces the "taxation" element of the public pension system, thereby reducing labor market distortions. It also improves the management of the reserves. Funding can also begin through the development of optional, privately managed programs (private pension systems).

Few governments in Eastern Europe have tackled this entire agenda. All of the Baltic countries, Albania, Georgia, and the Czech Republic have tackled major parts of it, with some success. Of these, only Latvia and Georgia have adopted radical pension reforms. While Lithuania, the Czech Republic, and Estonia have been able to avoid the kinds of pension cost explosions faced by Poland, Bulgaria, and Slovenia, even the former three countries are experiencing steady growth in expenditures, as they have simply not reformed entitlements sufficiently. Estonia was able to implement a steady increase in retirement age, but left in place all the exemptions from the Soviet period, even adding a few. Lithuania and the Czech Republic courageously eliminated almost all early retirement, but chose generous formulas as they attempted to return to the status quo ex ante. Lithuania and Estonia have also

[4]Strictly speaking, the savings of the working generation is not a "burden" since the money saved will come back to them later. Saving represents postponed consumption, however, which has a cost. Were the members of this generation able to obtain from future generations the equivalent on a per capita basis to what they are transferring, they would be better off than under a reformed approach that includes more funding and less reliance on current transfers. However, this is an unrealistic scenario.

experienced a large growth in disability pensioners, probably as a result of lax certification.

Hungary and the Czech Republic were the pioneers in starting private pension systems, demonstrating that transition capital markets can respond to a supply of long-term funds. In the Czech Republic, where subsidies are offered as an alternative to tax concessions, roughly 20 percent of the labor force is now participating in these programs. Russia and the Baltic countries hope to follow their lead shortly. In other countries, the strategy has been to muddle through, hoping that a resumption of economic growth—including growth in real wages and improved tax systems—will solve the problem.

Why has reform proven so difficult? First, the claims of current pensioners have not been resolved. Their pensions were originally based on some kind of earnings-related formula and barely replaced their monetary income. The policy response during hyperinflation (e.g., fixed-amount compensations for price increases) has for the most part eliminated these differences, so that the structure of benefits paid today in most of the countries is relatively flat. Most pensioners are not happy with this, and oppose pension reforms even though pensions are untouched. While the macroeconomics of fiscal stability and growth suggest that future entitlement payments should be reduced and savings by the current working generation increased, the political agenda is often quite different.

Second, the weaknesses of the system are poorly understood by most of the voters. Pay-as-you-go systems are inherently nontransparent, which is why reform is so difficult. Until a crisis occurs, most pensioners imagine that their contributions have been placed somewhere safe, that their entitlement is actuarially fair, and therefore that they are *entitled* to their benefits. After years of central planning, most of the active and retired populations are used to thinking of income as an obligation of the state and are unaware of the issues identified above. And of course, those groups entitled to special early retirement provisions want to keep them.

In short, there is not yet a constituency for reform. The active population has not focused on the cost of this system to them, as the contributions are paid by their firms. Even among policymakers, the depth of the problems is poorly understood. The extent to which the post-communist systems are at variance with both Western European systems and the systems of countries at their income level is not well known. And even in the high-income welfare states, public pay-as-you-go systems are facing pension financing crises.

Innovation and risk taking will be needed to move forward on this ambitious agenda of reform. Over the last year, a handful of countries have been developing major reforms that involve prefunding through a mandatory second pillar. In Hungary and Croatia, the governments have decided in principle to create a mandatory second pillar, despite the painful reductions this will produce in the pay-as-you-go system. Similar proposals are also circulating in Poland and the Czech Republic. In 1995, the Latvian government became the first in Eastern Europe to enact a radical reform of the system, including a commitment to developing the second tier for the purposes of prefinancing. Latvia achieved this goal by adopting a whole new approach to the benefit formula. The remainder of this chapter discusses that reform and draws from it lessons for further reforms.

## THE NEW LATVIAN PENSION SYSTEM

Since achieving independence from the Soviet Union in 1990, Latvia has moved steadily toward the establishment of a market economy and the development of democratic institutions. An initial reform of the Soviet system was undertaken in 1990. But the reformed system left in place most of the Soviet eligibility conditions (retirement at age 55 for women and age 60 for men, with earlier retirement permitted for certain occupations and categories of people). The benefit formula provided a flat guarantee of 30 percent of the national average wage, with an increase of 0.4 percent for each year of service. By July 1995, the average old-age pension was 33 lats, or 50 percent of the average net wage (pensions are not taxable). This formula implied full wage indexing for pensions, although in practice this indexing did not take place when revenues were inadequate.

In January 1995, the government submitted to Parliament a new pension reform concept, calling for the introduction of a three-tier system. The first tier would be a modified pay-as-you-go system, with stronger links to contributions and a minimum pension to protect the lifetime poor. The second tier would be a mandatory, funded system of privately managed savings accounts. Participation would be limited to new entrants and the younger members of the current labor force. The third tier would be voluntary, privately managed pensions, organized primarily (but not exclusively) through employers. The new concept was accepted by Parliament, and work began immediately on the first stage of the reform—new legislation for the first tier. This legislation was submitted to Parliament in July 1995 and approved in November 1995 as part of the package of welfare system reforms. The new system took effect in January 1996.

The new public pension system has two main elements:

- Pensions are linked directly to an individual's total contributions and the retirement age on the basis of a new formula.
- Provision is made for introduction of the second tier. Beginning in 1998, contributors will have the option of assigning a portion of their contributions to privately managed individual savings accounts. This will result in a partial funding of the system, reducing the debt for future generations.

The new public pay-as-you-go pension system is a notional defined contribution one. It is designed to mimic the contribution-based pension that would be offered in the private sector by an efficient insurance company. The system starts by giving an account to everyone paying the social tax. As contributions earmarked for the pension system are paid, the account is credited as if it were a savings account. The "capital" in the account earns a rate of return just as a savings account would. This rate of return is equal to the growth of the sum of wages on which contributions are collected (the contribution wage base). At retirement, the pension paid is equal to the total capital in the person's account, divided by the expected postretirement life span for all those of that person's age. For example, if a person has 10,000 lats in his or her account at retirement and is expected to live 10 more years, the pension will be 1000 lats per year or 83 lats per month. The pension will be indexed, adjusting for price changes.[5]

In this system, individual benefit levels are not specified until retirement. However, each contributor gets an annual statement showing the capital in his or her account. A table of average life expectancy at retirement (called the G-value) is also published every year by the government. Since life expectancy changes very slowly, and the amount of capital in the account is known, those nearing retirement can roughly estimate their future pensions (as they did under the old system).

In the new system, there is no mandatory retirement age and no "full pension." The minimum retirement age will be 60 years for most participants. However, the system provides strong incentives to work longer. Longer working years will shorten the number of payments, allowing each to be higher, and increase the initial capital. As a result, assuming a constant wage, the pension will double when an individual works until age 70 instead of 60.

The new system also includes a minimum guaranteed pension for all those who reach the age of 60. This minimum is set at the level of the social pension, a social assistance pension for those adults who were disabled at birth. The social assistance pension is also available to those who reach the age of 65 but do not have 10 years of service. The nominal level of the social pension is set by government. It is currently 25 lats (60 percent of the average pension and 20 percent of the average wage). Once the second tier is in place, the minimum will include both first- and second-tier funds, providing a floor under the total pension.

Transitory provisions in the new law gradually enforce the minimum retirement age of 60. Some politically sensitive exceptions remain, including a provision for early retirement at 55 for women and a few occupations (e.g., wind instrument players, ballet dancers). However, the minimum guarantee does not apply to anyone who takes a pension before age 60. Thus, these

[5]For a detailed analysis of the new system, see Fox et al. (1996).

groups will be entitled only to an actuarially fair pension, which for average workers is about 50 percent of what they would get at age 60 and 55 percent of what they would have gotten under the old system. It is expected that most will find this pension to be so low that they will continue to work, and this will greatly reduce the number of early retirees.

Hidden subsidies in the form of pension credit for noncontributory periods have also been removed. All subsides are now explicit, as any pension credit for noncontributory periods requires actual contributions into an individual's notional account. For time spent in higher education (maximum of 8 years), in military service, or at home taking care of children (maximum of 3 years per child), contributions to the pension fund are made by the state budget in the form of budget transfers, using the minimum wage as the contribution wage for transfer purposes. The cost of these transfers to the state budget is estimated at roughly 17 million 1996 lats (0.3 percent of GDP). For those receiving social insurance benefits (e.g., unemployment or disability benefits), transfers are made from these funds to the pension fund.

The formula for disability pensions has not been changed in the new pension law. However, the new law converts disability pensioners into old-age pensioners at age 60. A new disability formula was submitted to Parliament in September 1996.

How do the actual benefits compare under the old and new systems? Assuming that under the old system, the required quarterly indexing would have taken place in 1996,[6] most new pensioners with full years of service retiring after 60 do not suffer a benefit decline as compared with the old system. For those who work longer, benefits increase—by over 200 percent for those who work another 10 years. Benefits are larger as well for those with higher incomes (who in the future will also contribute more). Benefits may be smaller for those whose lifetime incomes are low. This is a disadvantage of the contribution-related formula—it is not redistributive within the age cohort toward the lifetime poor. However, given that the old system was unaffordable, the projected benefits under that system are probably on the high side. Under the new system, early retirees will be penalized. For example, a woman who retires at 55 will experience on average a 25 percent decrease in her pension under the new system if she stops contributing.

With regard to the macroeconomic impact, after 10 years the expenditures on pensions are projected to be one-third lower than they would have been under the old system. As a result, the contribution rate (payroll tax) allocated to pay pensions will fall from about 26 percent of payroll to 20 percent by

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[6] This is a strong assumption. Indexing due under the new system (semiannually) was delayed from April to May in 1996 because of a lack of funds.

2001. This represents primarily the effect of delayed retirement and decreased benefits for early retirement, but it also results from switching to price indexing of benefits in the face of growth in real wages. This savings will be allocated to second-tier accounts through a process of gradual participation. It is expected that by 2005, about 10 percent of total contributions will be invested—a potentially large increase in national savings. All new entrants into the labor force after 1998 are expected to participate in the second tier, so the ratio of invested resources to the revenue inflow will increase over time. For Latvians under age 40 (who will begin receiving pensions in about 20 years), about 40 percent of their pension is expected to come from second-tier funds. The system dependency ratio will fall steadily from about 80 percent to below 50 percent by the end of the period.

Provided Latvia realizes at least some economic growth, the system should be affordable. Affordability is maintained in the first instance through the indexing provisions. During the accumulation period, contributions in the "notional" account are indexed to the inflow of resources, so that liabilities do not grow more rapidly than resources. Investment of reserves in second-tier funds helps ensure affordability as well. Pensions are also indexed to life expectancy, automatically adjusting to demographic changes. Finally, during the payment period, pensions are price indexed until 2002, and after that indexed to a mix of wages and prices; this will avoid rising liabilities during an economic downturn.

Since benefits are completely and fully dependent on contributions in the new system, a large part of the disincentive effect of a traditional social insurance tax disappears. When benefits are unrelated to contributions, the social insurance contribution becomes a tax, and like any other tax embodies a loss of income and utility to the payee. The more closely benefits are related to contributions, the less loss of income and utility the system implies, and the easier administration becomes. There is always some loss of income and utility associated with a mandatory contribution system, however. This is because even if pension benefits are considered 100 percent deferred compensation, a lat today is always worth more than the promise of a lat in the future. (This consideration is even stronger if that promise comes from an unaffordable public pension system subject to short-term political pressures.)

The new system also permits a flexible adjustment of benefits to changes in life expectancy, thus avoiding the whole acrimonious debate over retirement age. Moreover, the system has the advantage of containing one simple formula that covers all circumstances. In so doing, it provides a wider range of options for older workers. Anyone over the age of 60 can take a pension if he or she desires, or continue working and get a higher pension later, or do both and get a slightly higher pension later, or stop working for a while and then start again. These options can be especially important for women, who tend to have greater responsibility for taking care of dependent family members, and those who may have uncertain health, who may work part of the time and may require limited income support at other times.

As noted earlier, the new system also provides for a smooth transition into the second tier. Grafting a funded system, especially a defined contribution scheme, onto a defined benefit scheme can be expensive for those already covered by the existing scheme (as many Latin American countries have discovered).[7] With the notional defined contribution structure, benefits in either scheme depend solely on contributions. These contributions can be allocated to the second tier on either a mandatory or voluntary basis without creating any negative labor supply incentive problems.

## LESSONS FROM THE LATVIAN REFORM

The Latvian pension system is not perfect—no pension system is. In particular, because of the high costs of pensions already granted and the desire to compensate with increased pensions those who lost the right to early retirement, the system remains expensive in the initial period. As a result, the target rate for pension expenditures is 20 percent of payroll (well above, for example, the costs of the generous Swedish system), but even this target will not be achieved until 2000, under the optimistic scenarios. The provision for early retirement for women may induce them to leave the labor force too early, possibly resulting in an increase in poor widows later on. Nonetheless, the new system represents a major reduction in entitlements and a strong break with the Soviet guarantee approach, perhaps serving as a new model for a pension system that provides old-age security without compromising economic growth objectives.

How did the Latvians succeed in their radical approach? First, the pension reform offered something for all key stakeholders. The most vocal opposition came from existing pensioners, who realized that no increase was promised for them. However, they also came to understand that the reform offered them some certainty with respect to purchasing power. In addition, the proposals to allow pensioners to work and still receive a pension helped garner support. Future pensioners liked the idea of a higher pension if they worked longer. A few special groups also won the right to receive a lower pension early.[8]

[7]Disney (1996) provides an excellent analysis of the problems OECD countries have experienced in trying to add funded programs.

[8]From an economic point of view, there is no reason why everyone should not have the right to retire early, since the formula is actuarially fair. However, such a provision runs the risk of creating a group of poor retirees who retire early, but prove unable to live on their low pensions. Such a result would defeat the social purpose of the system.

Second, the notional defined contribution system fundamentally changed the tone of the debate. It established the principle that everyone's benefit is based on his or her contribution. It also helped neutralize the groups who claimed to be especially deserving by making explicit the cost of providing the benefit. Under the previous system, redistributions could occur simply through the addition of favorable treatment for one group to the pension law—requiring no analysis of the costs to the rest of the pensioners or to future contributors. As a result, Latvia had a large number of these redistributions. Examples are (1) early retirement for special groups (which encouraged retirement at the earliest possible date) and increases in pensions for longer service, and (2) pension credit for noncontributory periods, such as maternity leave or military service. In all of these cases, the favored group received more benefits for the same contribution. Under the new system, noninsurance redistributions, such as subsidies for maternity leave, require explicit contributions into an "account" (e.g., into the social insurance fund or the second tier). This feature makes the new system much more transparent than the previous defined benefit system.

Finally, Latvia is one of the transition leaders. Its commitment to a market economy is strong, since transition is seen as an essential part of restoring the country to its former (pre-Soviet occupation) greatness. This nationalist commitment is bolstered by significant assistance from the Latvian diaspora. Significantly, an early Minister of Welfare was a Latvian-Australian with 40 years of experience in private insurance in Australia. This political context provided fertile ground for a market-oriented pension solution.

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# 15

# From Safety Nets to Social Policy: Lessons for the Transition Economies from the Developing Countries

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## INTRODUCTION

Few topics related to transition economies have been the subject of as much discussion as have the social costs of market-oriented reforms. Yet the empirical evidence upon which the debate is based is far from complete. This is due in part to the difficulty of comparing poverty lines across countries: poverty has both absolute and relative dimensions, and is quite different in Zambia than in Poland, for example. It is also difficult to distinguish the effects of prolonged economic crisis on the poor from those of difficult but necessary macroeconomic adjustments. Moreover, the truly poor and vulnerable tend to have a weak political voice, and therefore little influence on the debate about social costs. Not surprisingly, the numerous attempts to implement safety net measures during economic adjustment in both developing and transition economies have had varied results (Graham, 1994). This experience has led to an evolution of thinking about social welfare issues during transition, which has implications not only for the design of safety net measures in the short term, but also for the reform of social-sector institutions over the longer term.[1]

During the first wave of adjustment programs in the early 1980s, most attention was focused on developing the appropriate mix of policies to achieve stabilization and structural reform, and little attention was paid to the issue of

[1]This chapter focuses only on social-sector reform in the context of economic transition, and does not attempt a full-scale discussion of theories of institutional change. One of the most influential and comprehensive studies of institutional change is found in North (1990).

social costs. This situation had changed by the mid-1980s. First, a consensus gradually developed on the appropriate policy mix: the reduction of fiscal deficits, the elimination of price controls and trade restrictions, the introduction of realistic and unified exchange rate regimes and positive real interest rates, and a shift to relying on the private sector rather than the state to run most productive enterprises. As this consensus became clear, policymakers could begin to focus attention on social welfare issues (Williamson, 1994). Second, by the mid-1980s, as the results of adjustment policies became clear, a broad debate began about their social costs. Concerns about these costs were heightened by the publication of a highly critical study by the United Nations Children's Fund (UNICEF) in 1987 (Cornia et al., 1987). Initially, this debate focused solely on the social costs of adjustment policies and resulted in numerous efforts to develop safety net measures within the multilateral development banks. Yet by the late 1980s, the debate had been altered once again by evidence from country experience. It had become increasingly clear that the poor fared far worse in the countries that failed to adjust than in those that adjusted in a timely manner.

The contrasting examples of Chile and Peru are illustrative. During the adjustment crisis in the early 1980s in Chile, the poor were effectively protected from declines in social welfare through targeted employment and nutrition policies. With the subsequent resumption of growth in the late 1980s and early 1990s, poverty decreased substantially, falling from approximately 45 percent of the population in 1986 to 28 percent in 1994. In contrast, in Peru, during a prolonged period of "postponed" adjustment from 1985-90 that resulted in hyperinflation and economic collapse, per capita consumption fell 50 percent on average. It fell even further for the poorest two deciles—over 60 percent. Poverty rates rose from 17.3 percent in 1985 to 54.7 percent in 1990 (Marcel and Solimano, 1994; Glewwe and Hall, 1994).[2] In Africa, meanwhile, the few countries that successfully adjusted also had better records on the poverty reduction front than did nonadjusters (Demery and Squire, 1995; Bruno et al., 1996).[3]

Adjustment is a necessary but not a sufficient condition for poverty reduction, however, and there are still many unanswered questions. The first of these is the relationship between poverty and inequality, and here the evidence is far less convincing, although some recent work clearly suggests that poverty increases with inequality (Birdsall and Londoño, 1997). Another important area that is increasingly recognized as critical to poverty reduction, but in which we have very little empirical evidence, is that of institutional reform

[2]Poverty figures for Peru are for Lima only, and would be much higher if data for rural areas were available.

[3]Data for Africa are extremely limited as a result of both the limited availability of household-level data and the small number of successful adjusters.

(Graham and Naim, 1997). Nevertheless, it is very difficult either to reduce inequality or to implement institutional reform in the absence of growth. And while some countries that adjust, such as Bolivia, grow more slowly than others, such as Peru, because of resource endowments, institutional structure, and a variety of other factors, adjusters outperform nonadjusters overall with regard to growth and poverty reduction.

There are two reasons why nonadjusters perform poorly as regards poverty reduction. First, cross-country evidence demonstrates a clear relationship between growth and poverty: poverty declines during periods of growth and increases during periods of recession (Bruno et al., 1996; Morley, 1995). While adjustment has short-term costs, its ultimate objective is to achieve sustainable growth. Thus countries that adjust successfully also tend to reduce poverty. Beyond the issue of adjustment, empirical evidence suggests that countries that maintain market-oriented macropolicies over time, and in particular liberalized trade regimes, grow much more rapidly than those that do not, regardless of initial conditions (Sachs and Warner, 1995). Second, while adjustment has costs for certain sectors, it provides a coherent policy framework within which one can identify and protect vulnerable groups. In contrast, it is very difficult to protect poor and vulnerable groups in a haphazard policy framework, where macroeconomic distortions and high inflation erode real income levels and provide numerous opportunities for rent seeking. The poorest tend to be the least able to protect themselves from the costs of inflation, while the wealthy are better positioned to pursue strategies such as sending assets abroad. At the same time, the poor are less able than the wealthier to use economic distortions for personal profit, for example by speculating on exchange rate differentials.

Thus the debate has shifted somewhat, from an emphasis on short-term safety nets to one on appropriate macroeconomic policies, coupled with longer-term investments in health and education. Recent research exploring the long-contested relationship between inequality and growth has found that investment in longer-term social welfare policies, education in particular, has positive effects on growth and therefore poverty reduction (Birdsall et al., 1995; Benabou, 1997). The effects on growth of transfers—a category that includes safety nets—are mixed, and seem to depend on the nature of the transfers and how they are allocated (Benabou, 1997). This should come as no surprise, since the ability of safety nets to reach the truly poor and vulnerable depends to a large extent on the political context and on the administrative capacity in particular country settings. This does not diminish the important role safety nets can play as transition tools, but does emphasize the importance of evaluating investments in safety nets in the broader context of social policy. From both political and administrative standpoints, it is much easier to set up short-term safety net programs than it is to implement reforms of the public-sector institutions that deliver basic services. At least in Latin America and

Africa, this greater ease, combined with concern about the immediate costs of adjustment, may have resulted in too much emphasis on safety nets at the expense of attention to the latter institutions.

A brief review of selected experiences with safety net policies in the next section helps explain the changing nature of the debate on the social costs of adjustment. The chapter then turns to an examination of the politics of reforming the social-sector institutions that deliver public services. The discussion in these sections provides relevant lessons for the transition economies, many of which have made far less progress either in implementing effective safety nets or in reforming social welfare institutions than have countries in other regions. The final section presents a brief conclusion.

## SAFETY NETS: LESSONS FROM EXPERIENCE

The cross-regional record of safety nets is mixed. In some cases, safety net programs have been able to reach the poor and vulnerable and contribute to the political sustainability of economic reform at the same time. Yet in other cases, they have merely been short-term palliatives to stave off the political opposition of vocal groups, and have had little impact on either poverty reduction or the longer-term political sustainability of reform (Graham, 1994). There are two reasons for this mixed record. First, the overall policy framework is critical. Safety nets cannot serve as poverty reduction tools—or even provide effective social welfare protection—in the absence of policies to generate sustainable growth in the long run. Safety nets are short-term mechanisms that can play an important role during transition periods. The benefits they provide, however, such as short-term unemployment and income support, cannot substitute for macroeconomic reform and sustainable growth on the one hand, and for basic social welfare policies, such as primary health and education, on the other. And safety nets must complement rather than contradict the general direction of the macroeconomic reform program: they should not generate fiscal deficits or create labor market distortions.[4] In practice, safety nets have not always been implemented according to these principles.

The second reason for the mixed record of safety nets is that their implementation is not free of political constraints, and there are distinct trade-offs involved in directing benefits to the politically vocal versus the truly needy. The conventional wisdom, and usual practice, is that the poor have a weak political voice, and governments in the process of implementing reform and facing intense political opposition have few incentives to focus safety net benefits on the poorest. In addition, the poorest are often not as directly

[4]Wages paid in employment programs, for example, must be below the market minimum so they do not serve as disincentives for seeking alternative employment in the private sector.

affected by adjustment measures as are slightly better-off urban consumers. Thus governments tend to respond to this political trade-off by focusing most of the benefits of compensation efforts during reform on vocal rather than needy groups. Yet it is not necessarily cost-effective, from either a political or poverty reduction perspective, to concentrate all benefits on vocal opponents of reform, as they are unlikely to be as well off as they were prior to reform regardless of the level of compensation. In contrast, reaching groups previously marginalized from public benefits is likely to have greater political as well as poverty reduction effects. This is more likely to occur if benefits are distributed in a manner that incorporates the participation of beneficiaries, thereby increasing their political voice as well as their economic potential. Examples are provided by numerous countries' experiences with demand-based social funds (Graham, 1994). Such a dynamic is not always possible, however, and there are political contexts where governments must expend a fair amount of resources in order to placate vocal and organized opponents of reform, or reforms will be politically unviable and face reversal, an outcome that tends to be far worse for the poor.

There are positive examples of countries in which extensive macroeconomic reforms have ultimately generated growth, and in which safety nets have been an important part of the reform process. The models for successful safety nets differ. The contrasting examples of Chile and Bolivia demonstrate how the choice of a safety net program reflects different political and institutional contexts.

In Chile, reform was implemented under an authoritarian regime and in a highly developed institutional framework. The government was able to rely on a preexisting and extensive network of mother and child nutrition programs and target those programs to the poorest sectors. A series of public works employment programs was also targeted to the poorest by keeping the wage level well below the minimum. Public social services were restructured to benefit the poor, and private alternatives were introduced for those who could afford them. While per capita social expenditure decreased during the crisis years, it increased for the poorest deciles (Graham, 1994). These safety nets were critical to protecting the welfare of the poor during deep recession. Unemployment, for example, peaked at almost 30 percent of the work force in 1982. Yet welfare indicators such as infant mortality not only continued to improve, but accelerated in their rate of improvement during the crisis years. Chile's record was possible because of its extensive preexisting social welfare system and its relatively efficient public-sector institutions. Political context also played a role: a democratic government might face greater obstacles to reorienting social welfare expenditures to the poorest at the expense of the middle sectors than did the Pinochet regime. Yet it is important to note that the targeted approach has been maintained and even extended since the transition to democracy in Chile (Arriagada and Graham, 1994).

Bolivia, in contrast to Chile, had much higher levels of poverty and far less developed institutions at the time of reform. The government implemented the Emergency Social Fund (ESF), a demand-based social fund (the first of its kind) that relied on proposals from beneficiaries to allocate projects and on local governments, nongovernmental organizations, and the local private sector to implement them. While the ESF was not able to target the poorest sectors, as they were the least able to present viable project proposals, it was able to reach large numbers of the poor at a critical time (1 million people out of a population of 7 million benefited from ESF projects). At the same time, the ESF provided important impetus to the building of local organizational and institutional capacity. Since the "completion" of adjustment, the ESF's successor, the Social Investment Fund, has relied on the same basic principles, but focusing specifically on health and education benefits rather than on short-term employment and incorporating collaboration with the line ministries into its operations (Graham, 1992). This is an attempt to overcome one of the primary drawbacks of social funds: while operating outside the realm of the mainstream public sector is precisely what makes social funds flexible and rapid, it also means they do not contribute to reform of the public sector.

Both Chile's experience with targeted social policies and Bolivia's with the incorporation of beneficiary participation have helped shape the debate on safety nets, as well as social welfare policy more generally. The Chilean experience emphasizes the importance of targeting safety net efforts (and social policies) to the truly needy in order to provide effective protection, whereas the Bolivian experience demonstrates the importance of incorporating the participation of the poor and local institutions in order to enhance the sustainability of poverty reduction efforts.

There are also numerous examples of countries that have failed to implement comprehensive reform and whose safety net policies have neither led to sustainable poverty reduction efforts nor reached needy groups. One such experience was the DIRE program in Senegal, a country that has postponed important structural reforms for over a decade. DIRE, a credit program designed to help laid-off civil service workers and unemployed university graduates during adjustment, channeled interest-free loans to these groups without incorporating need criteria or project viability into the allocation of loans. Not only did the resulting projects have an extremely high failure rate (32 percent), but over $3 million was lost or "filtered" through the public bureaucracy. This is hardly an efficient manner in which to allocate resources in one of the poorest countries in Africa, nor did it contribute to sustainable reform. DIRE's failure was due to poor design, as well as to the priority of political over poverty reduction objectives. In addition, and perhaps most important, because the program was not part of a government commitment to a comprehensive macroeconomic reform effort, it was not sustainable in either economic or political terms.

While safety net efforts in adjusting countries have a mixed record, the experience provides some important lessons, both for future safety net policy and for social welfare policy more generally. The effectiveness of targeted social safety net benefits has highlighted the extent to which the allocation of basic social services, such as health and education, is skewed toward wealthier groups in many countries, as well as the need for better targeting of social welfare benefits in general. While social expenditures must be at a realistic level—and in many countries in Latin America these expenditures fell well beyond desirable levels during the debt crisis—the allocation of expenditures is as critical as overall amounts, if not more so. In Brazil, for example, only 18 percent of the poorest groups, who account for over 40 percent of the population, are covered by social security, and they receive only 3 percent of social security benefits. In Venezuela, over 50 percent of the education budget is spent on higher education (Birdsall and James, 1990; Angell and Graham, 1995). Chile, in contrast, provides a good example of how social expenditures can be made far more effective in reducing poverty when they are targeted. With the transition to a democratic regime in 1990, the targeted approach of the military government was maintained, while social expenditure was increased at a rate of almost 10 percent per year. Because the demand of upper- and middle-income groups for social services was now served by the private sector, government increases were able to benefit the poor disproportionately. As noted above, poverty has fallen markedly in Chile: from 45 percent in 1986, to 40 percent in 1990, to 28 percent in 1994—and is projected to fall to 17 percent by the year 2000 if the economy maintains its current trajectory of 6 percent annual growth (Cowlan and de Gregori, 1996). Bolivia, meanwhile, provides an important example of how the incorporation of beneficiary participation can lead to more sustainable poverty reduction efforts, and in particular enhance local institutional and organizational capacity. In Bolivia, the demand-based approach is now being extended to reforms in the education sector, in addition to the Social Investment Fund's cooperation with the ministries.

In many other countries, however, social expenditure remains skewed to wealthier groups. As noted earlier, public focus on the social costs of reform and on short-term safety net measures, particularly in the absence of progress on macroeconomic reform, can divert attention from necessary reforms in the mainstream social sectors. Precisely because many safety net programs are implemented outside the mainstream public institutional framework, they avoid addressing difficult problems within it. This underscores the importance of implementing safety nets in a broader context of macroeconomic reform. When safety net measures *are* implemented effectively, and introduce key principles such as targeting of the poorest and beneficiary participation, they can provide impetus—as well as some guiding principles—for the broader process of social-sector reform.

## THE NEXT STAGE: THE POLITICS OF REFORMING SOCIAL-SECTOR INSTITUTIONS

While there are clearly political trade-offs involved in the implementation of safety nets, the politics of implementing permanent reforms of the institutions that deliver public services are even more complex. Reform of such institutions requires more implementation capacity than does either macroeconomic reform or the implementation of safety net measures, and entails very different political dynamics. The providers of public services tend to be politically powerful and highly organized, while the users, although numerous, tend to be diffuse and poorly organized. It is no surprise that most governments, already faced with the political challenges of macroeconomic reform, postpone or avoid more difficult reforms of public institutions, particularly when the implementation of visible safety net policies can address public concern about social welfare issues, at least in the short term. Yet in most countries that *complete* adjustment programs, it becomes evident that for growth to be sustainable in the long run, there are no alternatives to reform of the social sectors. In much of Latin America, for example, public attention has shifted from the costs of adjustment measures to concern about the quality and quantity of basic public services, particularly health and education.

Despite these difficulties, it is possible to make progress in reforming social-sector institutions, and to do so under a democratic regime. In Latin America, Chile is the country that has made the most progress in implementing structural reforms of the social sectors, and it has done so under authoritarian rule.[5] Yet the reforms have been maintained and even extended since the 1990 transition to democracy. And since then, a number of other countries in Latin America—and a few in Africa—have implemented "Chile-style" reforms under democratic regimes. Progress has been most visible in the social security arena in Latin America, but there have also been some reforms in health and education.[6] The policy framework—rapid and extensive macroeconomic reform—has been critical to the political viability of these reforms

[5]East Asia also provides several examples of efficient and well-targeted social expenditures, in particular investments in basic education (see Birdsall et al., 1995). Yet because the East Asian countries were neither democracies nor undergoing major economic adjustments at the time their social welfare frameworks were established, their experiences are less relevant to the transition economies. Indeed, most East Asian countries have not had to reform their social welfare systems dramatically; rather, they were initially set up in an efficient manner in the context of good macroeconomic policies. Pension systems, for example, were not established in most East Asian countries until it was clear that they were affordable from a fiscal standpoint. This is in sharp contrast with the experience of most Latin American or transition economies.

[6]Argentina, Bolivia, Colombia, and Peru have all implemented major social security reforms. A major health-sector reform is under way in Argentina, and Peru is beginning such a process. In Africa, among other countries, Zambia has implemented far-reaching health-sector reform (Graham, 1996a).

(Graham, 1994). Extensive economic change provides governments with unique *political* opportunities to implement additional reforms in the social welfare arena as it undermines the position of established interest groups, which often monopolize the benefits of public services at the expense of the poor (Adrianzen and Graham, 1974; Angell and Graham, 1995). Slow or stalled economic reform, in contrast, allows such groups greater political opportunities to maintain their privileged positions.

In addition to the political opportunities provided by reform, there are already low expectations of the state in much of the developing world, which also makes it easier for governments to introduce change. Poor management over time, coupled with the fiscal constraints imposed by the economic crisis and debt problems of the 1980s, resulted in a deterioration of the quality and coverage of basic public services in most countries. Upper- and middle-income groups that could afford to do so have shifted to private systems, leaving the poor and lower-middle-income groups as the primary users of public services. This reduces the potential opposition to reforming public systems, yet at the same time highlights the importance of social service reform for poverty reduction.

Integral to the sustainability of such reform efforts is altering the political balance so the beneficiaries of reform have a stronger voice in the political debate. Many of the successful reform efforts have included explicit or implicit efforts to create new stakeholders in reformed systems. Chile's education reform, for example, which introduced choice between public and publicly subsidized private schools, created substantial numbers of new stakeholders in the private education system. Zambia's health reform, by devolving responsibility for management and resources to local-level actors, has similarly created new stakeholders who have proven to be capable of resisting central-level efforts to reverse the reform process. The Peruvian government is attempting to build support for the privatization process by selling off a portion of public company shares through a "citizen participation" program, which allows low-income investors to buy shares in installments at low interest (Graham, 1996b). The Bolivian government is planning a similar scheme, which will distribute 50 percent of the proceeds from privatized companies to all adult Bolivians as shares in a new private pension scheme.

While these are positive trends, there is a great deal of room for progress. East Asia's early investments in basic education, coupled with sound macroeconomic management over time, are now paying off in the form of higher sustained growth and lower levels of poverty than in other regions (Birdsall et al., 1995). Latin America's progress on the macroreform front in recent years has been impressive. It is only now turning to the social investment side of the equation, and results will take time. Chile, which began its process of reform in both these arenas much earlier than the other countries in the region, is now seeing results in terms of both growth and poverty reduction. Other countries will follow suit, but only as they complete both sides of this policy equation. Thus social-sector reforms will be critical. Most countries in Africa, meanwhile, with a few exceptions, have yet to implement the macroeconomic reforms that can make social-sector reforms economically and politically possible.

## LESSONS FOR THE TRANSITION ECONOMIES

The record of safety nets and social policy reform in the developing world is relevant for the transition economies, although the contexts are quite different. First, the macrotransformations in the transition economies are necessarily far more extensive than are the adjustments in developing countries. In many cases entire work forces must be deindustrialized. Existing social welfare systems, many of which are run by public enterprises rather than the central government, are fiscally unsustainable and are not designed to cope with poverty and unemployment resulting from the transition to the market. This obviously makes it more difficult to provide effective safety nets. One potential approach for safety net policies in such a context is to concentrate specific programs on pockets of high unemployment, where social funds or public works could alleviate negative welfare effects, and at the same time to target the universal system of social welfare benefits, such as monetary allowances, to particularly vulnerable groups, such as children in large families. Under the current structure, these benefits are universally provided, but because of fiscal constraints, their real value is marginal and eroding further. Targeting these benefits to vulnerable groups would allow governments to raise the benefit levels enough to reduce poverty without adding to the fiscal burden.

Second, the politics of the process are more complex in the transition economies: there are higher expectations of the state; reform has stalled in many cases; and the concerns of some politically influential groups, such as pensioners, dominate the public debate, while very little attention is paid to the situation of even needier and more vulnerable groups, such as the children of the working poor. The public debate on social welfare in the transition economies has mistakenly focused on two issues—the plight of pensioners and the pace of reform—while excluding several equally critical concerns. Pensioners have fared worse than the average in some countries (most notably the countries of the former Soviet Union) and better than the average in others (the Eastern European countries). In general, not all pensioners are vulnerable, and it is elderly pensioners living alone who are at risk. In contrast, children in large families, most of which have at least one parent working, are the group most likely to be poor in all the transition economies (Milanovic, 1997; Braithwaite, 1995).

The debate about rapid versus gradual reform has focused on the high social costs purportedly associated with rapid reform. Yet in the countries that have pursued rapid reform and been able to implement it fully—Poland, Czechoslovakia, Estonia, Latvia, and Albania—inflation has been reduced quickly, and growth has begun to recover, which will have consequent effects on poverty reduction (Åslund et al., 1996).[7] In large part reflecting the extent to which production under central planning failed to reflect genuine consumer demand, output declined markedly in the initial reform stages in these countries. Gradual reformers have merely postponed these inevitable declines, and now lag far behind the faster reformers in terms of recovering growth. In addition, contrary to common assumptions, gradualists have not fared better in the political arena: more of them have been voted out of office than have their radical counterparts (Åslund et al., 1996).[8]

In few countries has the debate focused on social-sector reform. And even in the strongest-performing radical reformers—Poland and Czechoslovakia for example—attempts at social-sector reforms, such as pension reform, have stalled because of political opposition. Only Estonia, which for several years had the most promarket government of the transition economies, has moved ahead with pension reform. Yet progress in this arena is critical. No other region has experienced a deterioration of basic social welfare indicators, such as infant mortality and life expectancy, like that experienced by the transition economies. In addition, as a result of demographic as well as economic changes, existing systems are simply not sustainable from a fiscal standpoint. Pension systems in particular, which account for the bulk of social expenditures in most transition economies, are likely to present the most immediate financial crises in the absence of social security reform. Pension spending as a percentage of gross domestic product (GDP) ranges from 5 to 6 percent in Russia and the Baltics to 12 percent in Poland and Hungary (*The Economist*, 1994).[9]

The debate over social-sector reforms in the transition economies resembles the stalled debates over social welfare reform in the OECD countries. Yet the social welfare and financial situations in the transition economies are far more fragile. And a Catch-22 type of scenario is also at play: the maintenance of current social welfare systems in many countries is part of the explanation for stalled reforms. Under the enterprise-based social benefit system,

[7]Russia attempted radical reform, but the reformers were ousted from the government before the reforms could take hold.

[8]Radical reformers have lost elections primarily in situations where proreform forces have been less united than the former communists. And even where this has been the case, as in Poland and Estonia, reforms have not been reversed.

[9]These figures are for 1992. The implicit debt of Ukraine's pension system, for example, is 214 percent of GDP. Among Organization for Economic Cooperation and Development (OECD) countries, only Italy's debt, at 242 percent, is higher. Hungary's is 172 percent, Japan's is 144 percent, and the United States' is 89 percent (see Kane, 1995).

workers lose access to social welfare benefits if they become unemployed. This is one of the principal reasons managers are reluctant to lay off redundant workers, keeping them on the payroll even if they do not work or get paid so they can maintain access to critical benefits such as health and education services (Pinto et al., 1992).

While it is evident that social systems in transition economies need reform, there is no clear example in the region to which countries can turn. Recently, even the highly successful Czech prime minister, Vaclev Klaus, faced an electoral setback over the social-sector reform issue. Having lost his majority in parliament by a narrow margin, he now needs to make extensive efforts to build a new coalition of support for his reform agenda (*The Economist*, 1996).[10] Some OECD countries, such as Italy, have attempted to implement social security reform, yet because the reform was watered down as a result of union opposition, it is likely to be far less effective in either providing better pensions or reducing the government's implicit debt. Other countries, including the United States and France, are debating the issue, but with little progress to date. The rapid reformers in the transition economies should look to Latin America, not the OECD countries, for examples. Chile is by far the world's leader in the social security reform arena; its complete switch to an individual contribution-based system is credited with substantially increasing that country's savings capacity (Corsetti and Schmidt-Hebbel, 1995).[11] Now other countries, such as Peru, Colombia, and Argentina, provide hybrid models to examine in addition. Rapid reformers should also capitalize on the political context: it is much easier to implement far-reaching change while the overall policy framework is in flux, and interest groups have yet to establish clear positions (as in the Latin American examples), than it is to do so in a status quo policy framework (such as that of the OECD countries).

Before concluding, two tactical points are worthy of note. The first is the need to alter the political balance through strategies that create new stakes in the process of reform. Czechoslovakia, with its voucher privatization strategy, provides a prime example of such a strategy. While many observers criticize the measure from an economic efficiency standpoint, virtually all observers concur that the program was key to building widespread support for the privatization process, thus making it irreversible. In contrast, in Russia, voucher privatization was poorly implemented, allowing insider traders to dominate the process and monopolize the benefits, further delegitimizing the

[10] Social welfare reform (health and pensions) was a major issue in the parliamentary elections in June 1996. While Klaus's party received a higher percentage of the vote than it did in 1992 (44 versus 42 percent), it received fewer parliamentary seats, which went to the Christian Democrats in three industrialized regions.

[11] Private-sector saving in Chile increased from nearly zero in 1979-1981 to an average of 17.1 percent of GDP in 1990-1992.

process of reform in the public mind. Chile's social security reform was based on the concept of creating new stakeholders in the private system. Explaining and selling the reform to potential participants was key to its success, even in an authoritarian context.[12]

This points to the second critical tactical component of reform: government communication. Effective government communication has been key to the success of macroeconomic and sectoral reforms in a variety of contexts (Graham, 1994). It is particularly critical in the transition economies, where public anxiety about the social costs of reform is high, and understanding of the market process and of the potential benefits of social welfare reforms is very low (Graham, 1995). The misguided debate on poverty in the transition economies noted above is a case in point. An effective government communication policy, aimed at explaining and selling reforms to the public, will be key to any successful social-sector reform effort in these countries. For example, if the public understood that the trade-off for increasing expenditures on pensions might well be a reduction in immunizations for children, the debate over social-sector reform might be more likely to lead reform.

## CONCLUSION

There is no clear recipe or model for successful social-sector reform in the transition economies. Yet there are valuable experiences in the developing world, particularly in Latin America, with both safety net policies and social-sector reform that are far more relevant for the transition economies than are the experiences of the OECD countries. Several conditions necessary for effective safety nets and for social welfare policy emerge from these experiences. First, in the absence of a sound macroeconomic policy framework, no social welfare reform is likely to succeed. Second, targeting social expenditures to the poorest sectors makes them far more effective from a poverty reduction standpoint. Third, there are major political obstacles to reallocating expenditures to the poorest, but a context of rapid and far-reaching macroeconomic reform provides governments with political opportunities for doing so. And political opposition can in part be overcome with strategies that involve the beneficiaries in the process of reform, thereby creating new stakeholders. Finally, effective government communication with the public will be critical to any reform effort.

[12]Based on author's interviews with Jose Pinera, Minister of Labor and Social Security at the time the reform was implemented, Washington, DC, and Santiago, June-July 1996.

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# V

# Transforming the Role of the State

# Democracy, Social Change, and Economies in Transition

*Charles Tilly*

States emerged as distinctive sorts of organizations some 10,000 years ago. Before then, victorious violence and organized power certainly existed, but did not crystallize in states; they did not congeal, that is, into coercion-wielding organizations, separate from kinship structures, that exercised priority in some regards over all other organizations within delimited territories. Economies, on the other hand, have belonged to social life since the beginning of human time, at least in the sense that groups of humans created social relations by means of which they allocated scarce resources. From the invention of states onward, state agents have strongly influenced economic processes by extracting resources, making war, creating administrative structures, and—in greatly varying degrees and forms—intervening in exchanges and commitments among people falling under their jurisdictions. Thus for a hundred centuries humans have created, experienced, debated, analyzed, and prescribed relations between states and economies.

Normative and prescriptive ideas shadow almost all discussions of states and economic transition. In our own time, social democrats prefer states that intervene in economic activity sufficiently to ensure some minimum of justice and welfare; capitalist liberals want just enough state—and just the right kind—to guarantee property, enforce contracts, and tune public finances in a way that supports economic growth, while libertarians and anarchists call for little or no state at all. Of course each of these normative-prescriptive positions rests on non-normative theories concerning the likely causes and consequences of state action in its various guises. But each causal account also clings to a set of preferences.

The analyst's job is to open some distance between one and the other, at least to the extent of examining under what conditions, if any, trajectories of change from existing to desirable situations could actually occur. Success in that distancing will mitigate the effects of teleological reasoning, the special form of built-in preference that analyzes change in terms of approaches to, or failures to approach, some target condition such as a full market economy and/or extensive democracy. Even when applied to processes in which human agents are seeking well-defined goals, teleological reasoning hinders explanation. It does so because:

- Human interaction always entails limited information, bounded rationality, error, unanticipated consequences, and constrained error correction, all of which produce discrepancies between outcomes and consciously articulated ends.
- Multiple paths away from a given social situation are almost always possible.
- Hence explanation entails showing what chains of causes selected for one of those paths and against the others.

One way to create analytical distance between causal processes and desired outcomes is to think of human history since states emerged as a huge set of natural experiments in connections between states and economies. Many sorts of state and many kinds of economic organization have flourished somewhere in the world over that long period, but in retrospect most historians of the two claim to find dramatic covariation between them—autocratic empires typically coinciding with landlord-dominated but peasant-based agrarian economies, urbanized trading economies typically supporting thinner oligarchic states, and so on. At a minimum, these natural experiments give us the means of thinking critically about two issues raised by any discussion of states and economies in transition: (1) static interdependencies between state structures and forms of economy, and (2) dynamic relationships between changes on the two sides.

Fiscal strategies illustrate both the static and the dynamic interdependencies. Three decades ago, Gabriel Ardant (following leads provided centuries earlier by Niccolò Machiavelli and Jean Bodin; see, e.g., Ardant, 1965) insisted that fiscal policies tied all sorts of states to their ambient economies. Ardant was an economist and socialist who long served as a high fiscal officer of the French state, but acquired the leisure to reflect and write when Charles de Gaulle came to power and detached him from his administrative duties without being able to force his resignation. Free to travel widely and advise foreign governments on fiscal affairs, he noted wide variation in the effects of ostensibly superior fiscal practices from country to country—or, more precisely, from economy to economy.

Ardant called particular attention to the relation between an economy's commercialization and the efficiency of different fiscal policies. With commercial activity sparse and major trade flows well channeled, for example, customs, excise, and other taxes that can be collected at relatively few monitoring points tend to bring in larger returns for a given effort than do wealth and income taxes. Only with extensive labor markets, wage labor, and governmental monitoring of employing units do income taxes ordinarily yield enough revenue to make the extensive and continuous record keeping and surveillance they entail worthwhile.

Ardant also pointed to the reciprocal relationship: state fiscal strategies affect ambient economies by giving their participants incentives and opportunities to hide assets, move capital, shift from one sort of production to another, and create flows that bypass monitoring points. Moreover, they frequently involve state agents in promoting those activities that support their own crucial enterprises—for example the production of rice in a Tokugawa Japan whose governments depended heavily on taxes in kind. Thus for Ardant the effectiveness of a fiscal program depended not on its conformity to some abstract ideal, but on its fit with the particular economy from which state agents were extracting resources.

As Ardant pointed out, state interventions in economies look quite different from the top down and the bottom up. From the top, we see agents of a state engaged in a set of extractive, coordinating, and controlling activities. Those activities result from some combination of demands (1) from within the state for conditions and resources that will permit operation of state enterprises, such as the military, and (2) from powerful constituents outside the state who borrow state power in pursuit of their own interests. From the bottom, we see people and organizations operating within the state's ambit who react to state agents as regulators, monitors, exploiters, and/or allies. Ardant wrote a dramatic account of tax evasion and rebellions incited by taxation, for example, as responses to manifestly unjust and grossly inefficient fiscal regimes. Only an interactive account that represents both top-down and bottom-up views will provide a means of describing and explaining state-economy relations.

We can generalize the sort of reasoning adopted by Ardant. Across Europe as a whole over the last millennium, varying intersections of organized capital with organized coercion have yielded very different sorts of states and economies. Taking variations in state structure as the object of explanation, we can define a range from (1) regions of sparse capital and abundant coercive means to (3) regions featuring extensive concentrations of capital along with great fragmentation of coercive means, passing by (2) a midpoint of relative equality in concentrations of capital and coercion.

In the first sort of region, typified by Poland over most of its last thousand years, state formation followed a *coercion-intensive* path. At the other extreme, typified by much of the Low Countries, *capital-intensive* state formation prevailed. Around the midpoint, where England and France operated through much of the millennium, *capitalized coercion* characterized the transformations of states. In the long run, military superiority gave the forms of state that developed in capitalized-coercion regions an evolutionary advantage. Before the decisive nineteenth-century expansion of relatively bureaucratic, well-capitalized, and coercion-subordinating states, however, coercion-intensive states long survived in the guise of tribute-taking, warrior-landlord-dominated empires that preyed upon the capitalists who came into their grasp. At the capital-intensive end of the range, likewise, city-states, city-empires, and trading federations thrived for centuries before capitulating to their military rivals.

Each of these alternative state-formation processes had a somewhat different impact on economic activity within its territory: first because each type of state intervened distinctively within its surrounding economy, and second because each fortified a different set of economic actors. Under the first heading, states' searches for resources to maintain their own activities held overwhelming predominance until the nineteenth-century. Coercion-intensive states tended to employ levies in kind rather than cash; to allocate monetary taxes as a function of political vulnerability rather than wealth or income; to seize conspicuous unprotected wealth militarily; and to place the collection of revenues in the hands (or fists) of relatively autonomous regional or cultural magnates, thus pushing economic activity toward a division between coerced production of basic goods and quick-return investment in activities generating mobile and easily concealed assets. Capital-intensive states tended to favor cash levies; to draw revenue from excise taxes and customs; and to purchase military means on national or international markets, thus promoting the further commercialization of their economies.

Under the second heading—differential favors to economic actors—we might characterize the coercion-intensive varieties as landlords' states, the capital-intensive varieties as merchants' states. The contrast sets a landlord-dominated Russia against a merchant-dominated Venice. That comparison, to be sure, simplifies brutally: in Russia, for example, tsars from Ivan the Terrible onward subjugated autonomous nobles to imperial power and created a relatively effective imperial bureaucracy, while in Venice an oligarchy of merchant families set strong limits on the activities of their lesser confreres. Nevertheless, a patent difference appears between the forwarding of landlord interests in coercion-intensive Russia and the promotion of mercantile activity in capital-intensive Venice.

Although many theories of state-economy relations give ultimate priority to economic organization, then, no sensible account can neglect the mutual dependence of state and economy. In economies featuring extensive markets for raw materials, producers' goods, consumer goods, capital, and labor, agents of states intervene incessantly not only by means of fiscal policy, military procurement and expenditure, monetary controls, infrastructural investment, and other obviously economic activities, but also by establishing, operating, and altering institutions that govern relations among economic actors. Douglass North and his collaborators have made compelling cases for the fundamental influence of such institutional arrangements on levels and distributions of economic activity (see, e.g., North 1985, 1991).

Whatever else they do, states always serve as instruments of exploitation. I mean exploitation in the classic sense of the word: actors who control valuable resources enlist the effort of other actors in producing goods by means of those resources, but award those effort-expending actors less than the net value their effort adds to aggregate production. States serve exploitation in two different ways—through direct production of goods and through intervention in the production of goods under control of their favored collaborators. Through most of their history, states have directly produced military goods for the benefit of their rulers; sometimes produced fiscal goods, such as monopoly salt or tobacco, to sell for state revenues; but otherwise concentrated on assisting exploitation by their ruling classes.

Capitalist states have continued that pattern, canting their assistance toward owners of capital. Socialist states, on the other hand, have broken the pattern by placing major producing organizations under direct state control—often in the name of the people at large or at least of the working people, but with the actual effect that officeholders have become the chief exploiters. Officeholders in socialist states—and, for that matter, in nonsocialist states as well—become exploiters to the precise extent that they divert production by means of collectively held resources from collective goods to their own private benefit.

Democratic arrangements, whether coupled with relatively socialist or relatively capitalist states, redirect and mitigate exploitation in two ways: first by greatly enlarging the circle of exploiters (which at an ideal extreme becomes coextensive with the citizenry), and second by committing organized effort to the production of collective goods. A regime is democratic, as I understand it, to the extent that its institutions deliver (1) broad citizenship; (2) equal citizenship; (3) binding consultation of citizens with respect to state policies and personnel; and (4) protection of citizens, especially members of minorities, against arbitrary action by agents of the state.

Such a definition strikes a middle ground between formal criteria stressing elections, parliaments, and related institutions, on the one hand, and substantive criteria stressing equity, commitment, and well-being on the other. Even if (1) deep economic inequality and autonomous militaries threaten democratic institutions thus defined; (2) contested elections, parliaments, and independent judiciaries tend to promote binding consultation of citizens, as well as their protection from arbitrary state action; and (3) democratic polities thus defined favor equity, commitment, and well-being—all of which seem likely—it serves explanation better to exclude these elements from *definitions* of democracy.

Democratic regimes concentrate their benefits on citizens. True, in many Western states legal residents actually qualify as near-citizens; within the European Union (EU), for example, differences in rights between citizens and ostensible foreigners from elsewhere in the EU are diminishing. Similarly, Latin American states maintaining major migration streams to the United States are increasingly granting dual citizenship to their emigrants who acquire U.S. citizenship. After a century or so during which Western states insisted on sharp distinctions between citizens and foreigners, the line is now blurring. As analysts, we can accommodate such facts either by expanding the definition of "citizen" or by substituting for "citizen" in our definitions of democracy something like "persons who live continuously under the jurisdiction of the same state." Either approach draws attention to a crucial fact about states: all of them actually impose multiple degrees of citizenship, if only by excluding minors, prisoners, and certified incompetents from full exercise of citizens' rights. To that degree, all polities fall short of full democracy.

The Task Force on Economies in Transition has divided its efforts between two complementary pursuits:

- First, identifying ways of describing and explaining economies in transition (especially economies emerging from state socialism) that differ from teleological accounts built on the assumption that extensions of private property and market relations *ipso facto* promote effective capitalist economies.
- Second, specifying the place of political institutions, including democracy, in economic change.

We have been willing to assume that post-communist economies will integrate more extensively into the circuits of world capitalism than did their Warsaw Pact predecessors, but not that they will become replicas of existing capitalist economies. We have argued that both institutional legacies of state socialism and continuing involvement of state actors in economic change must significantly affect how closer integration into the capitalist world occurs, and with what effects.

With respect to states and democracy, our inquiry has therefore concentrated on the following sorts of questions:

- How do the existing world economic organization and the legacies of state socialism constrain likely paths of economic change in post-communist economies as compared with previous entries into the capitalist world economy?
- To what extent do those constraints explain the phenomena rulers, critics, and academic analysts of post-communist economics have commonly labeled as failure, resistance, corruption, and distortion?
- How, why, and with what consequences are changes taking place in the political institutions that significantly affect economic activity—property

rights, patronage, and influence networks, as well as formal organizations and constitutions?

- What future changes are likely in these areas, and why?
- To what degree, and in what ways, do the answers to the above questions explain recent changes in property rights, production, household economic behavior, and welfare policies? What implications do they have for future policies in these areas and their likely effects?

Available answers to these questions lie on a continuum from liberal to institutional. A strictly liberal account argues that free-market economies, wherever and whenever they form, greatly resemble each other, dissolve impediments to their operation left by previous regimes, and transform social structure in similar inexorable ways. It follows that (1) existing capitalist economies provide likely models for the futures of economies now experiencing expansion of market activity, (2) future trajectories from nonmarket to market economies will resemble those by which existing capitalist economies arrived at their present organizations, (3) interventions to hasten such changes can reasonably consist of constructing institutions now characteristic of advanced capitalism, and (4) observers can measure the success of such interventions by the rapidity with which market-mediated transactions increase.

A strictly institutional account, in contrast, argues that previously existing social organization and culture strongly constrain all economic change, and that the economic arrangements of market capitalism depend on a particular and historically exceptional set of institutions, so that there can be no replications of previous capitalist economies and transitions to them. It follows that (1) existing capitalist economies provide misleading models of futures for nonmarket economies now experiencing expansion of market activity; (2) the paths of such economies to more extensive markets will differ both among those economies and between them and existing economies; and (3) effective interventions to hasten market expansion will require close analysis of existing social structure, extensive revamping of underlying nonmarket institutions, and continuous monitoring of nonmarket effects with an eye to feedback that will transform the conditions and likely consequences of intervention.

The above discussion, of course, draws cartoons to dramatize contrasts between extreme positions. All the chapters in this volume fall somewhere between these extremes. Nevertheless, the implied continuum from one extreme to another helps identify significant differences among our authors. For example, Polishchuk's essay on "missed markets" criticizes Russian reformers for assuming an extreme version of the liberal scenario. He identifies incomplete democratic institutions as obstacles to economic advance. Yet Polishchuk himself ends up endorsing a relatively liberal position: that if reformers would stimulate the formation of factor markets, other markets would develop in a fairly orderly fashion. Leitzel's analysis of Soviet and post-Soviet rule evasion, in contrast, takes a strongly institutional line, stressing how the carryover of practices and social relations from the previous regime promotes forms of privatization that offer great profits to a few individuals while diverting capital from productive long-term investments. Without drastic institutional reorganization, his analysis implies, Russia will follow a distinctive and dangerous path toward bandit capitalism.

In general, the more institutional a position taken by our authors, the more they consider existing state organization to constrain economic change and the less they suppose that expansion of markets will generally promote growth-enhancing governmental arrangements. On the relation between capitalism and democracy, however, arguments array differently along the continuum. At a liberal extreme, extensive capitalist markets more or less automatically dissolve authoritarian polities and move them toward democracy. Midway across the continuum, causality reverses, with analysts giving priority to democratic institutions; absent some minimum of equality and breadth of citizenship, plus binding consultation and protection of citizens, runs the argument, capitalist economic relations will not work. But at an institutional extreme, each regime changes so differently from others that—whatever the direction of causality—no general functional interdependence exists between capitalism and democracy. At that extreme, analysts tend to explain the rough empirical correspondence between capitalism and democracy in the contemporary world as a consequence either of joint diffusion from the West or of differential incorporation into a capitalist core.

Although theorists of democracy, capitalism, and economic growth commonly take strong positions on how each of these processes covaries with and affects the others, no consensus has emerged among students of these subjects. Even within this one section of our volume, opinions run from Åslund, who, while conceding that a "strong civil society" promotes economic growth, generally treats democracy as an outgrowth of capitalism, to Walder, who implies that China is experiencing rapid economic growth and extensive alteration of state structures without moving at all decisively toward democracy. Åslund's position approaches the liberal end of our continuum, Walder's the institutional end. In between stands Przeworski, who argues forcefully that certain sorts of democratic state institutions—but only certain sorts—provide essential underpinnings for capitalist economic growth. The debate continues.

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# 16

# The State in a Market Economy

*Adam Przeworski*

> In framing a government to be administered by men over men, the great difficulty lies in this: you must first enable the government to control the governed; and in the next place oblige it to control itself.
>
> James Madison, *Federalist 51*

## INTRODUCTION

The transition from command to market economy entails not only economic but also political reforms. As the allocation of resources becomes decentralized, the inevitable question concerns the role of the state in the economy. This is why reform of the state appears on the agenda of all countries transforming their economic systems. The goal of this reform is to build institutions that would empower governments to do what they should while impeding them from doing what they should not. And this means that reform must be not only administrative, but also broadly political.

What one thinks about the proper role of the state depends on the model of the economy, as well as of the state itself. One question is "What should the state do?"; the other is "What kind of state will do all and only what it should?" Hence, this chapter begins with a brief recapitulation of debates about the proper role of the state in the economy, and only then addresses the issue of state reform. The next section briefly reviews the history of controversies concerning the relation between the state and the economy; the discussion includes consequences of the economic theory of incomplete markets and imperfect information for our understanding of this relation. The following section examines three classes of principal-agent relations: between govern-

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ment and private economic agents (regulation), between politicians and bureaucrats (oversight), and between citizens and government (accountability). I conclude that the quality of state performance depends on the institutional design of all these mechanisms, and that well-designed institutions will allow and induce governments to intervene in the economy in a way that is superior to what occurs in a noninterventionist state.

## THE STATE AND THE ECONOMY: CONTRASTING PERSPECTIVES

To understand the rationale for state reform, we need to look back at the history of debates about the proper role of government in the economy. These debates have gone around in circles, with arguments about market failures being countered by claims about regulatory failures. As one reviews the history of these controversies, they appear almost as a boxing match, with the state and the market alternately on the ropes.

In a standard neoclassical model of the economy, there are markets for everything, now and for the future; everybody knows everything, and they know the same things; and there are no public goods, no externalities, no transaction costs, and no increasing returns. Since under these assumptions the market generates the first best allocation of resources, state intervention, in any form or fashion, is but a transfer of income; in turn, transfers of income, by causing rates of return to diverge from the competitive allocation, reduce incentives and misinform about opportunities. This conclusion follows directly from this model of the economy: since the state has nothing to contribute, anything it does is pernicious. The market wins round 1.

Yet the very fact that this model must be characterized at least in part negatively—by the absence of public goods, externalities, transaction costs, and monopolies—indicates an immediate problem. In the presence of these "failures," markets no longer allocate efficiently. This was the observation underlying the doctrine of state intervention enshrined in the 1959 Bad Godesberg Programme of the S.P.D.: "markets whenever possible, the state when necessary." The general prescription that emerged from this observation was that markets should be left alone to do what they do well—allocate private goods in those cases where the private rate of return does not deviate from the social rate—while the state should provide public goods, facilitate transactions, correct externalities, and regulate monopolies due to increasing returns. Round 2 goes to the state.

Neoliberals attacked this view in several ways: (1) by arguing that in the absence of transaction costs, the market can deal efficiently with market imperfections under a suitable reassignment of property rights (Coase, 1960); (2) by pointing out that the notion of market imperfections, including public goods, is unclear, and no theory specifies them ex ante (Stigler, 1975); and (3) by remarking that even if the market fails to act efficiently, there is no guarantee that the state would do any better (Stigler, 1975; Wolf, 1979). Neoliberals maintain that prescriptions for state intervention are based on a naive model of an omniscient and benevolent state. They claim that the reason the state intervenes is the same as the reason for any other economic action: someone's private self-interest. Hence while the state is necessary for an economy to function, it can and does damage the economy. Here lies the fundamental dilemma of economic liberalism: "The economist recognizes that government can do some things better than the free market can do but he has no reason to believe that democratic processes will keep government from exceeding the limits of optimal intervention" (Posner, 1987:21). Indeed, analyses of the downfall of Keynesianism presented in the mid-1970s, whether from the left (Habermas, 1975), the center (Skidelsky, 1977), or the right (Stigler, 1975) were almost identical: the state became powerful, and for this reason it offered an attractive target for rent seeking by private interests (Buchanan et al., 1980; Tollison, 1982). As a result, the state was permeated by special interests, private logic prevailed, and the internal cohesion of state interventions disintegrated. Thus round 3 ends with the state on the ropes.

The goal of "constitutional" economics became to disable state interventions, particularly those that discriminate among private projects, respond to current economic conditions, or directly transfer incomes. Thus, for example, in Posner's (1987:28) view, "a government strong enough to maintain law and order, but too weak to launch and implement ambitious schemes of economic regulation or to engage in extensive redistribution, is probably the optimal government for economic growth." The neoliberal approach for limiting the state includes (1) reducing the size of public administration, (2) reducing the size of the public sector, (3) insulating the state from private pressures, (4) relying on rules rather than allowing discretionary decisions, and (5) delegating decisions subject to dynamic inconsistency to independent bodies that have no incentives to yield to political pressure. Public administration should be reduced because the state is "bloated," and the productivity of public services is allegedly lower than that of the private sector.[1] The public sector should be privatized because governments are supposed to be more responsive to political pressures from public than from private firms. The state should be "insulated" from political pressures so it will not fall prey to rent seeking by private interests. Economic policy should be governed by rules, such as the gold rule or the balanced-budget amendment in the United States, that would eliminate discretion and thus overcome the suboptimality due to dynamic

[1]Presumably, the size of the government productive sector is optimal when the marginal products of the public and private sectors, with regard to the capital stock (Barro, 1990) and employment (Findlay, 1990), are equal. For econometric evidence that in many countries the state is too small by this criterion, see Ram (1986) and Cheibub and Przeworski (1997).

inconsistencies (Kydland and Prescott, 1977). Finally, an alternative to rules is to delegate important policy decisions, particularly in the monetary realm, to institutions that are independent from political pressures and thus have no incentives to yield to dynamic inconsistencies (Cukierman, 1992).

Yet the view that markets are efficient even in the absence of "traditional" failures now appears dead, or at least moribund. The inefficiencies originating from the absence of some markets and from imperfect (more accurately, endogenous) information[2] are both more profound and more devastating than the imperfections that blemish the neoclassical market. In a recent summary, Stiglitz (1994:13) put it bluntly: "The standard neo-classical model—the formal articulation of Adam Smith's invisible hand, the contention that market economies will ensure economic efficiency—provides little guidance for the choice of economic systems, since once information imperfections (and the fact that markets are incomplete) are brought into the analysis, as surely they must be, there is no presumption that markets are efficient." When some markets are missing, as they inevitably are, and information is endogenous, as it inescapably is, markets need not clear in equilibrium, prices do not uniquely summarize opportunity costs and can even misinform, externalities result from most individual actions, information is often asymmetric, market power is ubiquitous, and "rents" abound. These are no longer "imperfections": there is nothing out there to be blemished, no unique "market," but many possible institutional arrangements, each with different consequences.

Moreover, some forms of state intervention are inevitable (Cui, 1992). The economy can function only if the state insures investors (limited liability), firms (bankruptcy), and depositors (two-tier banking system). But this kind of state involvement inevitably induces a soft budget constraint. The state cannot simultaneously insure private agents and not pay their claims, even if the latter result from negligence induced by the insurance ("moral hazard"). If markets are incomplete and information imperfect, moral hazard and adverse selection render first-best allocations unattainable.

Even the most ardent neoliberals admit that governments should provide law and order, safeguard property rights, enforce contracts, and defend from external threats. The economics of incomplete markets and imperfect information allows room for a much greater role for the state. The neoclassical complacency about markets is untenable: markets simply do not allocate efficiently. Even if governments have only the same information as the private economy, some government interventions would unambiguously increase welfare.

Thus the state has a positive role to play. Yet round 4 ends at best in a

[2]One way to think about incomplete markets is that we know we will be making transactions in the future. In turn, a good way to think about imperfect information is that we learn from observing the actions of others, including their willingness to buy and sell.

draw. All we know now is that there are important things the state could do. But the consequences of the neoliberal punch still linger: will the state do what it should and not do what it should not?

## PRINCIPAL-AGENT RELATIONS

Once we understand that markets are inevitably incomplete and economic agents have access to differing information, we discover that there is no such thing as "the" market, only differently organized economic systems. The very language of "the market" subject to interventions by "the state" is misleading. The problem we face is not that of "the market" versus "the state," but of specific institutions that would induce individual actors—whether economic agents, politicians, or bureaucrats—to behave in a collectively beneficial manner.

Suppose your car has been making strange noises. You go to a mechanic, explain the problem, leave the car, and wait for the result. One day later, the car is ready, the mechanic tells you that the shock absorbers needed changing and that it took 5 hours, and you pay and drive out of the garage, the noise gone. You chose the mechanic, and you can reward him by going back to him if you are satisfied with the outcome or punish him by going somewhere else if you are not. But there are all kinds of things the mechanic knows that you do not: whether he wanted to do the best job possible or as little as he could get away with, whether the car required a major repair or just a minor adjustment, whether he in fact did the job in 5 hours or only 1. You are the "principal," and he is the "agent." You hire him to act in your best interest, but you know that he has interests of his own. You can reward or punish him, but you will have to decide which to do with imperfect information, since he knows things you do not and does things you do not see. What can you do to induce him to work for you as well as he can?

When some markets are missing and when particular individuals have access to differing information, relations between classes of actors are those of principals and agents, linked by explicit or implicit contracts. Agents have some information that principals do not directly observe: they know their own motivation, they have a privileged knowledge of their capacities, and they may have a chance to observe some things principals cannot. They also undertake some actions that are, at least partly, hidden from the principal. The generic problem facing the principal is thus how to induce the agent to act in the principal's interest while meeting the "participation" constraint—providing the agent with income (or utility) above the next best opportunity—and the "incentive compatibility" constraint—allowing the agent to act in self-interest. You must pay the mechanic enough for him to want you to come back, and you must make him know that you will come back only if he has done a good job.

The "economy" is a network of multifarious and differentiated relations between particular classes of principals and agents: managers and employees, owners and managers, and investors and entrepreneurs, but also citizens and politicians, and politicians and bureaucrats. The performance of firms, of governments, and of the economy as a whole depends on the design of institutions that regulate these relations. What matters is whether employees have incentives to maximize effort, whether managers have incentives to maximize profits, whether entrepreneurs have incentives to take only good risks, whether politicians have incentives to promote public welfare, and whether bureaucrats have incentives to implement goals set by politicians.

Institutions organize all these relations—those that are purely "economic," such as between employers and employees, owners and managers, or investors and entrepreneurs; those that are purely "political," such as between citizens and governments or politicians and bureaucrats, as well as those that structure state "intervention"; and those between governments and private economic agents. If the economy is to operate well, all these principal-agent relations must be structured appropriately.

At the cost of being schematic, let us consider only three classes of such relations: (1) between the government (politicians and bureaucrats) and private economic agents, (2) between elected politicians and appointed bureaucrats, and (3) between citizens and government.

The performance of an economic system depends on the design of all these relations. Private agents must benefit by behaving in the public interest and must suffer when they do not, and so must bureaucrats and politicians.

### Government and Economic Agents (Regulation)

The role of the state is unique since the state sets the incentive structures for private agents by exercising its legally qualified coercive power: mandating and prohibiting some actions by law or changing relative prices through the fiscal system.

Let us take an example. Suppose I buy car-theft insurance. I drive to my destination and have a choice of parking a few blocks away from where I am going, in a place where the car is unlikely to be stolen, or parking just in front, in a place where the car is more likely to be stolen. Given that I am insured, I take the risk and park in the more dangerous place. Now the state comes in: it taxes me and uses the tax revenue to place a policeman in the dangerous place. As a result, car theft is less likely, the insurance company loses less money, and my premium goes down, more than compensating for the increased tax. The state is inextricably present in my relation with the insurer: although our relation is strictly "private," it is shaped by the state. The state permeates the entire economy; it is a constitutive factor of private relations. Problems of institutional design cannot be avoided by throwing the state out of the economy. They must be confronted as such.

Yet government intervention in the economy—what is referred to as "regulation" in the United States—is not simple even on paper, not to speak of practice. The generic problem is the following (Baron, 1995). The regulated firm has information about some of its conditions, such as its cost of production or the demand for its outputs, which is superior to the information available to the government (the "regulator," understood in broad terms as elected politicians or appointed bureaucrats). Moreover, this firm undertakes some actions the regulator cannot observe directly, but can only either infer from outcomes or monitor at a cost. The regulator has a legal authority to set prices or rules. Once the regulation is issued, the firm decides whether to produce and how much. The regulator's problem is then to set up the best trade-off between the rents of the firm and the surplus of consumers.

Given hidden information and hidden actions, first-best regulation is not possible. The firm will always extract some rents. Thus regulation can be optimal only subject to the information available to the regulator; at most it is "second-best optimal regulation" (Baron, 1995:14).

Moreover, since any kind of state economic intervention has distributive consequences, different groups affected by regulation—firms, industries, employees, consumers, or public action lobbies—have incentives to seek regulation that benefits them and resist regulation that hurts them. The regulators can in turn benefit privately by supplying the interventions sought by the private actors. These private gains may consist not only of being (re)elected, but also of getting rich while in office or once out of office. As a result, regulation may induce clientilistic ties between the regulators and the regulated groups. To this extent, regulation is "endogenous"; that is, it is supplied in response to demand by the groups potentially affected by it.

As an example, consider a situation simplified from Laffont and Tirole (1994:Ch. 16): There are two periods. In period 1, a firm that is a natural monopoly has either high or low costs with some probabilities. A firm with high costs can invest to lower them. This investment is socially beneficial. A good intervention—one that maximizes consumer surplus—is then one in which the government subsidizes investment if the firm has high costs in period 1, and the government does not pay for investment otherwise. A bad intervention is one in which the government fails to subsidize investment by a firm with high costs, or subsidizes a firm with low costs and splits the rents with the firm.[3]

The institutional problem is then twofold: (1) how to *enable* the government to intervene in a good way and (2) how to *induce* it to act well. Only the first question is considered here; the second is discussed below.

[3]For example, the head of a regulatory agency subsidizes the firm only to be hired as its vice-president.

To be able to intervene in a good way, the government must have some information about the costs faced by a given firm, and must be either legally capable of setting prices for the regulated firm (so that the cost of investment will be borne by consumers) or financially capable of subsidizing the firm out of tax revenues. Yet this is not sufficient. The reason is that even if the investment is subsidized, either by consumers or directly by the state, the firm will not undertake it unless there is a reasonable certainty that the profit due to the investment will not be confiscated once the costs are sunk. Suppose the firm expects that the government may change, and the new government will tax away its increased profits. Then the firm will not invest even if it receives the subsidy, and knowing that the firm will not invest, the optimal intervention for the period 1 government will be not to subsidize investment, even thought it is socially beneficial.[4] Hence, to be able to intervene well, the government must be committed to not confiscating the firm's profits during the second period.

The problem of commitment stems from the moral hazard of the principal. Even though the government would want the firm to invest, once it does so, the government will want to tax away its profits. Hence, agents cannot be sure that they will be rewarded if they behave well. This problem is present in many principal-agent relations, including purely private ones. But it is inherent in political relations. The ultimate source of political sovereignty—exercised by the democratic process—rests with "the people," in its eighteenth-century singular. And this implies that no government can fully precommit all future governments. An absolute guarantee of property rights is not possible. True, property rights can be, to various degrees, protected by the constitution. But constitutions cannot specify everything and must leave leeway for legislative discretion, as well as judicial interpretation. Moreover, even though the process may be difficult, constitutions can be changed: vide the nationalization of the Chilean copper industry by a constitutional amendment in 1970. Hence, property rights are inherently insecure.[5]

The result is a paradox of regulation: in those countries where it is easy to pass regulatory legislation, it is also easy to change it, so commitment is not credible; in those countries where it is difficult to change laws, so that commitments are credible, laws are also difficult to pass. Spiller (1995) shows the difficulty of making credible commitments in different institutional contexts. In different countries commitments are enforced by either (1) judicial review of decisions of regulatory bodies (prevalent in the United States, where 80 percent of the decisions of the Environmental Protection Agency are contested

[4]On the difficulties of designing optimal policies without a credible commitment, see Laffont and Tirole (1988).

[5]The almost exclusive emphasis on the security of property rights is in my view misplaced. The reason investment is low in many countries is not insecure property rights, but the absence of institutions insuring savers and investors against reasonable risks.

in courts); (2) highly detailed legislation (e.g., Chile's 1980 electricity regulation); or (3) contracts between the government and the firm, enforceable under contract law (e.g., Bolivian COBEE since 1912). But here the paradox appears. If a political system generates majorities and party discipline, even detailed legislation can be overturned when legislative majorities change. In turn, where the political system generates a highly divided party system, such legislation is difficult to overturn once it has been adopted, but it is also difficult to adopt.

Yet even if the cost of this insecurity may be that resources are underutilized,[6] commitment is not always optimal. For the danger is that a particular government will make a bad commitment, one that serves its own interests or those of its private allies, rather than those of the nation.

To return to our example, note that a commitment is socially beneficial only if the government intervened well during the first period, that is, if it subsidized a firm with high costs. If the government gave a subsidy to a firm that had low costs to begin with, the firm will have gained rents at the cost of the public, and if all future governments are committed to not increasing the tax on the firm, the new government will not be able to recoup these rents. As Laffont and Tirole (1994:620) observe, "The cost of commitment is that the government may identify with the firm and bind the nation to a bad outcome over the long run."

There are thus good and bad commitments.[7] Imagine the following situation, due to Calmfors and Horn (1985). Early in its term, the government announces that if unions push wages up and create unemployment, it will not accommodate by expanding public employment. But come election time, the government will want to win and will employ. Thus, the initial announcement is not credible, unions push wages up, the government accommodates, and the outcome is suboptimal. The government must precommit itself, by rules or delegation, to not increasing public employment on the eve of the elections. This is a good commitment. But suppose the government does not precommit, unions push wages up, and the election time arrives. Now the government wants to expand public employment. But the unions anticipate that once reelected, the government will fire the new public employees. Hence, the government commits itself to not doing so, say, by passing a law of "immovability" of public employees. This is a bad commitment. If governments bind themselves in response to pressures from special interests, their commitments will not be optimal. Hence, a central institutional issue of state reform is how

[6]Using data based on interviews with entrepreneurs in 28 countries, Weder (1995) found that the rate of economic growth is significantly lower where entrepreneurs report having to cope with unexpected changes of laws and where they do not expect governments to adhere to major policy pronouncements.

[7]For an exchange on this point, see Przeworski and Limongi (1993), Elster (1995a) and Przeworski's comment, and Elster (1995b) again.

to enable governments to make good commitments while preventing them from making bad ones.

I have used throughout the example of government regulation of a monopoly. Yet the same considerations apply to other forms of economic intervention. They also apply to “social” regulation, for example of health, safety, the environment, and employment (Baron, 1995). State intervention can be superior to nonintervention when governments have some information about private agents, when they have legal or fiscal instruments to regulate, and when the institutional framework allows credible commitments.

Yet none of these conditions guarantees that governments will intervene in the public interest. The very capacity of the state to intervene makes it an attractive target for influence by private interests, and the very ability to commit opens the possibility of collusion. Hence, there are reasons to expect that the quality of state intervention in the economy depends on the internal organization of the state—in particular, on the relations between politicians and bureaucrats—and on the design of the democratic institutions that determine whether citizens can control politicians.

## Politicians and Bureaucrats (Oversight)

In a democracy, the authority of the state to regulate the life of the society coercively is derived from elections. Yet many of the functions of the state and all of the services the state supplies to citizens are delegated by the elected representatives to someone else, specifically to the public bureaucracy. Delegation is inevitable. As Kiewiet and McCubbins (1991:3) observe, “desired outcomes can be achieved only by delegating authority to others.”

Delegation raises the standard principal-agent problems. Since it is impossible to write legislation that would fully specify the actions of agents under all contingencies, the executive and administrative agencies are left with a significant degree of discretion.[8] But the objectives of bureaucrats need not be the same as those of citizens or of the elected politicians who represent them. Bureaucrats may want to maximize their autonomy or the security of their employment, render clientilistic favors to friends and allies, shirk their duties in office, aggrandize their budgets, (Niskanen, 1971), or simply get rich—all at the expense of the public. Again, they have private information concerning the benefits and costs of their actions, and they undertake actions that cannot be observed directly, but only inferred from outcomes or monitored at a cost. Hence delegation must inevitably give rise to agency costs.

[8]This is also true of courts. Shihata (1995:221) observes, for example, that “while the legal codes of a country may deny a creative role for courts and refer them in the absence of text and custom to such sources as ‘natural law’ or ‘the general principles of morality,’ it is probably more useful to concede, as the Swiss Civil Code does, that in such cases the judge will rule according to the rules he would have established had he to act as a legislator.”

Indeed, given the discretion bureaucrats must enjoy, the question is how to avoid a regime of "policy without law," as Lowi (1979:92) describes the U.S. political system.

Some of the agency problems inherent in managing the public bureaucracy are not different from those confronted by private organizations (on these, see Hammond and Miller, 1985; Holmstrom, 1982; Groves, 1985; Miller, 1992:128-158). Yet public bureaucracies differ in some important ways from private ones. One difference stems from the difficulty of setting criteria by which not only individual agents, but also teams of them, could be evaluated in the public sector. Private firms often perform multiple tasks, but to the extent to which they face a market constraint, their performance can be measured by financial criteria. Yet public bureaucracies are faced with multiple targets that are not simple to set[9] and cannot be reduced to a single dimension. Another difference between private firms and public bureaucracies is that the latter are more frequently monopolies, which in turn implies that there are no comparative yardsticks by which their performance can be evaluated. As Tirole (1994) observes, the performance of management at Ford can be compared with that at General Motors, but this manner of measuring performance is not available when public agencies constitute monopolies.

Faced with these difficulties, public bureaucracies are prone to rely on conformity with rules rather than on incentives. This managerial style is called "police patrol" by McCubbins and Schwartz (1984). It consists of an a priori control of processes, as opposed to an a posteriori control of results. Tirole (1994:14) observes that "the central feature of a bureaucracy is that its members are not trusted to make use of information that affects members other than themselves, and that decisions are therefore based on rigid rules." The principal establishes rules, such as "work from 9 to 5," "do not use the telephone for private conversations," or "do not spend more than 20 minutes on a client," as well as reporting requirements. Agents are judged by whether they are observed to conform to such rules and by what they report. Needless to say, this is not a very effective mode of control: not only is it costly (the principals bear the costs of monitoring and of the time agents spend on filing reports), but it does not establish any direct relation between incentives and performance. Nevertheless, this is the way most public bureaucracies operate, and perhaps it is for good reason: if monitoring individual effort and eliciting private information are prohibitively expensive, reliance on rules may be the third-best.

There are a number of measures that can be taken to alleviate these agency problems.

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[9]Tirole (1994:4) cites as examples the difficulty of assessing the performance of the U.S. Department of State in "promoting the long-range security and well-being of the United States" or of the Department of Labor in "fostering, promoting, and developing the welfare of wage earners of the United States."

**Designing contracts.** Even with the difficulties involved in monitoring individual efforts of team members, the principal can create incentives for the agents by (1) setting wage levels sufficiently high to attract agents of high quality, who have higher opportunity costs; (2) offering sufficient career advancement (which entails wage differentials); and (3) establishing monitoring systems that will make job loss likely in the case of bad performance (see Haggard, 1995).

**Screening and selection.** Recruitment to the public sector must be sensitive to costly signals, such as education, that indicate the potential performance of the agents.

**Institutional checks.** Kiewiet and McCubbins (1991:33) point out that "agents are often in a position to do more harm to the principal than to simply withdraw effort: embezzlement, insider trading, official corruption, abuse of authority, and coups d'etat are all testaments to this fact. Whenever an agent can take actions that might seriously jeopardize the principal's interests, the principal needs to thwart the agent's ability to pursue such courses of action unilaterally." The solution offered by Kiewiet and McCubbins is "institutional checks [that] require that when authority has been delegated to an agent, there is at least one other agent with the authority to veto or to block the actions of that agent."

**Creating multiple principals or multiple agents with dissonant objectives.** Tirole (1994) observes that most governments are divided in such a way that it is not the task of any particular position or agency to maximize general welfare, yet their interaction is supposed to generate this effect. One example is the division between "spending ministries," which are supposed to promote substantive goals, and the finance ministry, which is supposed to control spending.

**Creating competition.** Such competition can be either between state agencies and private counterparts (say, in delivering mail) or among state agencies in the exclusive sector. While there are some costs due to duplication of effort and perhaps economies of scale, competition facilitates the measurement of performance and, if combined with correct incentives, enhances performance.

**Decentralization.** This is a complex and controversial topic. Arguments in favor of decentralization typically rely on observing that local provision of public services enhances the accountability of the government by bringing it closer to the people it serves. Arguments against decentralization assert that it diminishes the capacity of the government to reduce regional income disparities, requires higher administrative capacity (Haggard, 1995), and can induce a soft budget constraint in which the less efficient jurisdictions will be more highly subsidized by the central government.[10] Moreover, as Prud'homme (1995:204) observes, "the decentralization of taxes and expenditures works against the decentralization of activities and is likely to lead to a concentration of growth in a few urban locations."

Finally, public bureaucracies are different from private firms in one fundamental way that opens the possibility of more effective monitoring. To explain what is entailed, we need to step back.

A private firm has owners and a bureaucracy, which is an agent of the owners. It delivers products to the public, which does or does not buy the goods and services offered by the firm at a price. By revealing its demand for the firm's products, the public sanctions the firm; it generates profit or losses for the owners. Hence the principals, the owners, get free information from the public about the performance of the firm. The owners read the "bottom line," perhaps compare it with the performance of similar firms, and reward or punish the bureaucracy.

We have already seen one contrast between a private and a public agency—that the latter does not have a single "bottom line." Another contrast, to be discussed below, is that politicians may or may not want to sanction the bureaucracy. But most important, citizens' evaluations of the performance of public agencies do not have any direct sanctioning power. State services are produced and delivered by a bureaucracy, whose members are appointed by politicians. Citizens' control over the bureaucracy can be only indirect, since democratic institutions contain no mechanisms that would allow citizens to sanction directly the legal actions of bureaucrats. Citizens can at most consider the performance of the bureaucracy when they sanction elected politicians. As Dunn and Uhr (1993:2) observe, we do not even seem to know how to think about principal-agent relations involved in controlling bureaucrats: "It is by no means clear what place executive officials are meant to play as representatives of the people. Are they agents of the government or of the people?" Hence, while the state bureaucracy is supposed to deliver services to citizens, it is accountable to politicians (or to other bodies appointed by politicians, such as courts or administrative oversight agencies).

Yet precisely because the state bureaucracy delivers services to citizens, they are best informed about its performance. Moreover, if politicians care about citizens' welfare, the citizens have the same interests as the politicians, who are the principals, rather than the bureaucrats, who are the agents. The

[10] For more on this issue, see Prud'homme (1995) and comment by Sewell (in Prud'homme, 1995).

principals can thus rely on the information provided by the affected parties; this is, in the terminology of McCubbins and Schwartz (1984), "fire alarm" oversight. This form of oversight has two advantages: (1) it allows the principals to gather information at a lower cost than that of "police patrol" oversight, and (2) it provides better information, particularly about the most egregious violations by the agents. Even though the legal authority rests with the elected politicians, fire alarm oversight is a mechanism for the accountability of the bureaucracy to the citizens.

Fire alarm oversight requires institutional arrangements that facilitate citizens' monitoring of the bureaucracy, transmission of information, and sanctioning of violations. As Haggard (1995:41-42) argues, "The ultimate check on government must come through institutionalized forms of participation. This may either be 'corporatist,' such as building in NGO [nongovernmental organization] participation in areas in which they have expertise, or 'legislative,' such as adopting forms of local governance in which citizen participation is maximized."

To summarize the conclusions of the two previous sections, government intervention can be effective if the regulatory institutions are well designed, and politicians can better control bureaucrats if they solicit the cooperation of citizens. But the question that still remains open is whether politicians will want to intervene well and to control the bureaucracy.

## Citizens and Governments (Accountability)

The problem of citizens is to induce politicians to enhance the citizens' welfare rather than to pursue their own objectives in collusion with the bureaucracy or with private interests.

In many political systems, including democratic ones, bureaucracies appear to have autonomy from any control, completely insulated from public scrutiny. Moe (1990) offers a suggestive explanation for this pattern. Note first that in a democracy, bureaucrats can never be certain which political forces will control the government in the future, and they have reason to fear that a future government will be less favorable to their interests than the current one. Hence to protect themselves from the moral hazard of the principal—the possibility that their good behavior will not be rewarded by a future government—they seek to free themselves from any political control. In turn, the current government may fear that if it loses, the political forces that come into office will want to use the bureaucracy for their own advantage. Hence when the current government fears losing office, it has incentives to insulate the bureaucracy from political control, even at the cost of sacrificing its own influence over the bureaucracy. As a result, politicians and bureaucrats collude to make the bureaucracy autonomous, which implies that the bureaucracy will not be well designed to further social objectives and that bureaucrats will have no incentives to promote them.

Moreover, the principal-agent relation between citizens and elected politicians is a very special one, without parallel in the private world. Because sovereignty rests with citizens, they are the principals with regard to politicians they elect. But because the state is a centralized and coercive mechanism, it is the agents who decide which rules the principals must obey and who coerce them to comply. As Moe (1990:232) put it, "while citizens are nominally the superiors in this hierarchy, it is the legislators who actually hold public office and have the right to make law. Their role, as agents, is to exercise public authority, backed by the police powers of the state, in telling principals what to do."

Why then would politicians respond to citizens rather than collude with bureaucrats or some special groups to which they are beholden? The standard answer to this question is that under democracy, government can be controlled by citizens because it is elected.

In particular,[11] if the incumbents want to be reelected, whether because they value tenure in office per se or see it as an opportunity to advance private interests, citizens can induce government to represent their best interests by conditioning their voting decisions on the government's performance. Government is "accountable" if citizens can discern whether it is acting in their best interest and sanction it appropriately, so that those incumbents who act in the best interest of citizens win reelection, and those who do not do so lose. Accountability, in turn, induces representation through government's anticipation of the retrospective judgments of citizens. If political institutions meet politicians' participation ("self-selection") constraint (i.e., make it at least minimally attractive for people who have other opportunities to want to be reelected[12]) and the incentive compatibility constraint (i.e., make it in the interest of politicians to do what citizens would want them to do), then, anticipating the retrospective judgments of voters, governments will choose policies they believe will be positively evaluated by citizens by the time of the next election (Downs, 1957; Fiorina, 1981; Manin, 1995).

Yet asymmetric information between governments and voters makes representation difficult to enforce. Citizens typically do not observe some conditions of which politicians are aware. Such conditions may include the negoti-

[11]I say "in particular" because in some views, elections generate representation when voters use their votes prospectively to select good policies or policy-bearing politicians, rather than retrospectively to sanction incumbents for past performance. On the relation between elections and representation, see essays in Manin et al. (1997).

[12]For example, in Barro's (1973) seminal model of accountability, after-tax private incomes are larger when salaries paid to government officials are higher: a high salary for politicians increases the cost of job loss, and thus the effectiveness of electoral control.

ating posture of foreign governments or international financial institutions (whether they are accommodating or adamant) or the level of demand among the major importers of the country's exports. Citizens typically do not know as well as governments the impact of policies on outcomes, for example the impact of minimum wages on unemployment or of taxes on labor supply. With such incomplete information, accountability is not perfect: when citizens set their demands too high, politicians have no chance to be reelected and may dedicate themselves to the pursuit of short-term rents; when citizens set their demands too low, politicians can extract excess rents and still be reelected (Ferejohn, 1986).

While first-best representation is not feasible, institutional design matters. The behavior of the government is sensitive to the information available to citizens. Hence, we must ask again what institutional arrangements would alleviate these informational problems.

The first concerns the opposition. Citizens have two agents, not one: the incumbent government, which chooses policies, and the opposition, which wants to become the government. The opposition is an agent of citizens since it wants to win office, and to do so must anticipate the retrospective judgments voters will make about the incumbents at election time. Anticipating these judgments, the opposition has incentives to monitor the government and inform citizens (truthfully or not) about the bad performance of the incumbents. It can win elections if it persuades voters that the incumbent government has not been representative. Even if citizens initially care only about outcomes rather than the policies that generated them, the opposition can induce voters to care about policies if it succeeds in persuading them that different policies would have led to better outcomes (Arnold, 1993). And if opposition parties inform citizens about the misdeeds of the government or just about the sources of incumbents' money, they lower the cost of information to voters.[13]

Second, the mechanisms of accountability are not only "vertical"—of elected politicians to voters—but also "horizontal"—of different branches of the government to each other (O'Donnell, 1991). Elections are inevitably a plebiscitarian device: however informed voters are, their choice is only intermittently to ratify or reject decisions made by competing and cooperating teams of their representatives (Bobbio, 1989:116). A deliberative and open legislative process forces representatives to justify publicly the courses of action they advocate and to pool information they have. The legislative process is the occasion for spelling out the technical relations between policies

[13]I have to admit that I am not certain about the assertions in this paragraph. The opposition may have incentives to collude with the incumbents; see the experience of post-war Italy. Yet if the opposition always opposes, the information it offers is no more credible to voters than the information provided by the incumbents. I know of no model of accountability that includes the role of the opposition.

and outcomes in concrete terms and in some detail. It not only forces the executive to justify and defend its actions to other organs of the government, but also informs citizens.[14] Decree powers bypass this process and deprive citizens of the opportunity to learn about the quality of policies. By depriving the legislature of its deliberative function and citizens of information about the relative merits of alternative policies, decrees reduce the effectiveness of accountability mechanisms. Indeed, rule by decree should create a presumption that the executive is hiding from citizens, as well as legislators, some reasons for choosing particular policies.

Finally, the quality and amount of information available to citizens can be enhanced by institutions independent of other organs of the government. Such institutions may include (1) an independent board to ensure transparency of campaign contributions, with its own investigative powers; (2) an independent auditing branch of the state, an auditor general (World Bank, 1994: 32), in the vein of the Chilean *controlaría*; (3) an independent source of statistical information about the state of the economy; and (4) a privileged place for the opposition in overseeing the publicly owned media. These would be, to use the language of an Australian commission, "accountability agencies" (Dunn and Uhr, 1993).

## CONCLUSIONS

Let us conclude with an example. It is widely reported that worldwide, only about 40 percent of the funds allocated to targeted food subsidies ends up as food in the mouths of the poor; the rest disappears along the way. Faced with this fact, we can react in two ways. One is to say that since such programs are inefficient, they should not be undertaken. The other is to reform the delivery systems: to organize incentives in such a way that only those who really need the subsidies will apply for them; that government agencies will be able to recognize the needy; that citizens will be able to inform politicians as to whether those who need, and only those who need, subsidies are receiving them; and that politicians will fear being thrown out of office if most of the money ends up in the wrong pockets. I have argued that this latter solution is feasible and preferable. This is not to claim that a first-best allocation is possible; the best food delivery programs spend about 20 percent on delivery, and this cost is unavoidable. Moreover, some inefficiency is unavoidable since governments, as well as citizens, are constrained

[14]Persson et al. (1996) constructed a model of separation of powers in which the legislature informs citizens about the state of the world, the executive makes a budget proposal, and the legislature votes it up or down. Under these assumptions, the legislature informs citizens truthfully about the objective conditions, and citizens enforce representation through retrospective voting. Yet this is true only if the two powers cannot collude.

by information and transaction costs. The task of state reform is to make the government operate as well as possible under these constraints.

The reform of the state should be conceived in terms of institutional mechanisms by which governments can control the behavior of private economic agents, and citizens can control governments. The question of whether a neoliberal state is superior to an interventionist one cannot be resolved in general, since the quality of state intervention depends on the specific institutional design. But the neoliberal state is at best a benchmark against which to measure the quality of state intervention: given that market allocations are not efficient, disabling the state is not a reasonable goal for state reform.

State intervention can be superior to nonintervention when the institutional design allows governments to intervene in the economy, enables politicians to control bureaucrats, and enables citizens to control governments. At the risk of repetition, it bears emphasis that all are necessary. Governments must be able to distinguish when their interventions will increase social rates of return and must have instruments of effective intervention. But governments themselves must have incentives to intervene well and must be subject to sanctions when they do not act in the public interest. The elected politicians must want and be able to control bureaucracies, which are not subject to direct popular sanctions. Citizens must be able to discern good from bad governments and to sanction them appropriately, so that those incumbents who act well will win reelection, and those who do not will lose.

These conditions are stringent, and they can never be fully satisfied. But institutional design matters. The fact is that during the past 200 years, we have thought little about the institutional design of democracy. Since the great explosion of institutional thinking when the present democratic institutions were invented—and they were invented—there has been almost no institutional creativity. Except for the never-implemented provisions for workers' comanagement in the Weimar Constitution, the discovery of proportional representation in the 1860s and of mass parties in the 1890s were the last major political inventions. All democracies that have emerged since the end of the eighteenth century, including the most recent ones, have merely combined in different ways, often piecemeal, the preexisting institutions. Hence, there is a great deal of room for institutional creativity.

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# 17

# The State as an Ensemble of Economic Actors: Some Inferences from China's Trajectory of Change

*Andrew G. Walder*

By the 1980s, students of communism in Eastern Europe and the Soviet Union generally agreed that these economies were unreformable. Serious reform initiatives had been blocked by political considerations since the 1950s in the Soviet Union and most other communist regimes. Even in regimes such as Janos Kadar's Hungary, which had gone the furthest in attempting to insinuate market mechanisms and free enterprise, efforts at partial reform were consistently undercut by the stubborn reality of soft budget constraints and bureaucratic bargaining inherent in state ownership of industrial assets (Kornai, 1990a). Only a decisive break with the premise of state ownership could overcome these pathologies, something that could not be successfully undertaken as long as these societies were ruled by communist parties whose privileges and very existence were based on this premise (Brus, 1989; Winiecki, 1990).

The sudden collapse of communist party rule throughout the region unexpectedly removed what was viewed as the greatest single barrier to effective economic reform. Discussions of reform strategy reflected sharp divisions over the pace of change, with some calling for a rapid leap toward a market economy (Blanchard et al., 1991; Peck and Richardson, 1992; Sachs, 1993), and others calling for a more gradual evolutionary process that would take into consideration cross-national differences and institutional legacies (Kornai, 1990a; Murrell, 1991; Stark, 1990, 1992). Yet there was broad agreement about the general direction of change: the state's assets should be privatized, state agencies should withdraw from direct economic management, and government should retreat to a role in which it would provide neutral institutions to enforce contracts and property rights, the institutional foundations of a market economy (Blanchard et al., 1993; Comisso, 1991). Despite eloquent arguments that change is necessarily path dependent, and that capitalism cannot be made "by design" or through "central planning," the emphasis of work on governance in the economy is still how to place constraints on government actions (e.g., to bail out firms) and how to create the proper incentives for firms.

This emphasis was encouraged by three distinct and fairly explicit models of the communist state that had gained broad currency by the mid-1980s. Each was based on long and accurate observations of the workings of these regimes, and each was coherent, clear, and at the time highly persuasive. Together they appeared to provide clear guidance, by negative example, of what must be reformed in order to restore the economies of these countries. They also appear, in light of China's rapid economic evolution under Communist party rule, to have been flawed in identifiable ways. Whether these models led to ill-advised programs for reform in Eastern Europe I am not qualified to say (and I doubt whether they did). But they did—in combination with the fall of communist party dictatorships—foreclose thinking about the reform of state structures that turns out to have been central to China's economic transformation. The purpose of this chapter is to highlight what we have learned about incentives for state agencies and officials in China's reforms, not in order to provide "lessons" for Eastern Europe, but to underline the more general point that incentives for government agencies and officials are an integral part of any program of economic transformation (see Shirk, 1993).

## THREE MODELS OF THE COMMUNIST STATE

The first model highlights elite interests and political power. It has a distinguished European lineage, running from Trotsky (1937) to Djilas (1957) and Konrad and Szelenyi (1979). Communist states are in effect organizations that serve to perpetuate the advantages of a bureaucratic oligarchy or ruling class. The interests of those who rule are bound up with a system of central planning that allocates to them privileges in material distribution and in access to state property. Privilege flows from power. To use Szelenyi's language, a redistributive economy creates a class of "redistributors"—officials who have the power to allocate resources. Their privilege is founded on this power; their interests are tied to the preservation of central planning. This explains why impulses for economic reform were perennially so weak, and why regimes that did try reforms always pulled back from the brink.

Even in economies that underwent partial market reform, officials benefited disproportionately from markets because of their control of valuable assets, contracts, and licenses (Szelenyi and Manchin, 1987). In the language of institutional economics, communist bureaucrats derived economic rents from their positions in the planning system; they would use their power to defend those rents, and if market opportunities opened up new sources of income, they would use their power to extract rent from these activities as well, stunting the development of a market economy and derailing market reform (Winiecki, 1990). It was therefore highly unlikely under communist rule that market reform would progress to the point where it could turn these economies around—the interests of the powerful militated strongly against it (Brus, 1989; see also the work reviewed in Goldstein, 1996).

The second model highlights the features of the state as a distinctive form of economic administration, and analyzes the behavior of state agencies and firms under conditions of central planning and partial reform. The premises of the system create inherent behavioral tendencies that are as predictable as they are different from the workings of market economies. By far the most influential and coherent of such analyses is that of Kornai (1980, 1991). Kornai counterposed the economic mechanisms of central planning with those of a market economy. Production proceeded according to the preferences of planners, not aggregate demand. Production in firms was therefore resource constrained, not demand constrained: firms would produce to meet production targets until they ran out of materials (which they did habitually); they did not have to worry about finding customers for their products (or improving products to maintain their sales). Firms responded to their resource constraints by stockpiling materials (the "Kornai ratio" of inventory over output was a revealing measure of this) and engaging in barter trade, and sought higher investments to produce their own parts and supplies, rather than relying on specialized suppliers. The result of such practices is wasteful investment and lack of product innovation, and an economy that excels in early stages of growth when the mobilization of capital matters, but lags in subsequent stages, when organizational and technological innovation increase productivity and drive growth (Kornai, 1980, 1991; see also Winiecki, 1987, 1988).

To Kornai and other early reformers, the only remedy for these defects of central planning was to introduce market mechanisms: evaluate managers and allocate investment according to profit criteria, not plan fulfillment; make them find their own customers and compete for sales; and allow prices for products to fluctuate so they would better reflect relative scarcities. After more than a decade of experimentation in Kadar's Hungary, however, Kornai had concluded that such partial reform was doomed to failure; a market economy could not be grafted successfully onto socialist stock (Kornai, 1990a). Kornai's explanation for this is the most memorable and persuasive: market mechanisms were defeated by the redistributive practices of public ownership. The state and the firm were locked into a position of dual dependence: the state depended on the firm to produce goods for other enterprises, maintain employment, fund social services, and contribute tax revenues. At the same time, the firm depended on the state to set conditions that would greatly influence its success and prosperity—establishing marginal tax rates, granting investment loans and setting rates of repayment, and providing exceptions to price guidelines. Constant bargaining between the state and the firm led to countless exceptions to tax and financial regulations, resulting in a fiscal system that continued to redistribute revenue and opportunity from the more to the less profitable. Publicly owned firms facing market conditions therefore still had a soft budget constraint; bargaining undercut the incentives that were to be induced by market competition. The conclusion: public ownership is responsible for bargaining and soft budget constraints, and therefore the only feasible course of reform is to cut the ties of dependency between supplicant firms and the indulgent state by privatizing firms (Kornai, 1990b).

The third model highlights the fiscal structure of the state. From this perspective, the communist state is a formidable machine for the extraction of surplus and its mobilization for industrial investment. The state's coercive structures and monopolistic markets separate farmers from their produce at artificially low prices and keep the prices for their inputs relatively high; wages and consumption patterns are kept low, as are investment in "wasteful" consumer goods and "unproductive" investments such as housing, roads, and telecommunications (except for national defense). Savings rates are determined by central planners and are kept high; massive investment rates are biased toward heavy industry. The bias in the price structure, undervaluing raw materials, agriculture, commerce, and services in relation to manufactured products, reinforces the tendency to overinvest in manufacturing by making government revenues highly dependent on industrial production (Winiecki, 1987, 1998).

As a model of economic development, this fiscal structure reaped admirable successes in the first decades of communist rule. Its ability to enforce austerity and mobilize massive investment in key industries led to remarkable growth rates in the Soviet Union and later in China. Yet the centralized fiscal structure was behind the flaws of central planning identified by Kornai and others. It permitted the preferences of planners to reign over aggregate demand; the vast surpluses accumulated at the center were the foundation for bailouts and soft budget constraints. But for the reasons we have just seen, the fiscal structure supported a system of industrial administration that stifled innovation and productivity growth, causing these economies to fall further behind the market economies. It also put into the hands of government agencies and officials resources that were the foundation of their privileges. As long as this fiscal structure directed surpluses into the hands of government bureaucrats rather than the managers and entrepreneurs who generated them, a more market-oriented economy had little hope of succeeding.

Each of these models has clear implications for economic reform. Such reform cannot go very far, and cannot be very successful, as long as the communist party holds a monopoly over political power. Market reform will be undermined by soft budget constraints on firms as long as public ownership is maintained. Market reform cannot succeed under a fiscal structure that concentrates capital in the hands of government bureaucrats. Despite these persuasive arguments, however, the Chinese communist party has presided over a strategy of partial reform that has produced extraordinarily rapid economic growth. Such an outcome varies widely from the predictions one would draw from the above three models of the state and leads us to wonder why our earlier understandings have proved such a poor guide to Chinese developments. Research on the role of the state in China's economic reforms has progressed to the point where we can take stock of these models by drawing inferences from the Chinese pattern of change. The models assume circumstances that were never clearly specified, and these circumstances turn out to be variables. As a result, analyses of incentives for real-world state agencies and officials have lagged far behind the analyses of incentives for firms.

The discussion that follows begins with assumptions about the state as a fiscal system, and shows how the degree to which state finances were centralized varied before reform according to both the size of the country and past institutional choices. Under certain circumstances, fiscal decentralization can alter basic arguments about the state as a fiscal system, and change both the capacities and incentives of state agencies and officials. Next, we examine how a decentralized fiscal system can alter the basic predictions of models of the state as a system of industrial administration. Finally, we look at how these changes undermine past arguments about the interests of state officials with regard to market reform. Throughout, the approach is to treat the state as a variable ensemble of economic actors, actors whose behavior is just as central to the process of reform as is the behavior of firms.

## STATE FISCAL STRUCTURE AS A VARIABLE

While it is certainly true that the fiscal structure of the communist state was highly centralized and that revenue collection was focused heavily on industry by the price system, the extent of this centralization varied significantly across communist regimes. The most obvious reason for such variation is the size and scale of the economies. In small economies such as those of Hungary (and there were many such small communist nations), the central government owned and operated the vast majority of the industrial base. A relatively small number of large industrial plants contributed their revenues directly to the central budget, and received their investment and financing from the same source. It therefore makes sense to model such a state as a single centralized machine for revenue collection. On the much vaster scale of the Soviet Union, with subordinate republic and regional governments below the center, such a high degree of fiscal decentralization was not feasible. The subordinate republics had large budgets of their own, with enterprises lodged under them and contributing to republic revenues. Nonetheless, compared with China, the Soviet Union's revenue system was more centralized, with a relatively small number of large industrial complexes providing revenues directly to the central government, and with revenues collected by republic and regional governments being turned over to the center and subsequently reallocated to them in budgets.

China differed from these Soviet-style counterparts in two ways. First, in scale of population and administrative complexity, it dwarfed not only Hungary, but the Soviet Union as well. Many of its 30 provincial governments were the size of large nations, 2 of them having populations of more than 100 million. Below these were some 340 subprovincial districts and cities, and some 2,600 counties and smaller cities. The fact that China's population was still 80 percent rural meant that a great deal of economic activity, not just agriculture, but also subsidiary production and small-scale industry closely tied to agriculture, was lodged under even lower government jurisdictions. This was especially so in the 48,000 communes, which later emerged as rural town and township governments. Each of these levels of government had its own production plans and its own revenue bases.

Second, the degree of decentralization of China's planning and fiscal system was greater than that of the systems of the Soviet Union and the smaller communist regimes, even taking into account the above differences in scale and complexity (Qian and Xu, 1993). Khrushchev's 1957 effort to decentralize the Soviet economy failed. Mao, no friend of central planning, in fact began his own decentralization drives that same year, following Khrushchev's lead, and continued to decentralize the economy into the 1970s. Far fewer industrial goods were allocated by central government planners in China than in the Soviet Union. Balances of materials were handled at each level of China's government hierarchy. Provincial and county governments had their own plans. Over two decades, this affected industrial investment decisions such that China developed toward regional autarky, with large numbers of relatively small industrial enterprises located in regions in order to promote local self-sufficiency (Granick, 1990; Wong, 1986, 1987). Hundreds of subnational governments were to a considerable extent "redistributive economies" on a scale similar to that of Hungary. By 1985, there were over 100,000 state industrial enterprises in China, only 3,835 of which were under central government planning, contributing revenues directly to the center. These central enterprises produced only 20 percent of public-sector industrial output in that year (Walder, 1995a:275). Therefore, China was not so much a centrally planned redistributive economy as it was a coordinated hierarchy of well over a thousand of such economies, each collecting its own revenues from industries under its jurisdiction.

The relationship among these redistributive economies was essentially one of bargaining over fiscal transfers between jurisdictions. Because vast numbers of industrial enterprises were located at lower levels of the government hierarchy, local governments collected the bulk of state revenues. The only question was how much of these revenues a local government was able to retain. The typical redistributive practice was to extract more from those jurisdictions that had surpluses and to subsidize those jurisdictions whose revenues fell below local needs.

In the early 1980s, these fiscal relationships changed. Fiscal contracts, or ex-ante agreements, were fixed so that the division of revenues could be predicted. Rights to revenue flows were clarified. Incentives were built in. Provinces were allowed to retain a specified proportion of revenues collected over a targeted amount. Provinces, in turn, set such agreements with districts and large cities, and these jurisdictions, in turn, set such agreements with counties and small cities, and they in turn with townships and small towns. Moreover, revenues from private industry were not to be included in the base for redivision. Government jurisdictions down to the township level now had, in theory, clearer fiscal incentives to encourage local industry. The more rapidly industry grew, the more rapidly local revenues would grow. No longer would increased revenues be seized for redistribution by higher levels (Oi, 1992; Walder, 1992; Wong, 1987, 1988).

## A HIERARCHY OF REDISTRIBUTIVE ECONOMIES?

At this point one might ask, as many did, whether this kind of piecemeal reform, essentially tinkering with the old system, would have much impact. Would not the result of this fiscal decentralization simply be a hierarchy of thousands of smaller redistributive economies, each of which would replicate the fundamental problems of soft budget constraints that plague all public industry administered by economic bureaucracies? The answer to that question is a qualified, but firm, no. Why? The short answer is competition among government jurisdictions for market share and revenue; the long answer requires working through the implications of more than one “redistributive” state and the bureaucratic incentives created by decentralizing fiscal reform.

The central flaw of strategies for reform under communist party rule, as analyzed so lucidly by Kornai, is that the state has the capacity to redistribute financial resources among firms, thereby softening budget constraints and undermining the incentives of market competition among firms. Surpluses from profitable firms are skimmed off at higher rates to subsidize firms that are less profitable or operating at a loss. This weakens incentives for the profitable to perform even better and for the unprofitable to cut their losses. A “regime of bargaining” is recreated under partial reform, in which bargaining over financial terms replaces the traditional bargaining over production quotas, plant capacity, tax rates, and material supplies. The fundamental flaws of the system are not overcome (Kornai, 1991).

There are two assumptions behind this analysis, neither of which receives the same kind of attention as the relationship between the state and the enterprise, which is the centerpiece of the argument. The first is that the budget constraints on the state itself are relatively weak: the state can manipulate the money supply or the price structure, run a foreign trade deficit, or borrow internationally to cover any shortfalls (this of course cannot work in the long run, as Eastern European economies found in the 1980s). The second assumption is in fact the reason why the state bothers to bargain with firms at all—why can it not just say no? The reason is structural. While some enterprises may provide crucial inputs for other national firms that would otherwise have to purchase their supplies abroad, all enterprises meet central nonfinancial needs for the state: they maintain full employment and fund housing and social services for large numbers of employees. As a result, very few firms are ever closed, and the large industrial complexes, often among the biggest money losers, are virtually never closed. To do otherwise would be to create severe social problems. The nonfinancial interests of the state in public firms prevent the imposition of hard budget constraints and therefore lead partial reforms into an impasse of constant bargaining, with concealment of financial resources as the central strategy—a reproduction of the central flaws of the system.

If we conceive of the state not as a single redistributive system (a not unreasonable assumption for Hungary), but as a hierarchy of thousands of such redistributive systems, and if we consider the effects of fiscal decentralization on revenues and bureaucratic incentives across levels of this hierarchy, we can see the possibility of different results. Instead of the system being shifted into a new yet unsatisfactory equilibrium, we see the processes that can lead to the dynamic yet gradual transformation of the behavior of bureaucrats and thereby the premises of the entire system. While systematic econometric evidence pertaining to some aspects of this transformation has only recently appeared, interview studies and field observations suggest strongly that this is precisely what has been happening in China.

## First-Order Consequences of Fiscal Reform

The first step in the analysis of this dynamic transformation is to examine the impact of fiscal reforms across levels of a system in which only the small number of higher jurisdictions had the features posited by Kornai. At the pinnacle of this hierarchy in 1985 was the central government, a redistributive economy of 3,800 large industrial enterprises**,** each of which employed an average of 2,270 people. The revenues of the central government came directly from these large firms, which produced 20 percent of public-sector industrial output, and from the taxes remitted by lower levels of administration. At the next lower level were 30 provinces and below them another 320 cities and districts, which together owned 83,000 public industrial enterprises (an average of 235 per jurisdiction). Together, these firms produced 52 percent of national output in 1985. Below the cities and districts were 2,000 largely rural county governments, which owned another 68,000 public enterprises (an average of only 33 per jurisdiction), producing 13 percent of national output. Below the rural counties were 91,000 townships and towns with an average of fewer than 2 public enterprises each, and below these townships were another 80,000 villages with less than 1 enterprise on average. The fiscal reforms of the 1980s gave each of the 93,000 government jurisdictions above the village level clearer residual rights to increases in revenues (Walder, 1995a:275).

It is evident that the scale of the economy, the size of its revenue base, and the degree of industrialization drop dramatically as one moves from the top of this hierarchy of redistributive systems down to the smaller cities, counties, and townships. It is less immediately evident that as a result, the centrally defining features of redistributive economies disappear as one moves down the hierarchy.[1]

### The Intensity of Fiscal Incentives for Governments

The lower the level of the government's jurisdiction, the more its revenues rely on agriculture rather than industry, and therefore the lower its per capita revenues. Economic growth has a disproportionate impact on the revenues of less industrialized jurisdictions. Kornai's analysis of redistributive economies assumes a centralized system that itself already depends heavily on a developed national industrial base. The fiscal incentives for the smaller cities, counties, and especially townships and villages, where there is still a significant agricultural population, are much stronger than this model assumes. Additions to the industrial bases of these lower jurisdictions have a larger proportionate impact on revenues, and therefore fiscal decentralization creates more intense fiscal incentives in the lower reaches of the government hierarchy (Byrd and Gelb, 1990; Oi, 1992).

### The Capacity to Redistribute Within an Industrial System

While the vast majority of China's (mainly small) industrial enterprises are held by these lower jurisdictions, the *number of enterprises per jurisdiction* drops dramatically as one moves down the hierarchy. While there are almost 4,000 firms at the center, there are on average only 350 at the province

[1]The discussion in the next three subsections is a condensation of Walder (1995a).

and city levels (with wide variations around this mean), some 33 at the county level, and fewer than a handful in townships and villages. The lower-ranking jurisdictions therefore cannot redistribute revenues among firms with the ease assumed in the basic model. The smaller the number of enterprises, the more likely the industrial base is to be specialized in related lines of production (e.g., textiles and foodstuffs), and the more likely it is that all firms will be similarly hit by a downturn in business. In the small jurisdictions where one or two firms might contribute well over half of local revenues, there quite literally is no other source of revenue to compensate. The losses of the firm create havoc with local government finances, and government spending must be slashed immediately.

### The Budget Constraint on Government Itself

If a jurisdiction below the center suffers a revenue shortfall and cannot meet its fiscal targets as set by the next higher level of government, will that government jurisdiction not have its "debt" forgiven by the higher level, and in fact receive a subsidy? Should disaster strike, this will certainly be the case; should the situation be the result of decisions for which government officials can be held accountable, it will be done only with pain and difficulty. But the temporary covering of shortfalls, or the provision of subsidies, will create severe fiscal problems, for it will cut out completely any discretionary spending in the budget and halt all capital construction and industrial investment. The opportunity costs, absent in the old revenue system when any budgetary surpluses were automatically absorbed by the higher levels, will now be very large. Yes, subsidies are possible, but just enough to cover necessary welfare expenditures; the jurisdiction will be subsidized just to the point of stagnation and poverty. The budget constraint may therefore be soft—one cannot close down a county—but the fiscal consequences will be immediate and painful.

### The Nonfinancial Constraints on Government in Its Bargaining with Firms

These constraints also decline markedly as one moves to lower-level jurisdictions. Only large public firms provide a full range of benefits, housing, and other social services for employees. The smaller firms that dominate the counties, towns, townships, and villages provide few if any such benefits. In rural jurisdictions, employment does not present the same constraint as in the larger cities. Local residents who are laid off will usually still have a family farm to which they can return, or they will be able to migrate to other regions in search of wage labor. In those highly industrialized rural regions along the coast where demand for labor outstrips local supply, one can simply fire the temporary migrant workers first, and they then leave the jurisdiction. Thus nonfinancial constraints drop dramatically in the rural jurisdictions, and local governments are much less constrained in enforcing financial discipline—or in closing down firms—than the basic model allows.

### Competition Among Jurisdictions for Sales and Revenue

The implications of the above discussion for the thousands of government jurisdictions below China's center and its 30 provinces are quite profound. For the discussion implies that local government officials compete with one another for revenues by having their firms compete with one another in regional and national product markets. These thousands of local "redistributive systems" may operate in ways that echo the basic model's assumptions, but these are not the self-contained redistributive economies posited in that model. The industrial enterprises of small cities, counties, towns, townships, and villages do not constitute balanced input-output planning systems. These jurisdictions must purchase their supplies outside and sell their products far outside of their boundaries. True, public officials intervene deeply in the main business decisions of firms—to start new product lines, invest in one plant or another, or assemble capital and loans for one venture while deciding against another. But if local industry fails to thrive, local government revenues stagnate. Either local officials must actively promote local industry—by gathering information, making connections with potential customers, pulling in production subcontracts from cities, using their connections and knowledge to acquire loans in the provincial capital—or the jurisdiction will become a backwater. Under these conditions, the universal desire of officials to command larger budgets and build up local resource bases forces the local officials to become market-oriented agents who actively promote local industry. The hard reality of competition forces constant adjustments in local economic arrangements, and has transformed the orientations and interests of local officials with regard to the market economy (and, as we shall see below, the private sector as well).

## Second-Order Consequences of Fiscal Reform

The second step in this analysis is to examine the fiscal pressures placed on the higher levels by competition for sales and profits between their large firms and the vast numbers of smaller firms held by lower levels of government. During the first decade of China's reforms, industrial growth has been most rapid in the lower-level government jurisdictions in rural areas—counties, townships, and villages. This growth has come at the expense of the large state-owned enterprises held by the central government, provinces, and large cities. The share of output produced by this traditional state sector shrunk from almost 80 percent to less than 50 percent over the period. As the large-scale state sector has lost its traditional monopoly, its profit performance has suffered steady declines due to competition with the newer small firms (Naughton, 1992). As profits and sales have suffered, and as growth has shifted to the lower-level jurisdictions, the fiscal pressures on the higher-level government jurisdictions have increased in ways not apparent in the first-order impact of fiscal reform, and in ways not anticipated by the unitary models of the past.

At the same time that revenues due to the earnings of public industry have declined, the proportion of revenues received by the higher-level jurisdictions from the lower-level jurisdictions in contracting agreements has also declined. Higher proportions of national tax revenues have been retained at lower levels of government. This is due partly to the increased rights over revenue residuals enshrined in the reformed fiscal contracting system, but more importantly it is due to the rapid rise of "extrabudgetary funds" that come from new local taxes on industry, extra-tax levies, and revenues from private industry. The center's share of total government revenue shrank from an average of 50 percent in the decade prior to 1978 to an average of only 28 percent in the decade after (Wang, 1995:104).

The growing evidence of budgetary shortfalls at the center and the steady drop in the profitability of the large state enterprises has set alarm bells ringing among conservative national politicians and has been cited by some scholars as evidence that China's strategy of partial reform is failing. But as Naughton (1995) and others have argued, it is also evidence of the systematic introduction of competition into the Chinese economy, competition that hits the formerly monopolistic large-scale state sector and the largest and most self-sufficient redistributive systems at the top of the hierarchy especially hard. It is therefore not at all clear that these central difficulties are evidence of failing reform; they may in fact be the primary evidence that reform is succeeding.

This is the argument of a number of economists who emphasize the positive effects of fiscal pressures on government and financial pressures on firms (Jefferson and Rawski, 1994; Naughton, 1995; Rawski, 1994a, 1994b). A poor central government with large numbers of money-losing firms finds it increasingly difficult to bail out losing firms, and is constantly pushed to devise strategies to sell these firms to foreign investors, use them as part of a joint venture, or begin to transfer their employees to other firms and sectors. Large state firms with falling profits, facing a government increasingly unable to bail them out, must push themselves to reorganize and innovate to a greater extent than ever before (Rawski, 1994b, 1996). Several researchers are now finding evidence that falling profits coincide with increasing factor productivity. Long stagnant in the Mao era, according to these researchers, factor productivity began a slow rise in the mid-1980s and has increased at an accelerating rate since then (Jefferson et al., 1992). Incentives for managers are increasingly being linked to performance, failing firms are more likely to innovate, and investment is increasingly going to profitable enterprises and sectors (see the evidence reviewed in Walder, 1996). The second-order consequences of fiscal reform in a decentralized economy therefore place mounting competitive pressures and budgetary constraints on even the highest levels of government.

## THE INTERESTS AND ROLES OF GOVERNMENT OFFICIALS

The impact of these changed incentives and budget constraints on the behavior of government officials has been observed and amply documented for more than a decade. Government officials, party secretaries, and government agencies have behaved in ways that contrast markedly with the behavior of the conservative rent seekers with interests tied firmly to the planned economy that have been portrayed in earlier analyses. From a growing body of descriptive field studies, a number of distinct new roles can be discerned. All of them indicate the ways in which the interests of officials and agencies have become tied to the development of a market economy. Moreover, they illustrate the ways in which government officials in this transitional economy are themselves pivotal economic actors.

### Officials as Entrepreneurs

In many of the smaller rural jurisdictions in which there are only a few public enterprises in a village or township, or in which there is one that is much larger in scale than others, village heads or party secretaries will directly manage the firm that supplies them with their main source of revenue. To be sure, there are hired managers of these enterprises, but they work under the close direction and supervision of the official, who makes virtually all major business decisions, deciding on product lines, procuring contracts outside the locality, and securing investment loans. The role of government officials in these rural jurisdictions has rightly been described as entrepreneurial (Byrd, 1990; Nee, 1992; Oi, 1986, 1990).

### Government Officials as a Corporate Management Team

This form of involvement has been observed in smaller cities, counties, towns, and townships, and in villages that have a large number of public industrial enterprises. In this situation there are too many firms to monitor closely, and officials cannot take the same kind of active and direct role in management that they can take in smaller and less developed local economies. Instead, local officials govern their firms in a manner analogous to that of the top management team of a diversified company or small corporation. Major business decisions are made by the village or township committee, or by a subgroup of county officials involved in industrial administration. The hired managers of firms may originate proposals to change product lines or innovate, but the top officials make the final decisions. Once these decisions have been made, government officials on the management team are responsible for arranging finance with banks outside their jurisdiction, and making connections with state purchasing agencies, other large institutional customers, or foreign investors. In this situation, which appears to apply to a broad range of political jurisdictions from small cities down, party and government officials in effect manage a diversified portfolio of assets whose value depends on their market performance (Oi, 1992, 1996; Byrd, 1990; Nee, 1992; Walder, 1994, 1998).

### Local Developmental States

In addition to this direct managerial role played by party secretaries, heads of governments, and heads of local economic commissions or departments of finance, these same officials, and other branches of local government, behave in ways analogous to the behavior of "developmental states" elsewhere in East Asia. And they do so not only with regard to local public enterprises, but increasingly with regard to household, private, and foreign firms. These latter firms also can have a major positive impact on local revenues—and have the advantage of not being burdens on the local government if they fail. After a relatively slow start, these nonpublic enterprises have grown very rapidly since 1990, often with the active encouragement and concrete assistance of local government (Walder, 1998). Local government officials travel far outside their jurisdictions to gather technical information to assist the development of local firms with regard to both manufacturing technology and especially product specifications. They assist local firms in marketing their products outside the jurisdiction. They attempt to arrange sales contracts for local firms with large state agencies in the provincial capital or along the coast. And they try to make contacts with potential foreign investors and compete with other jurisdictions to create favorable conditions that will attract such investment (Oi, 1996; Zweig, 1991).

### Silent Partners in Private Enterprise

As part of an effort to secure their property by cultivating protectors in local governments, some private entrepreneurs seek to make silent partners out of government officials or agencies. Officials are hired as "consultants" or appointed to a firm's board of directors and receive compensation for no work. They are issued share certificates in the company without having to pay for them, or their relatives are hired for important positions (Liu, 1992; Solinger, 1992; Wank, 1995). These kinds of practices are common from the center down to the small cities and towns and are often attacked as a form of corruption. But they do open up sources of personal income that far outstrip those from official urban salaries and alter the interests of these officials regarding the private economy.

Such ties can be institutional rather than personal, and they need not involve arrangements that are corrupt. Many government agencies own assets that are potentially quite valuable in a market economy: real estate, buildings, street-front offices that can be converted to retail shops (Nee and Su, 1993). These assets can be allocated to private entrepreneurs in return for shares of the profits of the enterprise. Government agencies therefore become silent partners in a variety of real estate developments and retail and service establishments (Solinger, 1992; Wank, 1995). Land and real estate that had little value under the planned economy thereby become a windfall for local government agencies, which may retain these proceeds as “extrabudgetary funds” (and which may also decide to use some of them for personal compensation, housing, and so forth).

### Government Agencies as Investors in the Private Economy

It is evident to government officials from the center down to the rural counties that the returns to private enterprise often outstrip those from the traditional state sector, large parts of which give meager returns or are in fact a drain on the budget. This fact, in combination with the fiscal pressures on government agencies described above, means agencies strapped for cash must develop alternative sources of “extrabudgetary revenue.” And they do this increasingly by investing in the market economy. Examples of this are legion, and it is one of the most underresearched dimensions of China’s economy. The state security agency, for example, is part owner of a luxury hotel in Beijing, having created a partnership with one of Hong Kong’s wealthiest real estate tycoons. The private companies spun off from China’s military establishment have become actively involved in the export of arms and in the import of sensitive military-related technology—both of which have created highly publicized strains in U.S.-Chinese relations. Ministries in Beijing create spin-off high-tech companies in the city’s Haidian district—China’s Silicon Valley—making state planning ministries investors in highly profitable joint stock companies (Francis, 1996). Large state enterprises facing losses or declining profits invest in other lines of business by opening up associated collective or joint venture enterprises. They can reap greater returns from these enterprises than from their core business, in large part because they face more favorable tax regulations and do not have to bear the same social welfare burdens as with their core plants (Lin and Zhang, 1996). Finally, thousands of state agencies, government jurisdictions, and state enterprises find ways to place funds overseas and bring them back into China as “foreign investment”—

again facing more favorable tax and labor regulations. Lardy (1996) estimates that this circular flow of funds rivals the magnitude of genuine "foreign" investment.

The arrangements just described would obviously not pass muster under U.S. federal antitrust regulations, and they grossly violate U.S. legal norms regarding conflict of interest. This is a far cry from government as an impartial enforcer of contracts and property rights—the kind of legal and regulatory regime that so many observers of Eastern Europe insist is a prerequisite for a thriving market economy. Reformers in Eastern Europe whose goal is to have Poland "return to Europe" (Sachs, 1993) or to create the foundations for a free society in Hungary (Kornai, 1990a) would find little to emulate in these practices—and I have no quarrel with their cultural and institutional preferences. Yet the long-observed roles of government officials as economic actors in China does demonstrate fairly conclusively that earlier models of the state in which communist elites are defined by—and unshakably tied to—their privileges in the planned economy are better as a description of Soviet realities than as defensible general model of the state. Partial reforms have created a dynamic process of change—and of rapid economic growth—that earlier models of the state would not have deemed possible (see especially Nee and Lian, 1994). Indeed, the above discussion implies that this continuing economic transformation is naturally transforming the state itself. For a state whose agents have all developed alternative sources of revenue to those provided by their superiors, and whose agents have developed strong interests in the maintenance of a market economy, is also a central state that is progressively unable to contemplate a return to the former status quo (Walder, 1995b).

## CONCLUSIONS

China is no model for Eastern Europe. With the fall of communist party dictatorships, history there has already turned down another path of institutional development. Reform in Eastern Europe is premised on the idea that a liberal political system is to be constructed, and as part of this task the economic institutions of the past are to be dismantled as completely as possible. Reform in most of Eastern Europe aims to dismantle communist power; in China, the aim is to preserve it.

Despite this caveat, China's development over the past 15 years has shown that the models of the state on which critiques of partial reform in Eastern Europe were based—and that served as background assumptions for many programs for post-communist reform—are less general and less persuasive than was originally thought. What were supposed to be defining and stable features of state structures, relatively impervious to partial reform measures, turn out to have been variable characteristics sensitive to seemingly small initial changes in incentives for bureaucrats.

A case in point is the long-delayed process of privatization that has gained momentum in China in the past few years. Like the response to new fiscal incentives, this process is beginning at the bottom of the hierarchy and spreading upwards. Local government officials who manage a portfolio of market-oriented public enterprises have come to see the less profitable or loss-making enterprises as troublesome burdens, not worth the scarce time and resources they want to devote to their successful ventures (Kung, 1996; Ruf, 1996; Whiting, 1996; Walder, 1998). Far from wanting to preserve these public enterprises at all costs, they now actively seek to divest themselves of these dead assets by leasing them or selling them off at a discount. This long and slow process of privatization has grown naturally out of a process of fiscal change and increased competition. It did not require a preconceived and coordinated central plan or a central state-induced recession. Instead, the motivations to privatize have emerged gradually among officials themselves as a result of the altered incentives created by this evolutionary process of reform. To understand this process of change, we need to view the state as an ensemble of economic actors and to place the incentives for their actions at the center of our analyses. For it is not enough to point out that the state can play a major and important role in a transitional economy or that an evolutionary process of transformation is possible. We need to understand why, and specify the conditions under which this might be true.

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# 18

# Possible Future Directions for Economies In Transition

*Anders Åslund*

The post-communist world has now undergone up to 7 years of transition to a market economy. A great deal has been accomplished, but much has also failed. We can now begin to see how the societies of these countries are evolving. The purpose of this chapter is to try to envisage what sorts of economic models these countries are developing.

The focus of this chapter is the whole of Central and Eastern Europe and the New Independent States, with the exception of the former Yugoslavia, that is, 22 countries.[1] Thus the scope of the discussion is those countries that previously had a Soviet type of economic and political system. The 22 countries had differing levels of economic development and varying economic structures, which means that the costs of transition were bound to vary, but the emphasis here is on common features.

The next section considers how the countries have fared in the transition to date, assessing what factors have really mattered and how far the various countries have progressed. This is followed by a discussion of why certain reform policies have worked better than others; the answer provided here is that rent seeking is the key. Next is an examination of the major threats faced by these countries today. The future direction of economic policy is dependent not only on the past, but also on current problems. To a considerable extent, the predominant concerns are the same in most countries, and the

[1]Poland, the Czech Republic, Slovakia, Hungary, Bulgaria, Romania, Albania, Estonia, Latvia, Lithuania, Belarus, Ukraine, Moldova, Russia, Georgia, Armenia, Azerbaijan, Kazakstan, the Kyrgyz Republic, Uzbekistan, Turkmenistan, and Tajikistan.

pressure to resolve them is a driver of economic policy. These pressures are likely to push countries in similar directions. However, policy issues alone do not determine the course of reform. Another consideration is the political framework—what ideas are predominant, or what schools of thought compete on the policy-making stage, and what ideas and interests the politicians represent. Finally, the purpose of this chapter is to assess how these considerations affect the kinds of states the former communist countries are becoming and what future developments appear likely. Thus, the last section suggests four plausible future models, commenting on the probability of each and what factors may influence them positively or negatively.

## RESULTS OF ECONOMIC TRANSITION TO DATE

The aim of post-communist economic transition can be described broadly as to build capitalism—to depoliticize the economy, to activate markets, and to institute private ownership of the means of production (Kornai, 1992:360-365). An underlying belief supported by the new institutional economic history is that the economic institutions of capitalism can generate economic growth (North, 1981). A number of recent econometric studies covering a large number of countries support this view (Sachs and Warner, 1995; Gwartney et al., 1996).

A number of the 22 countries of interest here appear already to have entered a period of sustained economic growth under a new economic system. As of 1995, 4 of the countries—Poland, Slovakia, Romania, and Albania—had reached growth rates of 7 percent (Stockholm Institute of Eastern European Economies, 1997). Yet only Poland, having recorded several years of considerable growth, appears to have entered a stage of sustained growth. However, in most cases it takes a long time before substantial growth can be expected. What other criteria can be used to measure the attainment of capitalism?

We have settled for a qualitative target—capitalism—and its attainment should be measured by qualities. Three obvious criteria are financial stabilization, liberalization, and private-sector development: financial stabilization means that money is stable enough to function as a reliable means of exchange, liberalization is necessary so that market allocation can substitute for vertical state commands, and a dominant private sector is required to render ownership apolitical and pluralist. Each of these three criteria can be quantified, and the question is at what point we can say that a market economy has been reached.

In practice, the most obvious success indicator has been low inflation. The control of inflation and the return of economic growth are closely related. No post-communist country has restored growth without limiting inflation to 40 percent per annum or less, while all the countries that have contained inflation have returned to growth within a year or so (Fischer et al., 1996). There is also a strong correlation between inflation and decline in output. In 1995, 13 of the countries still had inflation exceeding 40 percent per annum, although virtually all inflation rates were lower than in the preceding year (Åslund et al., 1996:236-237). In 1996, nearly all the countries got inflation down to below 40 percent per annum. The only exceptions were Bulgaria in Central Europe and Tajikistan and Turkmenistan in the New Independent States.

In Belarus, on the other hand, inflation may explode again. There have been several such cases in which inflation has fallen temporarily to a low level and then increased. Examples are Russia and Ukraine in the summer of 1994. In those two cases, the temporary stabilization was based entirely on monetary policy and not on a sufficient reduction of the budget deficit. Sustained monetary stabilization needs to be based on fiscal adjustment as well. Only when the budget deficit has been limited so that what remains can be financed by noninflationary means has inflation been brought under permanent control (Fischer et al., 1996).

The frightening case is Bulgaria. In 1993, its inflation had decreased to 64 percent, but it doubled the next year—to 122 percent. Inflation was again reduced to 33 percent in 1995, but as the budget deficit stayed at almost 7 percent of gross domestic product (GDP), the exchange rate collapsed in 1996. As a consequence, inflation surged again to 305 percent a year (Stockholm Institute of East European Economies, 1997:1), and the associated social cost is likely to be very high. The Bulgarian experience illustrates the danger of trying to do only what is absolutely necessary, effectively walking a tightrope on the verge of an abyss.

The countries most successful in controlling inflation have not calculated how large a deficit they can finance. Instead, they have aimed at a balanced budget or a small budget surplus. Croatia had a budget surplus of 0.7 of GDP and a deflation rate of 3 percent in 1994; the Czech Republic has a steady surplus of 0-1 percent of GDP and had an inflation rate of 8 percent in 1995; Slovenia balances its budgets almost perfectly, although its inflation rate was 9 percent in 1995; and Estonia maintains a budget surplus of 0.5-1 percent of GDP, while it recorded an inflation rate of 29 percent in 1995 (Stockholm Institute of East European Economies, 1997). Presumably, some of these countries harbor hidden semifiscal budget deficits, but that is an additional argument for eliminating the official budget deficit.

With the exception of Croatia, not a single post-communist country has managed to achieve what would be considered low inflation in the West. This illustrates both how difficult and how important it is to combat inflation. One reason for the lingering high inflation is the existence of hidden deficits, often bad debts taken over by the government. Another reason is that these countries started with extremely devalued currencies, and real revaluation often takes the form of inflation. Substantial relative price adjustments are a third reason. In hindsight, common complaints that too much attention was being devoted to combatting inflation appear particularly misplaced (Nuti, 1992; Nuti and Portes, 1993; Portes, 1993). There is no room for fine-tuning in post-communist stabilization.

Another important criterion for successful transition is deregulation. In theory, stabilization can take place without liberalization, but in the reality it has proved impossible in the post-communist countries because price regulation is usually connected with substantial subsidies that must be reduced if financial stabilization is to succeed. Today there are a number of competing liberalization indices, produced by the World Bank (1996:14), the European Bank for Reconstruction and Development (EBRD) (1995), the Heritage Foundation (Johnson and Sheehy, 1996), and the Fraser Institute (Gwartney et al., 1996). These indices try to compound various indicators of liberalization, such as foreign trade obstacles, price regulation, tax levels, freedom of enterprise, and quality of financial markets. The World Bank liberalization index shows a clear correlation between liberalization and financial stabilization (de Melo et al., 1996).

In an international context, most of the post-communist countries do not rank very high on the rather varied liberalization indices. Unfortunately, the EBRD and the World Bank do not compare the transition countries with countries in other parts of the world, and the EBRD has not even elaborated a composite index. The Heritage index, which endeavors to reflect 1996, includes 140 countries. It puts the Czech Republic as no. 12, and Estonia as no. 26, but the next transition country on the list is Hungary at no. 57; Bulgaria and Russia are no. 100. The Fraser Institute ranks 103 countries for 1993-1995. Its earlier point of measurement puts the transition countries at a disadvantage, and the highest-ranking transition country is the Czech Republic at no. 51; Hungary is no. 85, while none of the post-Soviet states is included.

We can somewhat arbitrarily choose one of the liberalization indices and define a market economy as a country that surpasses a certain level on that index. Examining how far different countries have advanced toward a market economy at various times, it appears reasonable to put the threshold at 0.5 on the World Bank's liberalization index. Thus, we say that any country that surpasses this level is sufficiently liberalized to qualify as a market economy. Almost all the post-communist countries had passed this test by 1996. The exceptions are rare—notably Turkmenistan, Tajikistan, Azerbaijan, and Belarus (de Melo et al., 1996). We could also use the qualification of an open economy according to the criteria defined by Sachs and Warner (1995), which they identify as the threshold to economic growth. Today those criteria would result in approximately the same four countries being excluded. Moreover, there is only one example of an outright backlash after significant liberalization, namely Ukraine in 1993, which at the time had not been highly liberalized. With the exception of the four outliers, then, we might dare to suggest that sufficient liberalization to form a market economy has been undertaken, although this is only a tentative empirical conclusion. Yet even if much remains to be deregulated, the paradigm has changed to that of a market economy. We might also note that with regard to liberalization, the danger of going too far seems remote, while the risk of not going far enough is very high.

The third criterion for the transition to capitalism is expansion of the private sector, whether through privatization or the opening of new private enterprises. These two approaches are often presented as alternatives, but in reality tend to be complementary. Moreover, private-sector development is generally greater in countries with more financial stablization and liberalization (Åslund et al., 1996:245-248).

To develop the private sector takes longer than to undertake financial stabilization or liberalization. Unfortunately, statistics on ownership are of particularly poor quality. EBRD (1995:11) offers the most complete picture, but provides only estimates, which tend to be very conservative. No Western country has more than about 35 percent public employment or public share of GDP produced. Thus, the threshold for capitalism might be set at 65 percent. By 1996, all of the Central European countries, apart from Bulgaria and Romania, appear to have approached that level, and only the three Baltic states, Russia, and Kazakstan in the New Independent States.

There is a remarkable correlation among the above three criteria for capitalism. Two countries—Tajikistan and Turkmenistan—have not met any of the criteria. Bulgaria and Belarus have met only the liberalization criterion, and Azerbaijan has achieved only financial stabilization. Ten countries—Poland, the Czech Republic, Slovakia, Hungary, Albania, Estonia, Latvia, Lithuania, Russia, and Kazakstan—have met all three criteria. The 7 remaining countries—Romania, Moldova, Ukraine, Armenia, Georgia, the Kyrgyz Republic, and Uzbekistan—have not achieved privatization. However, reforms have progressed in all 7 countries, with the possible exception of Uzbekistan, and several of them may have passed the threshold for privatization in 1996. Therefore, of the 22 countries, 5—Azerbaijan, Belarus, Bulgaria, Tajikistan, and Turkmenistan—are failures to date, and 17 countries seem to be achieving capitalism.

Is it sufficient to examine only these three key criteria? Institutional development has sometimes been contrasted with them. The relationship is difficult to measure, but the attempts that have been made show a strong positive correlation between these three key criteria for the transition to capitalism and institutional development (de Melo et al., 1996).

There has been widespread concern that the transition from communism to capitalism has been marked by considerable social hardships (see the chapters in Section IV of this volume). Initially, anticipated high social costs in the form of a sharp decline in output, leading to a drastically falling standard of living and massive unemployment, were widely believed to argue against a rapid transition. A common argument was that a swift transition would lead to greater adjustment costs than would a more gradual transition, and would therefore lead to social or political upheaval that could derail the whole transition process (see also Nelson, in this volume). Many believed that the population would accept only a certain level of social costs and that this absolute limit must not be reached. A wide range of possible disasters was invoked, including starvation; social unrest because of excessive poverty, price increases, and income differentials; and labor unrest because of low wages and mass unemployment.

Today we have the record, and it is very clear. In general, there is a distinct positive correlation: the more radical the reform—in terms of deregulation, stabilization, and privatization—the smaller the total decline in output. The differences in the decline in output are stunning. Officially, GDP in Poland fell by 18 percent as compared with 86 percent in Georgia (Åslund et al., 1996). Official statistics generally overstate the decline in output, but the real decline has been reassessed at 7 percent in Poland and about 50 percent in Georgia, which is still a stark contrast.

Statistics for income differentiation exist for only a few countries, but there appears to be a sharp divide between Central Europe, with more radical reforms, and the New Independent States, with slower reforms. In Central Europe, the least radical reformer, Bulgaria, displays the greatest income differentiation in the region (World Bank, 1996:68-69). Previously, the Soviet Union had greater income differentials than Central Europe, but the differences were of much smaller magnitude.

Unemployment is perplexing because there is no correlation between it and decline in output or the nature of reform. On the whole, unemployment is greater in Central Europe than in the New Independent States, but within Central Europe the radical Czech Republic maintains a very low unemployment rate of around 3 percent of GDP (Åslund et al., 1996:237-243; Stockholm Institute of East European Economies, 1997).

Although social suffering has been great, it is remarkable that these widely expected problems did not result in social upheaval although ethnic strife has erupted in several countries. Today few remember that the EU sent food aid to Poland in the winter of 1989-1990 because of fears of starvation. The same fear was stronger in Russia in the winter of 1991-1992, but starvation did not occur. Communist governments had long argued that they could not raise consumer prices because of the danger of social unrest. When the Soviet government raised meat prices in 1962, it faced substantial riots, notably in Novorossiisk. The Polish government fell because of workers' unrest when it tried to raise food prices in December 1970, and it suffered serious unrest again in 1976 for the same reason. Yet none of the post-communist governments has experienced any serious popular unrest because of price liberalization. One explanation is that price increases for a few staple goods, such as meat and bread, are easily perceived as directed against the working man to the benefit of the elite, and can thus give rise to strikes and riots. Wider price deregulation, however, is clearly a change of paradigm and a transition to another economic system, not just an act of redistribution. Moreover, the very drastic price deregulations underlined how serious the crisis was, and there was no obvious alternative. In most countries, the previous level of price subsidies was untenable, and the preceding shortages were truly unbearable.

Labor unrest was another concern before the reforms. Many of the new post-communist governments were very worried about strikes over wages. Yet the region has in fact been characterized by a very low level of labor unrest, and wage pressure has been remarkably limited. A similar worry was that unemployment would skyrocket; there were forecasts that it would rise to half the labor force in a year or two. The rate of unemployment has risen, but on the whole has been lower in Eastern and Central Europe than in Western Europe, where it lingers at around 11 percent of the work force. This is the only respect in which the New Independent States has done better than Western Europe. In hindsight, it is obvious that the organization of labor remains very weak, and that the very limited degree of collective action would render significant strikes implausible, particularly in the short term. As workers have accepted massive reductions in real wages, employers have had little reason to lay them off, which is a major reason why unemployment has increased far less than output has decreased.

However we look upon the transition process, the empirical result is that it is better to undertake all the main transformations in concert and as rapidly as possible. There are no economic or social arguments for proceeding slowly. This was indeed the argument of a broad economic prescription literature from the beginning (Kornai, 1990; Lipton and Sachs, 1990; Blanchard et al., 1991; Fischer and Gelb, 1991; Åslund, 1992), while much of the theoretical literature dealt with trade-offs between potential negative effects of radical reforms that never materialized and obvious positive effects.

## THE IMPORTANCE OF RENT SEEKING

How can the above empirical results be explained logically? Why have the costs of slow reform been so high? How do inflation, regulations, and state ownership cause economic decline? Much of the discussion about post-communist transition has concerned structural adjustment costs and how they can be minimized. The problem with much of the theoretical literature on how to minimize adjustment costs is that it assumes a good government, working in the interest of the people. In practice, however, structural adjustment costs appear to be a secondary concern. Instead, the most serious social costs result from rent seeking by an elite that is exploiting the state for its own enrichment.

In a way, the state was privatized because so much of society was nationalized. To understand this drama, we need to identify the main means of rent seeking. I shall focus on Russia, because I possess the best knowledge about rent seeking there (Åslund, 1996).

The fundamental method of rent seeking was arbitrage: to buy something cheaply at fixed state prices and sell it at a high free market price at home or abroad. The great bonanza of arbitrage was in 1991 and 1992, when raw materials, notably oil, gas, and metals, sometimes cost as little as 1 percent of the world market price. The trick was to have access to these commodities in Russia and to be able to sell them abroad at the world market price. Considering the domestic and world market prices and the volume of exports of these commodities, it is easy to conclude that total rents arising from the export of oil, gas, and metals amounted to about 30 percent of Russia's GDP in 1992.[2] These rents went to state enterprise managers and commodity traders dealing in oil, gas, and metals; various middlemen; and corrupt officials.

A second, similar source of rents was import subsidies. Multiple exchange rates allowed this kind of arbitrage. In 1992, an importer of essential foods paid only 1 percent of the official exchange rate, and no less than 15 percent of Russian GDP went to import subsidies that year (International Monetary Fund, 1993:132-133, 140). Import subsidies did not show up in the Russian budget, as they were financed with Western commodity credits off the budget. Yet the Russian state is responsible for servicing and paying back these debts. The import subsidies went to a small group of commodity traders in Moscow.

A third form of rents was huge subsidized credits. When prices were liberalized in January 1992, money became scarce as the money supply did not rise as rapidly as prices. State enterprises urged the government and the Central Bank to replenish their working capital. Unfortunately, the government and the Central Bank accommodated them. As a result, from June to September 1992, the money supply increased by almost 30 percent a month. Worse, most of these credits were issued at highly subsidized interest rates, 10 or 25 percent per annum, while inflation was 2,500 percent a year. Thus, these credits were virtual gifts from the state to the receiving enterprises. The net credit expansion amounted to 33 percent of GDP in 1992, and the interest paid was less than one-tenth of that volume. Hence, the total volume of credit subsidies reached some 30 percent of GDP in 1992 (Granville, 1995:67). The subsidized credits were directed primarily to three kinds of enterprises: agrarian enterprises (primarily *Roskhlebprodukt*, the previous Ministry of Grain

[2]Total Russian exports in 1992 amounted to $42 billion. Of these exports, 70 percent was subject to export quotas and licenses. The average domestic price was less than 10 percent of the world market price, and the export tariffs collected were just over $2 billion (Aven, 1994; Åslund, 1995).

Procurement, which continued to purchase grain and bread), energy enterprises, and enterprises in the northern regions of Russia. However, these credits were channeled through about ten commercial banks, the so-called court banks. They delayed the disbursements for a long time and meanwhile let the credits work for their own benefit. Subsidized credits were a major source of the enrichment of the commercial banks.

*Nomenklatura* privatization of enterprises was a fourth source of rents, but surprisingly appears to have been much more limited than the others. In total, almost 17,000 large and medium-sized enterprises went through voucher privatization. In the spring of 1996, the total market capitalization of the 200 companies with the most-traded shares, which included Gazprom and the big oil companies, was about 7 percent of GDP (Government of the Russian Federation, 1996). Collectively the remaining companies that underwent voucher privatization were at most worth one-third of that amount. Moreover, surveys carried out by the World Bank showed that the initial ownership by managers was only 8 percent, though it rose rapidly to 18 percent in 1996 (Blasi et al., 1997). Even so, voucher privatization had given the managers only about 2 percent of GDP in total by the spring of 1996.

There are many other forms of rent, such as ordinary monopoly rent, corruption, racketeering, and rents from municipal real estate. Real estate might generate substantial rents, but otherwise these forms of rent are likely to be less significant than those discussed above. Racketeering seems heavily focused on the retail sector, and total retail trade amounts to one-third of GDP. Ordinary protection fees extracted from retail traders by racketeers are 15-20 percent of total sales. However, many retailers in small localities and shielded shops do not pay protection money, and it would be surprising if retailers did not learn how to escape racketeers when they evade taxes so successfully. Therefore, a reasonable assumption is that protection fees average 10 percent of total retail trade, which would mean that annual revenues from racketeering in retail trade amount to 3 percent of GDP, a relatively small amount.

Incredibly, we can conclude that gross rents amounted to about 80 percent of GDP in Russia in 1992. It is little wonder that people had a perception of lawlessness. Yet these are gross rents as compared with gross revenues of an enterprise, which can add up to several times the GDP. Net rents, corresponding to net value added, would be a far smaller share of GDP.

A relatively small group has benefited enormously from the rent seeking that arose at the end of communism and the birth of capitalism in Russia. The sectors offering the greatest opportunities for rent seeking have been energy, agriculture, trade, and banking. The rents have been heavily concentrated among state enterprise managers and early commercial operators in trade and finance. In contrast with profits gained in a competitive market, these rents have been extracted as a result of privileged access awarded by the state through corruption. The rents have been conditioned by state regulations that have effectively favored parts of the old elite.

Privatization implied some rent seeking, but much less than is commonly believed. A variety of financial flows caused a much larger transfer of resources from the state to managers than did privatization. Even so, privatization tends to be criticized much more than do other forms of rent seeking. The explanation is probably that privatization is a very visible, relatively transparent process, and people tend to blame what they can see. Moreover, rent seeking implied that managers benefited far more from unproductive transactions and manipulations than from production or enterprise profits. The managers' focus on rent seeking implied that they cared little about output or the utilization of the factories they managed, and a natural consequence was that output fell sharply. Privatization, on the other hand, often led to new enterprise behavior, making managers focus on profits rather than rents. Hence, privatization often initiated the ouster of corrupt and inept managers and the beginning of enterprise restructuring. Privatization, then, was actually a way of limiting rent seeking.

Ironically, it was technically easy to stop the main rent seeking. Export rents were abolished with the liberalization of exports and raw material prices, which occurred in many small steps in Russia. Import subsidies were eliminated by the government by the end of 1993 as the exchange rate was unified, and subsidized credits were abolished in late 1993. These four measures were all part of the radical reform agenda; they were undertaken in most of Central and Eastern Europe much earlier, but in the former Soviet Union, the reformers were too weak to impose their policies. In hindsight, it is obvious that this implied a great loss to society. Not only did much of the elite indulge in unproductive redistribution of wealth to their benefit at the cost of society at large, but they also neglected ordinary work, ranging from production to elementary government services. Hence, the greater the rent seeking, the more income differentials grew, and the more output fell.

There was far less rent seeking in Central and Eastern Europe than in the NIS, and the degree of rent seeking can explain much of the difference in the results of post-communist transformation between these two regions. Central and Eastern Europe benefited from fewer economic distortions, more economic and legal norms, a better-functioning state, and a stronger civil society than existed the former Soviet Union, where the old elite had been and remained amazingly free of social controls.

Rent seeking can also explain the strong correlation between the nature of economic reform and the political regime. Radical reform—defined as a certain degree of deregulation and a certain effort at financial stabilization measured ex post—was undertaken by five countries: Poland, Czechoslovakia, Albania, Estonia, and Latvia. All initially had liberal, nonsocialist governments. All the remaining socialist governments, on the other hand, undertook gradual reforms, as did four of the nonsocialist governments. Hungary and Lithuania did so as well, because their regimes were more nationalist than liberal. Bulgaria and Russia attempted radical reforms, but their governments were too politically weak to be able to sustain these efforts for even a year. In short, the capable nonsocialist regimes opted for radical reform, while all the lingering socialist regimes preferred gradual reform. Typically, those states that have failed to transform have been ruled by former socialists. These regimes are not very democratic, and they have been ruled in ways that enrich and further entrench the old elite. This poses a danger not only to the successful formation of a market economy, but also to democracy. The case is most obvious in Belarus, which is surrounded by democracies and more reformist countries.

## WHAT ARE THE THREATS TODAY?

As we explore what dangers the post-communist countries are likely to encounter in the future, four threats are apparent. First, nation building itself may fail, leading to general chaos. Second, a country may not accomplish elementary transition, but end up with persistent high inflation. Third, a country may not liberalize and privatize enough, or privatization may lead to excessive concentration so that it gets mired in corrupt, crony capitalism. Fourth, a country may become caught in the entitlement trap, with excessive taxes and social transfers.

The worst case is the first—that the newly independent state fails in its nation building, and does not even establish basic law and order and elementary state institutions. The obvious example is Tajikistan, which has collapsed in every sense of the word. Georgia appeared to be as badly off, but it seems to be recovering, even if the peace there seems fragile.

To date, only three countries—Bulgaria, Belarus, and Turkmenistan—seem really to have failed in their economic transition policies, as argued above. They continue to pursue irresponsible policies, leading to high inflation, continued regulation, and little privatization. In Bulgaria, the democrats lost power because of internal division after a short time in power, and their fragmentation facilitated the electoral victories of the old communists. A small group of former communists controls the big enterprises, which they run badly, causing losses. These losses are covered by state banks, which are controlled by roughly the same people who run the government, which recapitalizes the banks and runs a large budget deficit of about 7 percent of GDP in spite of a very larger foreign debt. Fortunately, the whole drama came to a head in 1996, as Bulgaria ran out of international finance; many of the banks collapsed when the government could no longer afford to refinance them. Ordinary citizens had little choice but to withdraw their bank deposits and exchange their leva for hard currency; the exchange rate of the leva collapsed, and inflation increased. The government responded by price regulation, which led to food shortages. GDP fell sharply in 1996. Fortunately, popular protests have grown so strong that the government has been altered, and early parliamentary elections seem plausible. This is a good example of how democracy offers a new opportunity for radical market reform. The presidential election in Ukraine in July 1994 is another example.

Belarus is ruled by a truly populist and authoritarian president who does not bother with economic laws, and his entourage makes money on illicit deals facilitated by economic chaos. Popular protests have been strong, but apparently not strong enough. Democracy effectively ended in Belarus in 1996 as a new authoritarian constitution was adopted, and the old parliament was reduced to presidential supporters. Similarly, Turkmenistan is run by the most totalitarian leader in any former communist state, who could not care less about economics. Naturally, a long period of economic mismanagement is bound to undermine the legitimacy of the regime, and the question is whether civil discontent will be strong enough to oust the flawed regime, or it will defend itself by nondemocratic means.

Crony capitalism, however, seems to have become a far more common problem. All over the former communist world, extensive corruption prevails as the government retains control over large resources—enterprises and real estate—and the state remains highly interventionist and arbitrary. To any observer of the Russian economy, it is obvious that the market economy does not function very well there as yet. Prices and mark-ups remain high; regional price differentials remain sizeable; the number of registered private enterprises is very small and declining; although bank and interenterprise arrears have stagnated, wage arrears and tax arrears have mounted; and stock prices are very low in comparison with the asset values of the companies. Any foreigner is still overwhelmed by the degree of regulation. Russia continues to license virtually all economic activities, and in many cases multiple licensing is required because of various branch legislation. Russia is the promised land of inspectors of all kinds. Rather than imposing strict legislation, the state inspectors tend to require bribes. The situation appears to be similar all over the New Independent States, in sharp contrast with Central Europe.

There is a real danger that several countries will remain mired for a long time in crony capitalism, so that even big capitalists will stay heavily dependent on the state. Several Latin American countries and India until the early 1990s are examples of such states, and their economies have not been very dynamic. The most apparent problem is that far too much property remains in public ownership. A related concern is that privatization will be directed to protégés of the regime to such an extent that private monopolies having a cozy relationship with a regulative state will evolve. This is also a concern for some countries that have done very well in terms of stabilization and liberalization. Such an economic policy could easily endanger democracy as well.

It may be noted that all the countries that are or might end up in the first three groups discussed above are those that pursued slow or gradual economic reform.

Finally, the threat of excessive state intervention is balanced by another problem, which might be seen as a possible solution. The whole of the New Independent States is seeing a steady decline in state revenues of about 5 percent a year. Average state revenues as a share of GDP plummeted to 29 percent in 1993, and the share is continuing to decline (Citrin and Lahiri, 1995:78). In 1996, most members of the Commonwealth of Independent States collected no more than 20 percent of GDP in tax revenues, and no shift toward higher revenues is noticeable as yet. The states that collected most taxes were Ukraine, with 35 percent of official GDP, and Russia, with 31 percent. As little financing is available, and most governments are determined to keep inflation under control, they have no choice but to cut expenditures to limit the budget deficit. The liberal response to this problem is to cut tax rates while broadening the tax base, abolishing tax exemptions, demanding that all liable for taxation actually pay their taxes, and accepting that public revenues should not be more than 20-25 percent of GDP. This would imply a minimization of subsidies, which would reduce state intervention to a more tolerable level. Social transfers would have to be capped, and pension reform would be required, increasing the role of savings and private pensions. The statist approach is to try to collect taxes by whatever means available, reinforcing the arbitrariness of state powers. Yet the shortfall of tax revenues is so great that it is likely to have a primarily liberal impact.

The leaders of the transition are facing the opposite problem. Their apparent threat is the entitlement trap (Sachs, 1995). The four Visegrad countries have public expenditures of around 50 percent of GDP. In particular, Hungary had public expenditures of as much as 62 percent of GDP in 1992 and 1993 (Banerjee et al., 1995:8). Worldwide, only Sweden and Denmark exceed this level. The dilemma is multiple. High public expenditures mean high taxes, but often a big budget deficit as well, which easily leads to an excessive debt burden, as is the case in Hungary. Large social transfers—23 percent of GDP in Hungary in 1993—weaken the incentives to work. The combined effect is that people work less productively than in a more liberal economy, and no economy with public expenditures as high as those of Hungary has been especially dynamic. By comparison, the economic lions in East Asia spend only a few percent of GDP on social transfers (Sachs, 1995). Countries in the New Independent States, however, are not very likely to fall into the entitlement trap because of their limited state revenues. Hence, the former Soviet republics have the possibility and challenge to opt for a much more liberal model than Central Europe has adopted. Estonia stands out as the country that has done so, but the Kyrgyz Republic, Moldova, Georgia, and Kazakstan seem to have embarked on a similar course.

## POLITICAL FRAMEWORK

As noted earlier, policy issues have only a limited impact on the course of reform; the political framework is also of vital importance. Three aspects of the political framework appear particularly relevant: the economic paradigm, political forces, and the state of civil society.

Economic thinking in the region has counterposed two paradigms. The first has been represented by those who have favored radical economic reforms; these have been largely trained economists. They have reflected the set of views that Williamson (1993) has labeled “the Washington consensus.” It implies limited fiscal deficits, strict monetary policies, price liberalization, deregulation of foreign trade, and privatization, and is being embraced by the International Monetary Fund (IMF), the World Bank, and the international community at large. A broad international consensus exists on the ways in which many of these problems should be approached, and these alternatives are clearly presented in a large literature. Reform economists and economic policymakers throughout the post-communist world have gained strength by drawing on this international consensus.

Proponents of the opposing pardigm have comprised not old communist doctrinaires, but rather the managers’ lobby. They did not advocate the old communist system, but they wanted the transition from the old to the new system to last a long time and to involve serious economic distortions that would allow them to maximize their rents. Hence, they favored subsidies from the government budget and subsidized credits to producers, arguing that output would fall otherwise. The size of the budget deficit and inflation were of no concern to them. They advocated domestic price regulation and export controls in order to generate export rents through arbitrage. Generally, they preferred a minimum of transparency to facilitate illicit deals. For instance, they suggested that production monopolies had to be controlled by the state; this led to far-reaching regulation of domestic trade, which in turn limited competition, as desired by the managers (Åslund, 1995).

For a long time, the managers enjoyed widespread support from people ignorant of the dilemmas of post-communist transition. Reform communists and most social democrats thought it sounded right to slow down the transition process. The less was the economic understanding, the more successful were the managers in their advocacy of a slow transition. This is one reason why the managers in the former Soviet Union were able to get away with much more malpractice than in Central and Eastern Europe. Over time, however, the population has learned and no longer accepts spurious arguments. The interests of many managers have also shifted from rent seeking to profit seeking as they have learned their new businesses and no longer want to depend on bureaucrats. Furthermore, rents tend to dry up. The inflation tax, and thus the rents from high inflation, falls as people and enterprises reduce their real cash balances and as the velocity of money rises; export rents decline with a real revaluation of the currency, bringing domestic prices closer to world market prices. Finally, weak reform policies tend to lead to serious economic crisis, and the only financing available for financial restructuring tends to be IMF money, which is provided only on the condition of sufficiently far-reaching reforms. The paradigm of the reform communists has therefore lost out, as it has proved utterly ineffective. Thus the international liberal consensus is making inroads throughout the region as time passes. There are certain countervailing forces, notably some protectionism in import policies, but such tendencies have thus far been limited.

It is possible that a new ideological divide is opening up between Central and Eastern Europe and the New Independent States. Central and Eastern Europe has assumed many features characteristic of Western Europe—a similar degree of liberalization, state ownership, taxation, social transfers, and income differentiation. The region is increasingly characterized by a party spectrum resembling Western European political views, ranging from conservatives, to liberals and peasant parties, to social democrats, with the occasional hard nationalists. The New Independent States, on the other hand, is much less liberalized, is much more corrupt, has more differentiated incomes, and collects much less in taxes. The weakness of the state is much more apparent, and the whole situation is more akin to Latin America two decade ago than to Western Europe. Hence, political and economic thinking is also developing along different lines. The political center represented by social democrats is strikingly absent; one school of thought considers itself *gosudarstvenniki* ("statists"), while another is far more liberal than similar groupings in Europe.

Which force wins out will to a considerable extent be determined by whether democracy or dictatorship prevails. Whenever dictatorship takes over, it is usual, though not inevitable, that a statist economic policy wins out, as such a policy can benefit people in power the most (Maravall, 1994). However, the strong correlation between political and economic regimes noted just after the demise of communism has been weakening with the passage of time. Some dictatorships, notably that in Kazakstan, have gone far in liberal economic reforms after substantial *nomenklatura* privatization, while Albania, an early radical reformer, appears to have given up democracy in 1996.

Civil society seems to have been a vital factor in the formation of both political and economic systems, and it is likely to remain so. Poland provides an enlightening example. It possessed a far more extensive civil society than most other post-communist countries in the form of the Catholic Church, the private peasantry, and the Solidarity trade union. While all these groups were vigorously opposed to economic reform, they effectively made it succeed, as they blocked much of the rent seeking of Poland's managers. Hence, Putnam's (1993) argument that a strong civil society contributes to economic growth has been borne out in the post-communist world, and the explanation is that civil society limits rent seeking.

## FOUR POST-COMMUNIST MODELS

The outcomes of the post-communist transformation have varied greatly, and it is obvious that they were not predetermined. The orientation and quality of economic policymaking during these first few years is likely to remain of fundamental importance for all these countries for decades to come. At the outset of the post-communist transition, a large number of possible economic models were discussed. Today, the number has shrunk considerably.

Only a few countries had sufficiently strong states to be able to opt for a more complex model. The Visegrad countries are adopting much of the Western European model, not least because they are preparing to enter the EU. Yet complexity is not entirely a good thing. These countries are also facing the danger of limited economic growth and the entitlement trap most clearly developed in Sweden as a result of taxes that are too high and social transfers that are too large. The entitlement trap is particularly evident in Hungary, but social transfers are of about the same size in Poland. Poland is frequently compared with post-war Italy—corrupt and messy, but highly dynamic.

Most of the countries have undertaken substantial reforms, but these have not been at all as far-reaching as they should be. The result has not been collapse, but corruption and crony capitalism, as in the old protectionist and interventionist Latin American model. Most countries in the New Independent States fall into this category.

It may be hoped that this state of affairs will not be permanent. As has been done by many Latin American countries, several of these former communist countries are likely to opt for a new liberal economic model with low taxes, limited social transfers, few regulations, an open economy, and far-reaching privatization. To date, Estonia has most clearly made such a choice, but several other countries appear to have started moving in this direction, including Latvia, Lithuania, Moldova, Georgia, the Kyrgyz Republic, and Kazakstan. This model is more reminiscent of the old U.S. model. More countries are likely to follow as they try to control their economic and social problems.

There are also countries that have done little and who may ultimately fail not only as economic reformers, but even as states. They could end up in a terrible economic situation reminiscent of parts of Africa, without a functioning state or economy. Tajikistan is currently in such a condition. Because of the combination of excessive state intervention and poorly functioning governments and markets, neither an East Asian model nor a well-functioning Western European model appears to be a plausible option for these countries.

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# VI

# Research Priorities for Post-Communist Economies

# Research Priorities for Post-Communist Economies

*Task Force on Economies in Transition*

## INTRODUCTION

Ends of empires tempt observers and participants into teleological explanations. In retrospect, the previously unpredictable becomes inevitable. A similar determinism is characteristic of thinking about the future of the post-communist successor states: it is widely presumed that their political and economic systems will evolve into close approximations of those of the most powerful members of the existing state system. Characteristically, there were many for whom Central and Eastern Europe and the New Independent States seemed to constitute a slate on which, once rubbed clean, leaders and planners could draw the designs they preferred. Now, after years of effort, conflict, change, and scrutiny, both the legacies of state socialism and the requirements of vigorous, viable alternative political-economic systems look much more formidable. This section proposes a program of research into the factors shaping the transformation of the post-communist world.

The U.S. government has an interest in promoting prosperity, democracy, and stability in Eurasia. In company with other Western governments, international agencies, and reformers in Central and Eastern Europe and the New Independent States, it focused its early analyses and interventions on ways to liberalize and stabilize command economies. Much less effort went into mapping either their likely future topographies or the paths that would take them there. As time has passed, however, those tasks have become more urgent. With respect to transformation—political, economic, and social—what is actually happening, and why? What might come next?

By the time the task force went to work, it was becoming clear that the widely varying historical heritages of the Central and Eastern European and post-Soviet states were causing large differences in their paces and directions of change. All had experienced state planning and communist rule, but to vastly different degrees over different time spans. Both before and during communist rule, their involvement with the capitalist West varied enormously, from relatively close in Czechoslovakia and Estonia to quite distant in Bulgaria and Tajikistan. The reactions of their peoples to the end of communist regimes and of Soviet domination ranged widely, as did ideas concerning desirable directions for change. Economic development, resources, ethnic composition, and geography posed differing opportunities and constraints. The international economy itself impinged in contrasting ways on successor states as different as Hungary and Uzbekistan.

When the task force began its work, both positive experiences (mainly in Central Europe and the Baltic states) and negative experiences (for example, in Bulgaria and Ukraine) had already confirmed the crucial role of stabilization measures and substantial liberalization of prices, markets, and new business entries—measures on which international financial and economic circles tend to agree. It was also becoming clear that these necessary measures were far from sufficient to transform command economies into stable, wealth-generating socioeconomic systems. Restarting and sustaining economic growth, mitigating poverty, and reshaping social organizations in ways that would be accepted by different national and ethnic populations required a much broader range of changes.

On such questions as how to liberalize labor markets and restructure industrial relations, competing models have their partisans, but experience with both post-communist and other economic regimes demonstrates that similar policies can produce quite different outcomes in different contexts. The dominant models of Western economics have important contributions to offer, especially as baselines for gauging what sorts of changes are actually occurring in Central and Eastern Europe and the New Independent States. But they can offer only limited guidance as post-communist countries move beyond stabilization and liberalization to rebuild sectoral institutions.

These conditions challenged the task force to seek more penetrating and provocative analytical frameworks, better documentation and explanation of current changes, more accurate identification of potential risks, and more nuanced guidance for policy interventions than were currently available. To this end, Sections II through V examine what has been taking place in post-communist economies and why, whereas this section elucidates priorities for further research. The research agenda presented here has three goals: (1) to direct researchers to the topics, issues, and processes most deserving of attention and analysis; (2) to encourage the elaboration and application of new approaches and methodologies, as well as the utilization of methods and tools developed in related social sciences, to the study of economies undergoing transformation; and (3) to focus the attention of U.S. government agencies and the funding community at large on priority areas for support.

In seeking potentially fruitful conceptual approaches and methodologies to improve understanding of the processes of transformation, the task force became convinced that approaches that treat these processes as narrowly economic are less useful than those which cross intellectual and disciplinary boundaries and apply concepts and methods from related social sciences, such as political science, sociology, and anthropology. Surveys that focus on short-run changes in prices, incomes, or the structure of ownership without grounding these phenomena in a larger sociopolitical context provide only limited insights and information concerning transformation—whatever the extent of its penetration or its likely trajectory. Similarly, we found case studies focused on developments in a single region or country less useful than cross-regional and cross-national studies. Only comparative studies—both those that remain within the bounds of a single discipline and those that cross disciplinary boundaries—provide opportunities to identify the key variables and determinants channeling change and affecting transformation.

Moreover, the task force found a wide range of research methods and techniques useful in elucidating various aspects of transformation. Some of these methods are relatively novel in much of the post-communist world, while others are benefiting from increased rigor in their application. Examples include the use of focus groups, public opinion research, time budget surveys, and surveys of household income and expenditures. Other methods, such as in-depth anthropological and ethnographic observation of local communities, can also produce remarkable insights concerning the context within which transformation is taking place.

## INSTITUTIONAL ANALYSIS

During 1995 and 1996 the task force held a series of five workshops on economic transformation. In analyzing the materials presented at these workshops and debating the hypotheses and conclusions advanced by the workshop participants, the task force began to focus on the new institutional economics as a singularly provocative and powerful conceptual tool. By this we did not mean to imply that other approaches are less valuable or insightful in analyzing a range of issues and topics; indeed, as suggested above, the task force views a variety of approaches as mutually reinforcing and amenable to cross-fertilization. The task force emphasizes the institutional change approach in this volume because we found it offered particular potential to improve understanding of economies undergoing transformation, as well as an appropriately broad and cohesive framework for analysis, and because this approach has been relatively neglected by those working in the field.

As discussed in the introduction to this volume, it should be noted that the new institutional economics uses the term *institution* in a way that differs substantially from its use in common parlance or in such disciplines as political science to include not only formal laws, operating rules, and organizations, but perhaps most saliently, the informal structures and norms that channel behavior.[1] According to this approach, institutions embody the "rules of the game" within which key actors (including individuals, households, ethnic groups, and enterprises) operate. When those rules change, the players face a different array of incentives and constraints. Their behavior is then shaped and channeled by the institutions that have changed, those that have not changed, and the tensions between the two. The task force concluded that research applying the institutional change perspective can enhance understanding of the transformation of the economies of Central and Eastern Europe and the New Independent States along a number of key dimensions.

First, an institutional change perspective illuminates a broad range of economic, social, and political processes. It brings together areas of inquiry from diverse fields in which specialists often proceed independently—sometimes too independently—of each other. It assists analysts in making connections among changes in national and international laws, norms, and structures; the responses of sectors, firms, households, ethnic groups, and communities; and the behavior of individuals. It also directs analysts to examine and identify the feedback mechanisms that link these levels of analysis.

For policymakers and their advisors, research applying an institutional change perspective can help explain why similar reform programs often produce markedly different outcomes in different settings. It can also help in specifying the incentives and structures that would facilitate institutional reforms.

Perhaps most critically, the institutional change perspective directs attention to evolving property rights and their enforcement. Secure property rights extend time horizons, promote investment, provide incentives for effort, encourage productive activity, and ensure the creation of wealth. Similarly, risk-reducing institutions, such as legal and organizational arrangements for limited liability and orderly bankruptcy, play crucial roles. The absence of secure property rights and related risk-reducing institutions favors shortened time horizons, disinvestment, speculation, rent seeking, crime, and corruption.

[1] "Organizations" are more or less formal associations, such as government agencies, business firms, and citizens' associations. Members of an organization pursue shared goals, and their interactions are governed by internal rules and structures. Organizations can usefully be viewed as collective actors whose behavior is shaped both by internal goals and rules and by the larger institutional context. "Structure" is a broader concept, encompassing not only organizations, but also other more or less enduring sets of relationships such as families, networks, and ethnic groups.

The institutional change perspective led the task force to highlight the distinction between economic activities that (1) promote the creation of new wealth, that is, are productive, and (2) simply redistribute existing wealth, that is, involve rent-seeking, predatory, and protective activities. Whereas productive activities involve the transformation of inputs into outputs, rent-seeking, predatory, and protective activities focus energies and effort on the appropriation, exchange, and control of already existing goods and assets. Analysts and policymakers need to recognize the distinction between these two types of activities, monitor the relative predominance of each, and identify policies that promote the former—the creation of new wealth.

The institutional change perspective emphasizes path dependence, or the dependence of current events on prior institutions and developments. Legacies from pre-communist and communist pasts, as well as the ways communist economic and political control unraveled, vary widely in different parts of Central and Eastern Europe and the New Independent States. These differing contexts—ranging from official economic policies to the strategies of individual firms, social and ethnic groups, and households—powerfully affect the character of the changes now under way. Path dependence highlights the fact that historical legacies are not simply deadweight obstacles to change, but also (1) constraints on what can happen next; (2) resources on which people inevitably draw as they create political and economic change; and (3) important models that affect what people regard as possible, acceptable, and desirable.

The institutional change perspective alerts researchers to the possible effects of the perspectives, values, and identities of different social and ethnic groups on their responses to changes in economic conditions. As North notes in his framework essay for this volume, economic change draws on (and is bounded by) existing stocks of knowledge. A "stock of knowledge" is not an objective entity divorced from context. The views of any group's members concerning valid or relevant knowledge will be filtered through their ideas of who they are, whom they wish to resemble, and how the world works. Romanian villagers, for example, will hold views of "property rights" that differ fundamentally from those generally accepted in Western capitalist countries, and these perceptions will shape the villagers' responses to changes in formal laws and government policies. The values and understandings of different groups are partly legacies from pre-communist and communist pasts. Like other legacies, they evolve, sometimes in direct reaction against other aspects of the past (for example, the current intense cynicism about political parties throughout the region is a result of prior experience with communist parties), and sometimes in response to new ideas, information, and opportunities. A key feature of the transformation has been the abrupt and dramatic increase in exposure to such new ideas as a result of increased exposure to foreign contacts and influences. Both gaining insight into existing cultural frames and monitoring how they are changing will be crucial for understanding the transformation process.

The institutional change perspective calls attention to formal institutions and informal norms and conventions and the coherence or conflict between the two. Lack of coherence between formal and informal institutions gives rise to widespread noncompliant behaviors, including corruption and the formation of underground economies. These behaviors operate at all levels of social life; identifying and understanding them is a requisite for explaining what is going on in changing economies. Networks are emerging to fill institutional lacunae. Just as networks of politicians and entrepreneurs are shaping the way enterprises respond to changing economic conditions and government regulations, networks of friends and relatives provide an important mechanism for households coping with the costs of economic restructuring. Networks in finance and ownership are also playing crucial roles in evolving and increasingly entrenched patterns of corruption and criminal activity.

Few analysts have made serious attempts to utilize an institutional change framework or to apply the insights of the new institutional economics to transforming economies. Although the potential rewards may seem self-evident, efforts to measure transactions costs or to determine the extent to which property rights have become secure confront a complex situation. Much of the wealth being redistributed or privatized was, and remains, outside any pricing system (e.g., privileges associated with nomenklatura status, access to opportunities for rent-seeking behavior), or was seriously mispriced (e.g., housing, utilities, health care). Assets are changing hands, or not, on the basis of insider networks; wealth is being shifted between economic sectors (e.g., from the military to the civilian); the previously underground economy is frequently becoming part of the official economy (but sometimes not); and criminal enterprises and corruption are filling the interstices left by inadequate institutional development.

Transformation is not a closely managed process. Many of its features are inchoate and unstable and operate out of control. At the same time, in some changing economies, different levels of government are making conflicting attempts to regulate critical aspects of transformation, sometimes interfering with efforts to establish a predictable fiscal and regulatory environment. As if this were not sufficient, none of the economies of Central and Eastern Europe and the New Independent States are developing in isolation: foreign investment, debt, capital flight, trade opportunities, and exchange rate instability all affect their monetary and fiscal policies, gross domestic product, and standards of living.

Despite the difficulties of observation and measurement in rapidly evolving and often chaotic circumstances, the enhanced understanding to be gained from research that analyzes dynamic tensions in institutional change and relationships between the redistribution and creation of wealth in transforming economies clearly makes the effort worthwhile. Such research should:

- Examine the relationship between formal and informal institutions, and determine the causes and consequences of various noncompliant behaviors and their manifestation in various underground economies.
- Specify how selected institutional changes alter incentives for productive, protective, and predatory behaviors.
- Examine how selected institutional changes influence the efficiency and equity of the institutions' operation.
- Explore the interaction between selected institutional changes and behavioral responses that result. Do those responses facilitate or raise obstacles to intended outcomes, encourage or block related policy interventions, or reduce or increase the tension between reformed and entrenched aspects of the system?
- Identify the dynamic feedback between selected changes and the behavioral responses of economic actors, and thereby the likely effects of the changes on the creation and redistribution of wealth.

As noted earlier, a wide range of research methods and techniques will prove useful in improving understanding of the processes of transformation. The task force wishes to emphasize the potential value of longitudinal panel studies. Such studies are especially useful for tracing trends and revealing emerging patterns of behavior and outcomes at the micro level, that is, within households, among particular social and ethnic groups, and within enterprises. With respect to households, cross-sectional time series and longitudinal studies would assist tremendously in identifying trends and patterns in family formation, fertility, migration, employment, and welfare. Panel studies such as the Russian Longitudinal Monitoring Survey and annual surveys being carried out in Central and Eastern Europe, particularly those conducted under the Luxembourg Income Survey, represent unique data sources that should be supported and expanded.

## PRIORITY RESEARCH AREAS

The task force focused its attention on four key components of political, economic, and social systems:

- Institutional change, property rights, and corruption
- Management, labor, and production
- Social trends, household behavior, and social-sector policies
- The changing role of the state

While these four areas do not exhaust the possibilities, they should nevertheless appear on any list of major issues involved in the transformation process. In theory, it would be desirable to shorten the list or identify a very small number of questions whose answers would, by themselves, generate major advances in explaining economic and political change. For the moment, however, the complexities and interdependencies are understood with greater clarity than the crucial nodes; to narrow the focus greatly now would surely exclude important analytic opportunities that will emerge as inquiry unfolds, relevant theory strengthens, and empirical verification proceeds. With this broad perspective in mind, the following subsections outline high-priority issues in each of the above four areas and pose some specific research questions that might be addressed in examining these issues.

### Institutional Change, Property Rights, and Corruption

**What kinds of institutional infrastructure (legal, financial, and administrative) are needed to support private ownership, free market exchange, investment, and economic growth? To what extent are different kinds of institutional infrastructure emerging? What are the likely consequences of extending ownership and exchange rights to land and housing? How and why are forms of property changing in post-communist economies? How much do current conditions and trends vary from one part of Eurasia to another? What explains the variation? What are the major types of underground activities in transition economies? How can their size be measured and their causes and consequences be determined?**

There is abundant evidence that property rights are changing in former areas of state socialism, with deliberate programs of privatization accounting for only some of the change, and often having consequences other than widespread property holding and investment by members of the general population. There is also good reason to believe that the sorts of property rights that emerge in Central and Eastern Europe and the New Independent States will (1) differ in important ways from the forms of property currently prevailing in Western Europe and North America, (2) significantly influence future economic organization and productivity, and (3) have a strong impact on future political institutions. We recommend a program of comparative research going well beyond idealized models of socialist and capitalist property rights, or of public and private property, to document and explain actual changes in property. The following are some specific research questions that might be addressed:

- What determines the allocation of human effort among productive, protective, and predatory activities? How can the resources devoted to each type of activity be measured, and the consequences of each for economic, political, and social development be determined?
- What new property regimes are emerging from the “social ownership” of the communist period? What residual de facto rights are being preserved from the earlier system? How do prior differences in communist property

regimes affect emerging differences in the timing, location, and forms of property relations (e.g., the mix of "public" and "private," the pace of privatization, and the emergence of exclusive ownership as opposed to overlapping use rights)? How do these differences affect transaction costs?

- How are use rights, income rights, and alienation rights to property assigned and enforced? What governance institutions are available to create incentives when these rights are separated and redistributed?
- What attitudes concerning property and ownership affect the rise of new property regimes? What do different groups of people think "property" means?
- How are relationships between property rights and citizenship rights developing? Why? What implications do these changes have for political stability (particularly in connection with ethnic/national questions)? In countries such as Latvia where citizenship is a prerequisite for property ownership, but some ethno-national groups do not have access to citizenship, what political consequences ensue? What have been the effects of Western pressures to reduce such discrimination?
- How can informal or underground economies be distinguished and their size and growth measured? How do various kinds of underground economic activity affect efficiency, equity, and stability?
- What conditions promote or inhibit rent seeking and corruption in post-communist economies? How can corruption and rent seeking be measured and monitored? What consequences do they have for economic change, human welfare, and inequality?
- What conditions promote organized crime, and how can it be measured and monitored? In what ways is it intertwined with "legitimate" economic activities, and with what effects?
- To what extent are underground activities reflected in the observed increased use of cocirculating currencies, such as the dollar and D-mark, and can observation of these monetary flows be used as an indicator of corruption, organized crime, and capital flight?
- How have different land tenure patterns and ownership rights affected productivity in different transitional economies?

### Management, Labor, and Production

**To what extent is a private, nonstate production sector emerging in transitional economies? What institutional infrastructure is needed to support the development of nonstate producers? What government policies impede or foster the growth of a private sector? To what extent is the structure of production adjusting to consumer demand and international integration? What institutional deficiencies or barriers impede economic adjustment and integration into the world market?**

Eastern Europe, Russia, and the New Independent States have accomplished an impressive transformation, privatizing a large share of production, liberalizing domestic markets, and liberalizing commercial relationships with the world market. At the end of 1995, 14 of the transition economies had, indeed, rekindled economic growth.

However, recovery in some of the largest transitional economies—Russia, the Ukraine, and Kazakhstan—appears to be in serious jeopardy. They face the task of building new state structures that can fulfill the essential functions of government and create the environment needed to support a healthy, prospering economy. However, the international community and international investors are uncertain whether the fragile new institutions of these countries are up to the task. In Russia in particular, missing institutions and harmful policies impede investment and the entry of new small firms. The lack of ownership rights to land blocks agricultural reform and retards construction of housing. At the same time, a confiscatory tax and regulatory environment, in conjunction with increasing crime and corruption, impedes the establishment of new private firms.

The following are some of the specific research questions that relate to institutional change with respect to the productive and financial sectors:

- To what extent are the transition economies creating well-functioning private sectors in agriculture, industry, and services? What factors impede the emergence of new private producers?
- What institutional arrangements are important in providing frameworks for production and investment in Western market economies? To what extent are similar institutional frameworks available to producers in the transitional economies? What are the consequences of missing infrastructure? What, if anything, can producers do when financial, legal, or administrative infrastructure is missing or dysfunctional?
- How do differences among various forms of privatization (employee buyouts, managerial/nomenklatura buyouts, mass privatization, auctions, and negotiated tenders) affect enterprise organization, performance, and productivity?
- How does the availability of legal, financial, and administrative infrastructure influence the form of enterprise governance and the scale of firms? How does it affect the supply of investment and domestic and foreign investors' perception of risk?
- What policies and mechanisms (such as prudential regulation and introduction of international accounting standards) are necessary to support well-functioning financial markets? What institutional changes are needed to allow financial institutions to bring savers and investors together in well-functioning financial markets?
- Are the institutional changes being introduced in stock exchanges and other mechanisms for financial mediation creating more transparent and ac-

countable regulatory frameworks, or entrenching old networks or bureaucracies in a new guise? What incentive structures are creating and reinforcing these developments?

- What changes are required to provide rule of law and enforcement of contracts? What changes are needed to bring regulation into conformity with legislation?
- What factors lead to the persistence of soft budget constraints in some transitional economies? What are the consequences of such constraints for government stabilization and structural change in the economy?
- What factors impede the movement of labor from areas of low demand to areas of potential growth? What institutions or policies would encourage greater labor mobility and mitigate its costs? What major factors other than geographic immobility impede improved labor productivity?
- How do the institutions of the international market impact domestic institution building? To what extent have the liberalization of international trade and consequent international competition induced changes in domestic institutional infrastructures?

### Social Trends, Household Behavior, and Social-Sector Policies

**What institutional changes are taking place at the household level? What is happening to household assets, such as ownership of land, housing, savings, and work-related skills? To what extent, where, and how are current economic and political transformations aggravating poverty, inequality, and insecurity? How are households coping with new economic pressures and the erosion of state services and assistance? Which populations are the most vulnerable, and does this change over the course of transformation? How and why are social transfers and delivery of social services changing, and with what consequences for (1) welfare, (2) economic transformation, and (3) political processes?**

Growing evidence suggests that since 1989, Central and Eastern Europe and the New Independent States have experienced considerable—in some cases dramatic—increases in poverty and inequality, substantial declines in health and life expectancy, and alterations in patterns of ownership and employment. At the same time, real expenditures on education, health, pensions, and other social assistance have declined, at least temporarily. Fundamental reorganizations of social-sector programs are being debated or (in a few cases) are under way. These trends have far-reaching and as yet poorly understood implications for welfare, economic growth, and political evolution.

Some specific questions that might be addressed by research in this area are as follows:

- What are the dynamics of impoverishment? How can it be determined whether what is occurring is a short-term by-product of transformation or the beginnings of long-term social inequality?
- Studies to date indicate that transformation has had particularly severe effects on children in both large and single-earner households, though important variations exist among countries and subregions in this regard. Especially in Russia and other countries where the impact has been acute, how can effects on these and other vulnerable populations be better monitored and analyzed? What are the relevant trends in child poverty in those post-communist countries which have experienced several years of economic growth, such as Poland?
- Who are the long-term unemployed? How and why does their composition by age, gender, ethnicity, education, and employment sector vary within and among countries?
- What patterns are emerging in the distribution of inequality by gender, age, and ethnicity? Why? Is a "feminization" or an "ethnicization" of poverty taking place?
- How do objective indicators of income and expenditures relate to subjective perceptions of current and future well-being, as well as future prospects, as measured by opinion surveys and focus groups?
- Do different social, generational, and ethnic groups or different genders have differing attitudes toward changes in property ownership and increased inequality? What aspects of inequality—differences in income, wealth, opportunity, security, political influence, or prestige—most concern these groups, and why? What implications do these attitudes have for policy?
- What substitutes are emerging for publicly provided social safety nets? How are households, women, extended families, and ethnic groups coping with the burden of welfare functions previously provided by the socialist state? What bases for forming social support networks (kinship, community, occupation) are emerging, and do they vary significantly by country? How well do they work?
- What are the scope and characteristics of growing private-sector (profit and nonprofit) education and health service facilities?
- How are localities coping with the erosion/collapse of old social service delivery institutions? What are the evolving roles of local governments, nongovernmental organizations, and private services? What are the major factors influencing local responses?
- In view of fiscal constraints (including the need to contain or reduce overall social expenditures in some Eastern European countries and weak revenue capabilities throughout the New Independent States), what strategies are emerging for sustainable and improved services in education, health, and social assistance?

• With regard to the choice between (1) entitlements and (2) varying degrees of individual responsibility for various sorts of services, how are shared understandings evolving among different social and ethnic groups and countries? What implications does that evolution have for public support of future regimes? What impact, if any, have mass privatization programs had on the distribution of wealth? Can further privatization efforts create a private-sector safety net? How would extensions of property rights to land and housing affect income and wealth distributions?

### The Changing Role of the State

**How are shifts in the scope, personnel, and formal organization of political life affecting property rights, economic organization, household experience, collective goods, and the viability of political regimes? Why, and with what consequences for the future?**

Both within post-communist countries and among Western observers, wide disagreements exist concerning the interactions between type of political regime on the one hand and quality of economic performance on the other. The great variety of paths followed by post-communist regimes presents a crucial challenge and an opportunity for researchers to trace causal connections between the two sets of factors. Prospects for democracy, economic growth, and public well-being are at stake.

Specific questions to be addressed include the following:

• How are sharp increases in the concentration of income and wealth at the top end of the distribution affecting political power, and how are these relationships mediated by formal and informal institutional arrangements? What are the emerging patterns of concentration of media control, and what are the implications for the political process? How are election campaigns being financed, and with what consequences?

• To what extent and how are new (or altered old) political and economic interests organizing to press their claims? How are these processes being mediated by formal and informal institutions?

• Do lower voting percentages in the region reflect a lack of internalization of democratic principles within important components of the population? Are there discernible variations by gender or ethnicity? What indicators other than voting would be more appropriate for gauging popular commitment to democratic ideals and processes?

• In those countries where state revenues have severely dwindled or collapsed, what are the major operative factors, and what incentives and capacities must change to restore the state's ability to collect revenues?

• How does a society assure itself of an honest and competent civil service? What institutional changes are required to this end?

- How are the mandates and structures of state organizations changing? What new levels or divisions of government are forming, and which ones are disappearing? How are state organizations presenting their mandates to relevant publics? In what ways, to what extent, and with what deliberate publicity do governmental appeals differ from those of the communist era?
- How are emerging political institutions and practices affected by social and ethno-national conflicts? What are the implications for long-term political stability and the continuity of economic policy? How equally or unequally do emerging political relations engage the energies of and impact areas of concern to different genders and ethno-national groups? What are the consequences for public politics, present and future?
- Are new legal and judicial mechanisms/institutions being successfully institutionalized? What role are they playing in the enforcement of contracts and the resolution of disputes? To what extent are preexisting judicial institutions assisting or impeding economic transformation?
- How do different social and ethnic groups and individuals conceptualize "the political" and their relations to parties, the political process, and the state? How do contending parties recruit, organize, and exert control over their members? To what extent do political parties consist of coalitions among kin, friends, and business associates?
- How much and what kinds of authority and responsibility have been shifted from state-wide to lower levels of government, and what are the implications for economic organization and growth, social policies and programs, and the legitimacy and capacity of all levels of government?
- What institutional changes are required to create stable tax-based government budgets? What is the division of government revenue and expenditure responsibility among central, regional, and local authorities, and what have been the consequences of alternative allocations of responsibility among different levels of government?

## PROPOSED RESEARCH PROGRAM

The interdisciplinary study of transformation, comparative analysis, and the fields of post-Soviet and Central and Eastern European studies have experienced vibrant growth, both qualitatively and quantitatively, in the West and the East since 1989. Although the growing body of work on democratization and other comparative aspects of transformation is producing valuable insights on Central and Eastern Europe and the New Independent States for analysts, policymakers, and practitioners, the particularities of the post-communist transformation have yet to be effectively integrated into this literature.

Somewhat paradoxically, after decades of having to search painstakingly for nuggets of information, post-Soviet and Central and Eastern European analysts are being inundated with data and finding it increasingly difficult to separate the wheat from the chaff. At the same time, a misplaced sense of triumphalism has led government agencies and independent foundations to underestimate the potential contributions of work in these fields and, as a result, to begin shifting their priorities and funding away from this area of the world. This trend, coinciding as it does with widespread retrenchment on university campuses, threatens to erode the financial foundations on which the research infrastructure in both comparative and area studies is based. Most important, it also endangers the replenishment and enrichment of these fields with a new generation of scholars and research analysts.

In producing this research agenda, the task force hopes to focus attention on, and bring some coherence to, the post-communist research enterprise by (1) calling into question the unconsidered assumptions on which much current work is based; (2) highlighting the need for work that is both interdisciplinary and comparative; (3) emphasizing the need to take history, politics, demography, and ethnography into account in both designing and analyzing the course and consequences of economic reforms; and (4) focusing attention on a particularly fruitful conceptual framework—the new institutional economics.

A cohesive research program can not only maximize the utility of increasingly scarce research dollars, but also enable analysts to concentrate on particularly salient aspects of transformation. Such a program can also promote synergy as scholars working in diverse disciplines bring their analytical skills to bear on common problems. Without a substantive and sustained program of research, current policy interventions in post-communist economies will surely fail in some regards and produce unanticipated, and all too frequently undesirable, effects in others. Although improved research cannot guarantee the achievement of particular policy goals, better-informed and more sensitively designed policy interventions stand a far higher chance of success than those which have not benefited from research-based analysis.

It is time for major, theoretically motivated and empirically supported inquiries into the four key research areas explored in this volume: (1) institutional change, property rights, and corruption; (2) transformation of management, labor, and production; (3) social trends, household behavior, and social-sector policies; and (4) the changing role of the state. In all four of these areas, research should be empirically grounded; comparative, seeking to explain both change and variation across Central and Eastern Europe and the New Independent States; and sensitive to ethnic, national, generational, and gender differences. This is not to say that every investigation should deal with every post-communist country, or every nationality, or every age group; on the contrary, as the chapters and essays in this volume show, close examination of changes and their causes in single cases can provide one of the best defenses against schematic reductionism.

The questions outlined in the preceding sections provide the necessary scaffolding for a major, focused, and cohesive research program. They are not intended to be either all-inclusive or exclusive. The task force believes the best work will be accomplished if the gates are opened as widely as possible to individual researchers, research teams, and research centers to compete for funding under the auspices of the program.

The development of new arrangements for coordinating and encouraging innovative research would substantially further the proposed research agenda. As a first step, the relevant U.S. government departments and agencies (the departments of State and Defense, the Agency for International Development, the National Science Foundation, and the various intelligence agencies) should undertake consultations aimed at coordinating government funding of research related to Central and Eastern Europe and the New Independent States. Institutionalizing channels of communication across departments and agencies having responsibilities in the region should not only assist the research effort, but also broaden the scope of government thinking on this area of the world at a time when new thinking is at a premium. Improved communication and coordination should reduce duplication of effort on the part of both government and researchers while enhancing the capacity to study, analyze, and understand change in a large and increasingly volatile part of the world.

The task force does not presume to dictate the individual components or determine the most appropriate sequencing of this research effort. Practical details concerning the mix of institutions, teams, and individuals to be charged with particular aspects of the work should be developed through consultation both within and among the agencies cited above, and with substantive input from the Kennan Institute for Advanced Russian Studies, the National Council on (Post) Soviet and East European Research, and the Joint Committees of the Social Science Research Council and the American Council of Learned Societies, as well as the leading foundations supporting work in these fields.

One beneficial by-product of the Cold War is the substantial existing infrastructure of research centers devoted to the study of Central and Eastern Europe and the New Independent States. In the United States alone, there are a large number of institutions that merit the appellation of centers of excellence and innovation, from the Berkeley-Stanford program, to the universities of Michigan, Wisconsin, and Indiana in the mid-west, to the Harriman Institute at Columbia and the Russian Research Center at Harvard. The hallmarks of these centers of excellence and innovation are their interest in fostering creative, high-quality work; interdisciplinary research; participation in inter-university and East-West partnerships; and their commitment to training a new generation of scholars and researchers who are equally adept with the most rigorous social science methodologies and the intricacies of area studies.

Opportunities for close collaboration with Eastern European universities have never been as great as they are today. Consortia of Western European universities are developing innovative institutions, such as the International

Center based at the University of Tuebingen, to promote this kind of work. Most significant, serious centers of scholarship are being resurrected in Eastern Europe (for example, Tartu University in Estonia) or newly created (for example, the Central European University in the Czech Republic and Hungary and the University of the Humanities in Moscow). Research that engages the talents and assists in the further training of a new generation of Eastern European social scientists should be particularly encouraged.

The following guidelines can help ensure the success of this proposed research program:

- Funding should be made available in 3- to 5-year increments so that institutions, research teams, and researchers can make the necessary substantial investments of time, energy, and resources.
- Research teams should not only be interdisciplinary but also, whenever possible, include researchers from Central and Eastern Europe and the New Independent States.
- Research projects should be explicitly designed so that, when appropriate, the data produced will be comparable across time and countries.
- Research topics should be proposed by individual investigators and research teams, not set by the institution(s) coordinating the research program.
- All of the research, and the underlying data on which it is based, should be publicly available, be deposited for use by other researchers, and, when possible, be accessible on the World Wide Web.

Observation of the above guidelines will enable researchers to build on each other's work and give policymakers confidence that the results produced are indicative of real socioeconomic trends and processes.

In addition, research conferences should be convened annually under the auspices of one or more of the organizations overseeing the implementation of this research program, such as the Kennan Institute or the National Council on (Post) Soviet and East European Research. These conferences should be focused on critiquing and refining the ongoing research effort. Individual researchers and research teams should be asked to present their results, as well as emerging hypotheses, to their colleagues and practitioners in the field. Such conferences would improve understanding, assist policymakers in obtaining a more up-to-date and nuanced view of developments in the region, and generate new avenues of inquiry. After 5 years, the research program should be revised and refined, preferably after broad consultations involving all major actors in the field, including the lead organization(s) overseeing implementation of the program, allied professional associations, private foundations, and the relevant funding agencies. After the revised program has been accepted by the funding agencies, there should be another round of proposals and funding, an additional series of conferences, and a further iteration of the research agenda.

Scientific judgment is inherently imprecise, whether one is quantifying the risks associated with nuclear reactors or identifying the effects of imposing stabilization strategies on transforming societies. Reasonable assumptions and widely accepted theories can and have been proven false, and strategies that have succeeded in one set of circumstances may fail in others. Important work needs to be done on the post-communist economies of Central and Eastern Europe and the New Independent States. At present, the processes and mechanisms are poorly understood, theory is deficient, and methodologies are uncertain. The research program outlined here represents a major step toward improving both the analysis and understanding of the political economy of the post-communist transformation.

# Appendix:
# Further Reading

# Appendix: Further Reading

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