

Evolution/Transition

Evolutionary Perspectives on Transition Economies

I. Diversified Paths of Transition

II. Evolutionary and Institutional Theories of Transition

March 27-30, 2002

Kyoto and Osaka

Japan Association for Evolutionary Economics

Funded by The Japan Foundation and Kyoto University Economic Society

***Evolution/Transition:
Evolutionary Perspectives on Transition Economies
March 27-30, 2002***

March 27, 2002

18:00-20:00

Reception at Kyoto Garden Palace

(Kyoto, Subway Marutamachi, 075-411-0111)

March 28 (Th.) Full Day Session

Grad. School of Economics, Kyoto University

Part 1. Diversified Paths of Transition

10:00 Opening Address

Sadayoshi Ohtsu (Kobe Univ.)

In search of an alternative vision on “Ten Years of Transition” – Survival between
Market Bol’shevism and Criminal Economy

Bernard Chavance (Univ. Paris VII)

Why national trajectories of post-socialist transformation differ?

<Central and Eastern European Countries and Russia>

Chair : Nobuyuki Kadowaki (Shiga Univ.)

Hiroshi Tanaka (Ritsumeikan Univ.)

An Approach to Typology (theory) of Transition Economies

Kazimierz Poznanski (University of Washington, Seattle)

Building Capitalism with Communist Tools: Eastern Europe’s Defective Transition

12:00 >>lunch<<

13:30

Funded by *The Japan Foundation and Kyoto University Economic Society*

Satoshi Mizobata (Kyoto Univ.)

Lessons from Economic Transformation:

Economic Actors and their Behaviour in Russia

Dimiter Ialnazov (Kyoto Univ.)

Economic Transition in Bulgaria from an Evolutionary Perspective:

The Currency Board and the Prospect of EU Accession

Etsuo Yoshino (Hokkaido Univ.)

Family is a Synthetic Symbol of Social Analysis in Transitional Economies

15:30 >>coffee break<<

16:00

<Chinese Way of Evolution/Transition>

Chair: Nobuaki Sasaki (Osaka City Univ.)

Z. Jeffrey Shi (Fudan University, Shanghai)

Rationality and Path Dependence in Institutional Change:

The Case of Agricultural Reforms in Post-Mao China

Hiromi Yamamoto (Kyoto Univ.)

The Evolution of Economic Reforms in China

17:00 >>Dinner<<

19:00

Feng Xingyuan (Univ. Witten/Herdecke and Rural Development Institute, CASS, Beijing)

Intergovernmental Competition and Evolution of Rules Governing the Fiscal Relations
in China

Song Lei (Nagoya Univ.)

The Achilles Heel of China's Economy: Understanding the Process of Institutional
Evolution in a Large Transition Economy

Feng Rui (Osaka City Univ. GS)

Relation of Central and Local Governments in the Industrial Policy in China's
Transition Period to Market Economy

20:30 Close

Funded by *The Japan Foundation* and *Kyoto University Economic Society*

March 29 (Fr.) Afternoon Session

Annual Meeting of the Japan Association for Evolutionary Economics

Kansai University, Senriyama, Osaka

Part 2. Evolutionary and Institutional Theories of Transition

13:00

Chair : Kiichiro Yagi (Kyoto Univ.)

Evolution and/or Transition: An Introduction

Vladimir I. Mayevsky (Center for Evolutionary Economics, RAS, Moscow)

Evolutionary Economics and Some Problems of Modern Russian Economy

Eric Magnin (Universite de Paris VII)

A Contribution to an Evolutionary and Institutional Approach of the
Transition Process

Kenji Tominomori (Obirin Univ.)

Polish-German Trade and Poland's Growth – An Explanation based
on Self-Organization Theory

Sheng Hong (Unirule Institute of Economics, Beijing)

Toward a General Theory of Transitional Economics

Aliya Kantarbayeva (George Washington University, Washington D.C.)

Stable Undesirable Norms in Modern post-Communist Transition Economies

Discussant: **Hans-Peter Brunner** (ADB: Manila)

17:00

Join the Party of the JAFEE

March 30 (Sat.) 9:30-16:50 Senriyama Campus, Kansai University, Osaka

**Join various sessions of the 6th Annual Meeting of the Japan Association for
Evolutionary Economics separately**

Secretary: Kiichiro Yagi (Graduate School of Economics, Kyoto University)

yagi@econ.kyoto-u.ac.jp TEL:075-753-3427 FAX:075-753-3492 (Adm.)

JAPAN ASSOCIATION FOR EVOLUTIONARY ECONOMICS

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Evolution and/or Transition: An Introduction

Kiichiro YAGI (Kyoto University)

1. Why Should We Deal With Transition Economies?

As the call for the foundation of our Association had a wider resonance than its organizers had expected, many hopes are laid on the future of evolutionary economics. One of them consists in the possibility that it provides us with a more suitable frame of reference in the understanding of historical process than traditional theories can. Most of the evolutionary economists avow themselves that they focus on qualitative changes in irreversible processes that are driven by interactions of multiple and diversified elements. This is precisely what historical researchers hold when they investigate into their materials. It is quite natural for them to expect that the emerging evolutionary direction of economics might become a bridge over the cleft that separates theoretical researches and historical or empirical researches in contemporary economic sciences.

Such a promise, of course, will not be realized without efforts. The research program of the evolutionary economics is clearly not such one that concentrates the energy first to develop a theoretical system and then to apply the completed theory to historical case studies. Another direction would be worth trying, i.e. choosing some appropriate historical topics and searching for appropriate theorizing through the discussion on the way of applying evolutionary viewpoint to them. In other words, we need a field where evolutionary theoreticians and historical researchers

meet in dealing with the same concrete historical processes.

Then, what does it mean to apply an evolutionary viewpoint to a historical process? If the 'evolutionary viewpoint' referred here should play a positive role in contemporary learning, in my view, it must be different from those 'stage theories' or 'system transformation theories' that have appeared several times and discredited themselves so far. In contrast to the wholistic concept of the evolution of 'society as a whole' or of 'economic systems', the methodology of evolutionary economics places the concept of evolution on the basis of the agglomeration of interactions of microscopic agents and of their reproduction in a field with concrete time-space dimensions. The problem to answer is whether such focus on micro-interactions eliminates the macroscopic concept of 'economic system' or opens a way to its reconstruction. This relates to the problem of the unit that evolves: Are they microscopic agents or 'economic systems'? We often talk on the 'transition' of 'economic systems', but in what meaning are we legitimate to do so? Should we confine ourselves to talk on microscopic evolution and its occasional patterns, or can we talk on the macroscopic evolution of 'economic systems'?

Fortunately, we have a very impressive historical phenomenon that is still going on since the mid of the 1980s. It is the dissolution of planned economy and the transition to market economy that covers

not only ex-communist countries in East and Middle Europe but also most influential Asian communist countries. Though socio-economic structures of these countries differ considerably, they shared the same vision of a socialist planned economy, whose prototype was established in the Soviet Russia in the late 1920s.¹ This vision corresponds with the political hegemony of one party that was organized under the cannon of Marxism-Lenism. The fact that over a dozen of nations entered the essentially same transition process simultaneously, supplies researchers ample materials for the comparative analysis. Really, the transitory process in those nations has shown an enormous diversity and evolutionary features that have differed each other. In most European nations in the former Soviet block, this process has brought an economic hardship whose depth hadn't been anticipated at the beginning of the process. As this is so, social scientists cannot miss the value of this costly historical experience.²

2. Transition from What to What?

After a troublesome and dissipated decade of the nineties, many researchers use the term 'transition' today with a reservation. To the Western economic advisors that persuaded East European politicians to

adopt the 'shock therapy', the *from what and to what* of the transition was self-evident. The system of planned economy must be eliminated completely and the system of free market economy was to be introduced. They considered the socialist planned economy as unnatural and thought that its destruction would liberate the movement towards the capitalist market economy like Western economies. It's not even a 'transition', since they didn't take the influence of initial condition on the process and result seriously; it was just a 'replacement' of the system.

However, as researchers of socialist economies used to be advised to discern the 'model' and the 'muddle' of central planning, real ways and structures were totally different from the ideal. They were diversified in each country. While East Germany, Czechoslovakia, and Soviet Russia had an impressively large industrial sector, the largest sector in Asian communist countries was that of agriculture. As Deng Zhihui admitted it, Chinese economy was in nature a developing economy despite its socialist sign. Even in the manufacturing sector, the vertical control in the original Soviet-Russian type planned economy was modified in China so as to fit its regionally separated administrative system.

In the case of Poland, E. Yoshino (1990) argued that a pre-modern "traditional East-European society" had been retained and institutionalized under the post-1945 socialist regime. From this viewpoint, it is this traditional society that is dissolving from the penetration of market powers that are now unfettered from the protection of

¹ This implies that the 'transition' problem from the planned economy has some relevancy to the capitalist economies that developed its control system under this model's influence.

² Aoki (1995) and Boyer (1993) stressed the significance of this transformation process by describing it as 'a substitute of experiment' or 'great experiment'.

socialist system. According to him, the ongoing process is the 'transition' from a pre-modern traditional to a modern individualistic society. K. Ohno (1996) proposed the term 'basic society' to describe the continuity and local creativity in the transition process. The so-called 'inertia' such as habits and value judgment that were inherited from the socialist era are elements of the 'basic society'. These are initial conditions that are not to be neglected in the analysis of the 'transition' process.

The initial conditions matter the problem of the destination of the 'transition', too. R. Medvedev (1998) denied the possibility of establishing capitalism in Russia on the grounds of ten points, five of which are related to the initial social-psychic conditions. Judging from his list of lacking factors for a Russian capitalism, we have to adopt a pessimistic view of the marketization of the Russian economy. The transplanted capitalist order in Russia will have to remain a 'Mafia-capitalism' or 'Jungle-capitalism'. His proposal is a social-democratic system, but he found no social group to push forward his ideal. He now gives his trust to Putin's effort to recover the authority of the government.

Kotz and Weir (1997) interpreted the demise of the Soviet system in Russia as the result of the seizure of power by the elite group that converted themselves to the supporter of capitalism. In order to occur such 'Revolution from Above', an extrication from socialist ideology and a penetration of liberal market ideology should have existed previously. Poznanski (1993) interpreted it

as an irreversible evolutionary development that proceeded before the political divide.

It is strange that most of Western advisors and Eastern reform politicians were willing to neglect the development before 1989/90 and tended to regard that a fully centralized planned economy existed at the dividing years around 1989/90. In Hungary reformist wing within the communist party had endeavored to introduce private sector in the planned economy; in Poland a newly developing private sector existed in addition to the non-collective agricultural sector. The reality of economic systems in both countries was a 'mixed economy' under the frame of the socialist control. The situation in China before the inauguration of the reform of state-owned firms was similar. However, the idea of 'mixed economy' was strictly rejected by reformers in the early 1990s. They condemned 'mixed economy' as the worst choice and advocated a 'jump' from a planned economy to a free market economy. But if they had been more realistic, they had to recognize that a period of the 'mixed economy' had been an inevitable step, wherever they wanted to guide their nations.³

Initial conditions were already results of the previous development. The transition process itself is diversified. Although one can apply the measure of 'freeness' of the economy under the cannon of IMF or OECD to the performance of each nation, it is still

³ See Sato (1997). I also remember that European Institutional economists (EAEPE) held their 1991 Viennese conference under the topic of "The Evolution of Mixed Economies: East and West".

difficult to say that these nations are converging in the formation of coherent system of the market economy.

3. Evolution: Micro Evolutions

The reflection in the former section suggests the superiority of an evolutionary perspective to the fixed conception of 'transition'. However, as I noticed in the first section, the wholistic concept of 'evolution' is not sustained without the basis in the interactions of microscopic agents.

One of the most favorite research fields of evolutionary economists is the dynamics of firms in the competitive market. In the simplest case, if profit-run private producers prevail over public owned producers, then we have a capitalist economy; if not, we have another order of economy ('socialist economy' or 'mixed economy'). This simplistic conception lay behind the privatization schemes of most European transition economies. However, this dichotomy is too rough to cover the diversified ownership structure of firms that have emerged in the transition period. While in China *Xiangzhen* firms owned by local government played a marvelous contribution in the growth of market economy, the voucher privatization in Czech has brought a superficial domination of 'investment funds' that have neither effective monitoring ability as well as financial resources to support the firms under their umbrella. In Russia, former managers and bureaucrats acquired the control of the privatized firms with the support of workers who gained assurance of the employment from them. In Czech and Russian cases the danger of the 'insider

control' is apparent.⁴

It was intended that the selection pressure on the privatized firms should be handed from the privatization agencies to the capital market as the stage of privatization proceeds.⁵ However, the ability of shareholders as well as the depth of the capital market was not sufficient to impose firms the discipline of efficiency. In Russian case, the privatization of firms stimulated the rent-seeking activity of managers and the opening of financial market liberated speculation that was accelerated by the inflow of short-term foreign money targeting the high yield of the Russian government bond. Under such conditions, the selection criterion in the market is totally different from that of normal capitalist market.

Though we must pay attentions to the transformation of ownership and control structure of the existing firms, the most impressive moving force of the market economy is the growth of newborn small and medium-sized businesses. Since most ex-state owned firms still suffer from the lack of profitability, the ability of growth and profitability of newborn businesses are highly valuable. Whether their growth is

⁴ For the understanding of the 'insider control', see Aoki (1995). K. Imai (2000) is an interesting reflection on the same problem in China.

⁵ The severest selection criterion in the privatization period was imposed by the East German *Treuhandanstalt*. This case, however, resulted in 'de-industrialization', because most firms responded it by a drastic reduction of capacity and employment even in fortunate cases of survival. (Kitamura 2000)

only a transitory phenomenon in the unstable conditions for large firms, or this contains genuine entrepreneurship that enhances the variety and efficiency of the production, will be crucial to the future of transition economies.

As some of evolutionary researches of competition and innovation (Nelson and Winter, 1983) suggest, the unit of the variation, selection, and its conservation (or reproduction) is not the firm but the routines (habits, knowledge, technology, and strategy) that firm holds as its asset. Firms can change their routines by learning (imitation and R&D) or by acquiring new resources. On the evolution of firm's behavior pattern in the transition economies, I confine myself to add two remarks here.

The first is the nature of competition, or of selection. In their analysis of the technological change, Kantarbayeva and Tsukatani (1999) introduced the 'Quastler selection' in addition to the 'Darwinian selection'. While the superiority of the technology determines the result in the latter, the initial position determines the outcome in the former. In such competition with a path dependent feature, the effort to acquire favorable position becomes dominant behavior pattern prior to the effort to enhance the efficiency or to invest in the R&D activity.

The second is that the routines of the firm have a close relationship with the skill and motivation of the work forces. Shareholders are not the sole source of the disciplinary pressure for a firm. The core work forces that develop their specific skills in the same firm have their interest in the

long-term viability of the firm. It is often maintained that the common interest of the managers and core work forces is the advantage of Japanese firms. Then, can't we find in the 'insider control', particularly of a kind in which the workforces are also involved, the seeds towards the effective 'stakeholder's control'? It is sure that as long as a 'soft budget' continues, the interest of workforce will not turn to the improvement of production and their skill. However, it is also true, that a pressure from outside itself will not break the vicious circle (low efficiency - low motivation - rent-seeking activity of managers) without a positive response from inside.

Microscopic evolution is also to be seen in the behavior pattern of individuals. In such a wide and deep change as occurring in the 'transition' period, one cannot oversee the widening gap among regions as well as generations.

The complete or partial elimination of the social control system over the inhabitant increased the mobility of the population considerably. The contrasting development of prospering metropolises and declining industrial regions pushes the people, particularly the youth to move into the metropolitan area. In China a large-scale (partly unofficial) inflow of rural population in the cities is undermining the traditional separation system of rural and urban populations. The temporary emigration to oversea countries and its return is also a factor that accelerates transformation of traditional societies. The change in the mobility of the population and its effect are surely multi-faceted phenomena. However, they are worth

studying.

A generation gap is conspicuous in every 'transition' economies. Since I have no statistical data, I confine myself to mention its revelation in the politics. Senior generations that had been accustomed to the secured life were generally the source of political dissatisfaction from which the ex-communist or revived communist parties acquire the support. However, since most of them are pensioners, they don't dare to overthrow the government that assures its payment by violent protest actions. On the other hands, among the youth disillusionment is prominent in the European 'transition' countries and Russia. In East Germany, the charge of the collaboration with *Stasi* discredited considerable part of politicians and intellectuals in the camp of civil movements. In Poland, Hungary, Czech, and Russia, the split and polarization within the camp of the 1989 Revolution cooled the enthusiasm for the reform politics. Together with the authority of the Western-led international organizations, several successful returned emigrants emerged as the self-claimed helmsman to the national wealth. Experiencing several political sways after 1989, the participation will of the youth in these nations seems to be exhausted at least in the years around 2000. Some of them are attracted by the success chance in the speculative market games, others seem to be secluded in a sort of 'me-ism'.⁶

Several economists revealed their

⁶ This rapid ebb of the political involvement in 'transition' nations seems to be one of the most fitted cases for A. O. Hirschman's reflection (1979).

anxiety of the deterioration of morals in 'transition' nations. As 'trust' is an essential condition to develop the division of labor and long-term market relations, this problem should not be overlooked.

4. Are there Integrating Factors?

The core problem is whether one can find in the 'transition' economies the working of the integrating factors that will contribute to the formation of coherent economic systems. However, as we can conclude from the overview above that the simplistic dichotomy between free market and planned economy (hierarchy: state or firm) is helpless and an intermediate area of the two poles is important for such factors.

Before the dividing years 1989/90, most East European economies had developed official and unofficial networks under the surface of the state control. The reformers of the early nineties intentionally neglected this interdependence of production units for the sake of forming the entity for the privatization. The drastic shrinkage of the Eastern market intensified the dissolution of the former networks. However, as Stark and Bruszt (1998) argue, the recombination of the units has proceeded soon among the privatized units.⁷ As Japanese firms operate in several kinds of groups, the formation of several patterns of associative networks was observed in Hungary and Czech. If we can assume that the Coasian 'transaction cost' in the unstable markets in 'transition' economies should be considerably high, the motive to form

⁷ See also B. Chavance and E. Magnin (1995).

binding relations between firms is easy to understand. The reorganization of ownership structure proceeds hand in hand with the consolidation of long-term relationship. Against the criticism of the informal monopoly to such associative networks, Stark and Bruszt (1998) prepared the concept of 'extended accountability'. The binding relations in the network should have 'accountability' to each actual (and potential) stakeholders of the firm. This is an embedded civic principle in the economic relations. It is a vain wish to wait for the prevalence of a universal trust in a plain market without the real extension of the self-binding relationship in several forms of associations.

However, it is the role of the state that provides private firms with preconditions of associations and their accountability. It includes not only the basic legislation of property and transaction laws and the foundation of legal procedure but also the institutionalization of the organization structure of corporations and the legal standard of transaction and of accounting. The state should not intervene the content of the private initiative, but it has lots to do in the field of the institutionalization of the economic activity.

The implementation of industrial policies is located also in the intermediate area between market and the hierarchy (government in this case). In the 'transition' period, the government must have a double face of the creator of the market and the judge of the market. The first job is not confined with the legislation and foundation of judicial infrastructure; it covers also the determination of the initial position of the

new market sector and the reorganization of the existing assets for that purpose. In Russian case, this job provided the *Nomenclature* in the communist era with the chance of usurpation of state property. In Chinese case, as a local government has virtually interpretative power in the implementation of the policy of the central government,⁸ it joins in the market game not only as a judge but also as a player with its own interest. As R. Feng (1999) describes, the conjoint behavior of local governments and private firms in their reigns lies behind most of the cycle (over-investment – over-production – consolidation of production sites) of Chinese manufacturing industry.

Lastly, what is the role of the vision in the integration of evolutionary developments? I started this paper by the assertion that we can form a group of 'transition economy' on the ground that all of them held the same vision of the centrally planned economy, whatsoever the reality differs. The destination of the 'transition' is generally assumed as a 'market economy'. However, it is not safe to regard that all the 'transition economies' have the same destination, at least in the vision. This depends on the precision of the 'market economy'. From the beginning, China has called its vision as 'a socialist market economy' and sometimes tended to adopt 'a new authoritarian regime' in politics. If we combine the economic system of 'market economy' with the political system of liberal

⁸ H. Zhao (1998) expressed the Chinese political system as "multilayered centralized regime".

democracy, we have to discern Chinese vision from that of East- and Middle-European nations.

Even in European transition economies and former Soviet Union countries, where former communist leaders has come back to the power, or retained its power, the monitoring of the international organizations is the only constraint to prevent the backlash against the liberalization program to which these nations avowed in accepting loans from them. The vision of the 'free market economy' is retained untouchable, though the social basis of the government differs from it.

The fact that the discrepancy between the vision and the reality has continued from the beginning to the present suggests that the 'vision' has not worked for integrating evolutionary tendencies but has performed an ideological function that concealed the diversity and deviation in the reality. One cannot deny the possibility that the diversified outcomes of the 'transition' might bring about diversified visions with some sort of political change. However, if a vision should perform an integrative effect in the 'transition', it should have both a resonance in the real economic development as well as the coherence that can provide the effective policy programs on the analysis of the reality.

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A Paper to be presented at the EvoEco Conference 27-March, 2002 in Kyoto

Title; **In search of an alternative vision on; Ten Years of Russian Transition; Survival between Market Bol'shevism" and "Russian Mafia" (Resume)**

Author; Sadayoshi Ohtsu (Kobe University)

1. A decade of transition in Russia - an overview of three stages of "development"
 - 1) 1992-1995 "shock without therapy"
 - 2) 1996-1998 "stability" and crash
 - 3) 1999-2001 "recovery" under Putin administration
2. Failure of Market Bol'shevism of Transition Policy- Marketization from Above
 - 1) Evidences of "failure", long and deep depression, impoverishment of the nation
 - 2) Reasons for failure, policy mistake, poor understanding of the initial conditions, enforcement of policy from outside
 - 3) The wayout for the population
3. Mafia and Criminal Economy, politically backed black power related
 - 1) Liberalization of control over economic activity
 - 2) Criminalization of the economy
 - 3) Squeezing out of the autonomous private business
4. The Structure of Survival in the Russian Transition Economy
Three actors of survival game
 - 1) Population at large (town dwellers, workers, peasants, students, pensioners etc.)
 - 2) Firms and enterprises (big industrial,
 - 3) government (central and local)
5. The development of Small business in Russia- an overview
 - 1) definitions and statistics of SB
 - 2) gainers and losers
 - 3) obstacles and barriers for development
6. Small size self-employment and black market business
 - 1) half illegal but legitimate work if the legislation become normal
 - 2) significance for human development
 - 3) evolutionary implications
7. Perspectives and Concluding Remarks

References & Tables

1. IPSSA, *"Small Business in Russia"*, Business thesaurus reference Publications, Moscow, 1998
2. IPSSA, *"Development of Entrepreneurship in Russia"* (in Russian), M.1999
3. Varese, F (2001), *The Russian Mafia: Private Protection in a New Market Economy*, Oxford: Oxford University Press
4. Lovell, S, Ledeneva, A and Rogachevskii, A (2000), *Bribery and Blat in Russia: Negotiating Reciprocity from the Middle Ages to the 1990s*, London: Macmillan Press LTD

**Why national trajectories of
post-socialist transformation differ ?**

Bernard Chavance

GERME, Université Paris 7
chavance@ccr.jussieu.fr

Paper presented to the Conference
“Evolution/Transition:
Evolutionary Perspectives on Transition Economies”
Kyoto University

March 27-30 2002

Draft!

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Introduction

The twelve years elapsed since the beginning of the post-socialist transformation have represented a unique historical experience of organisational, institutional and systemic change in numerous countries. This unfinished experience has been a challenge for various economic theories confronted to the task of interpreting and orienting an unprecedented and tremendous process of social and economic transformation.

1/03/02
12:03

This paper tries to assess the answers to the great challenge of post-socialism, by concentrating on the transition doctrine and on the institutionalist and evolutionary views. It also discusses some methodological questions raised by the problem of diversity in national paths of systemic change, as a major stylised fact of the first decade of transformation.

Transition doctrine and the convergence paradigm

Transition doctrine was a hodgepodge of various theories and ideas that had become influential worldwide in the 1970s and 1980s, with a strong antikeynesian and neoliberal bent. This included the monetarist view of inflation as the greatest evil possible, new classical rational expectations, some supply-side notions that demand is secondary, a hayekian confidence in the self-organization of the spontaneous order of the market. It also incorporated the Washington consensus of the time based on the « holy trinity » of stabilization-privatisation-liberalization. But the fundamentals of the doctrine were anchored in the neoclassical mainstream tradition, where individual rationality, the equilibrium paradigm and the market-centered efficiency and optimality approach reign supreme. Important features of this tradition are the use of static efficiency criteria, an implicitly normative world-view comparing imperfect historical situations to ideal equilibrium states, and a teleological deterministic conception of change, understood as a path-independent process. These were the true bases of the transition doctrine, which implied the following: a known systemic equilibrium end-point, the « market economy » would strictly determine the shortest (direct) way from the inefficient socialist economy; as the transition state would be inevitably unbalanced and prone to possible reversals, it should be as much shortened as possible. Speed was consequently essential. The strategy was unambiguous about the means: stabilization would abolish the perverse effects of inflation, privatisation would put the incentives right and liberalization would allow competition to operate the needed creative destruction. « Economics of transition » were consequently a kind of convergence theory, all the more so since the international financial organisations, influent actors in the process, naturally adopted an encompassing approach to the system shift of about 25 different countries. The strategy was clear, and – like earlier structural adjustment plans – it had to be essentially the same for all. In central Europe, this attitude was often matched by the strive for a return to historical « normality ».

The institutionalist and evolutionary reaction

12:03

1/03/02

Responding to the early hegemony of the transition doctrine, some authors or schools of thought criticized the finalist and big bang approach, stressing the importance of institutions and of the evolutionary character of economic change in general. While the neoliberal and neoclassical core of the transition doctrine was essential, the criticism camp has been interestingly quite pluralistic, including heterodox schools (e.g. institutionalist and post-keynesian economists, or economic sociologists) but also scholars referring to the Austrian tradition, to new institutional economics or to information economics.

A common feature of different critical attitudes has been the opposition to history oblivion and to the search for speed. Where the transition mainstream expressed its end-state polarisation and, in some cases, a *tabula rasa* view of post-socialist change as a companion to shock therapy and mass privatisation, institutionalist analysts stressed the legacies of the past, the dangers of revolutionary types of voluntaristic social upheavals, and generally championed gradualism in the realm of institutional change. It seemed that a new controversy between « teleologists » and « geneticists » was taking place, echoing the debate around 1930 in the Soviet Union. The role of re-emerging long-term historical trends was thus underlined (Berend, 1996), as well as the influence of the final period of former socialist systems (Kornai, 1990; Murrell, 1993; Poznanski, 1995) and of the various political « extrication paths » from the communist regime (Stark, 1992).

Some Austrian styled economists denounced the « constructivist » fallacy of the attempt to build capitalism in a symmetrical fashion compared to the former construction of socialism. Douglass North (1994) stated that it had been easy to change the formal constraints in most countries, but that enduring informal rules were more resilient, so that the real evolution would be different of expected outcomes.

A common theme in anti-finalist theories of change is the centrality of the *process* concept in spite of the *equilibrium* concept. Change is rather viewed as an unfolding process in historical time, where cumulative and circular causation is at work, where irreversible transformations occur, and where surprises and unexpected outcomes are plenty. Following these views, the term of « transformation » is often preferred to the conventional deterministic « transition », or the latter is simply understood in the very general sense of the systemic shift from socialism to capitalism.

The Chinese experience was very often considered in institutionalist theories of transformation as a strong challenge to the transition doctrine.

In China, a prolonged reform process based on a pragmatic attempt of the unreformed communist regime to accelerated economic modernisation had gradually evolved into a cumulative institutional and systemic process of change, that was accompanied by high and enduring growth, and also an exceptional increase in income per head. The whole Chinese story was questioning the basic tenets of the mainstream dogma: the unsustainability of any reform of the socialist economy, the perversity of gradual change, the futility of trying to jump over a chasm in several leaps, (later) the unescapable character of the «transitional recession» , etc. (Chavance, 2000b)

Twists and turns of real history

A great number of unexpected developments, or « transition surprises », have questioned the peremptory self-confidence of the initial transition doctrine. Prediction failures should not be judged a problem as such, when dealing with wide scale epochal changes ; nevertheless the positivist tradition in mainstream economics views accurate predictions – rather than realistic hypotheses – as a genuine test of scientificity. The most troubling surprise was the « transitional recession » or, to use a less euphemistic and more accurate formulation, the « post-socialist great depression », that touched all transforming countries. The expected « supply response » proved to be everywhere negative rather than positive, in the first years following stabilisation and liberalisation. A significant surprise was the industrial collapse of former East Germany, although it exceptionnally benefited of a wholesale institutional transfer and considerable and prolonged budgetary funding from the former West Germany. Difficulties and delays in privatisation were another worrying trend. Mass privatisation programs in the Czech republic and Russia were a success in terms of speed, but resulted in disturbing configurations in terms of distribution of ownership or corporate governance. A frequent trend observed in numerous countries was the extension of employee (or manager) ownership in the process of privatisation, a problematic result in the eyes of mainstream economics. Important financial and banking crises (Bulgaria, Czech Republic, Russia) occured. A striking diversity of macroeconomic and institutional change pathways became evident, with strongly different emerging national forms of post-socialist capitalisms. At a more aggregate level, the trajectories of central european economies on one hand and of Russia and Ukraine on the other were cumulatively diverging. The weakening of the state, the barterisation and the mafia-isation of significant parts of the latter economies, with an enormous increase of inequality and poverty, contrasted with the trend of recovered positive growth and relative state capacity of the former. Meanwhile China and Vietnam continued on their way of gradual cumulative (and opposed to

standard prescriptions) reforms under communist rule, and experienced lasting growth, external opening and increases in the average standard of living. (A comparison of these three stylised trajectories is given in the table in the annexed table). Some political surprises also occurred in the 1990s, like electoral victories of former communist parties transformed into socialist parties ; an ensuing surprise was also that they did not reverse the strategy of transition to capitalism and the economic policies followed until then, but on the contrary consolidated them.

At the beginning of the 2000s, a reasonable assessment of the transition doctrine could be the following. The case of central Europe and the Baltic states is controversial : in some respects it has vindicated the mainstream approach, in others it has refuted it. We have an example of such a controversy in the paradigmatic Polish experience (see e.g. Balcerowicz, 1995 ; Kolodko, 2000). In the case of Russia, it has been a grand failure – something even the IMF director Camdessus had reluctantly to admit. With China, transition doctrine has been faced with a rather aberrant experience according to its basic tenets, and that has actually contrasted positively in many economic dimensions with the rest of the post-socialist world.

The qualified transition doctrine

Faced with this variety of experiences and critiques, the initial doctrine was gradually qualified and transformed into a modified transition doctrine, in the second half of the 1990s, that partially incorporated some of the previous heterodox ideas about the role of the state and the significance of law, the importance of institutions, the actual diversity of national paths of change, the political and social legitimacy of systemic transformation, etc. A very harsh criticism of the «Washington consensus» applied to the transition was even made by the chief economist of the World Bank (Stiglitz, 2000). In some cases, the frontier between the mainstream approach and its institutionalist or evolutionary critics became thinner or even fuzzy. But most often the qualifications introduced remained limited, and sometimes even cosmetic.

In the EBRD *Transition Report 2000*, we read for instance that « one important lesson from the experience of the past decade has been that there is no unique process or «time-line» of transition from central planning under communism to a unique, easily identifiable, familiar form of market capitalism under democratic political institutions. (...) It seems a safe prediction that most of the EBRD's countries of operation will develop their own distinct brand of capitalism. » (EBRD, 2000, pp. 3-4). After this welcome clarification, the *Report* extensively discusses the evolution of EBRD's « transition indicators », where the advance of each country has

been measured since 1994 on a scale from 1 to 4+ in a few dimensions (private sector share of GDP, price liberalization, financial institutions reform...). National economies thus implicitly appear as more or less advanced or late on this unidirectional scale. How to reconcile the previous « lesson » with such a teleological and normative approach of deterministic convergence to an ideal equilibrium end-state remains unclear. This is a caricatured expression of the qualified transition doctrine, which only pays lip-service to alternative views. Any genuine comparative analysis of the process of change in different countries is thus prevented. Interdependencies between various institutional and organizational modes of transformation that result in emergent « distinct brands of capitalism » remain hidden. Moreover, the lack of a systemic approach is an obstacle to understanding how and why so-called virtue in one given dimension of change may be linked to perversity in another dimension. This approach seems even crudest than the old unilinear theory of « stages of economic development » (Rostow, 1960), that postulated a pre-determined single road for any national trajectory of modernisation, but nevertheless envisaged different qualitative successive phases in the process.

Some limits of evolutionary theories : discontinuity and futurity

The evolutionary approach should not be limited to classical effects of the past on the present, as it has to take account of two, related, decisive factors. The first is the importance of ruptures, discontinuities and radical novelty. The second is the role of futurity.

As noted above, institutionalist theories in economy generally stress the role of evolutionary change, the concept of *process* and the notion of cumulative causation. The importance they attach to historical sequences, to real continuities that lie beneath partial changes, the accent they put on the limited character of local transformations, have conferred to their criticism of the transition doctrine a genuine accuracy. However these theories have been mainly developed to analyse gradual and evolutionary changes: in this respect they face their own limits to understand wide systemic upheavals like the post-socialist transformation (or symmetrically, the initial formation of socialist systems). They often lack a concept of crisis, or a concept of revolution. Although they deal with mutations, with innovations, they do not generally consider large structural upheavals of big systems. Schumpeterian economics is more likely to discuss these revolutions, from a technological or organisational point of view. But what is needed is a notion of institutional and organisational revolution, as a part of an evolutionary theory of economic change (cf. Dockès, 1998).

It is correct to state that the weight of the past has been often underrated in the mainstream approach, as institutionalist analyses of *path-dependency* have rightly stressed. However it remains true that the role of anticipations, of *futurity* (to quote Commons) has frequently been decisive in actual transformation trajectories. The *path shaping* role of expectations (Hausner, Jessop, Nielsen, 1995), or the role of “anticipated institutions” (Federowicz, 2000), understandably stressed by Polish researchers, the creative individual and collective actions based on futurity, must not be underestimated in the experience of national paths of change, be they perverse, positive or even virtuous. While refusing the equilibrium end-state approach, we should acknowledge this role. Post-socialist systemic change implies that particular elements of the national economic system, their reciprocal relations and interdependencies, the totality of the system and its very nature, and even the environment of the system, are all transformed in a relatively short historical period. In such a (limited) time, individual and collective action is facing a new type of uncertainty, *systemic* uncertainty. Individuals and organisations often fall back on given routines and habits, on previously learned behavior or relations, but they also rely on anticipations of the emerging order, or of short-term opportunities. These very anticipations have creative, often unexpected, sometimes self-fulfilling consequences.

Another point about legacies is their ambivalence. Some act as constraints on accelerated change, others on the contrary facilitate transformation. Some have deleterious consequences, others produce beneficial outcomes. Any assessment of such complex and evolving role of the heritage of the past has to take into account the « historical specificity » of a national or regional path of transformation, and the role of contingent events rightly stressed by the *path-dependence* approach. This points to a methodological question about an encompassing theory of transformation. Different generalisations have been attempted in this direction, but they seem often problematic, as they can often be refuted by one or more national counter-examples. To draw « general lessons » of the transformation process so far, the challenge of diversity has to be faced, and inductive analysis of the variety of national experiences has to be done. If not, the risk is serious to wrongly generalise one specific or partial experience, or period, without dealing with historical specificity as a necessary component of general theorisation.

The transition doctrine, in its original or qualified form, has been fond of success stories, that were supposed to exemplify the beneficial consequences of such or such of its theses. But these stories were more often than not modified or reversed, producing surprising changes of assessments – but seldom convincing analyses of their causes. We first

observed the Polish exemplary shock therapy resulting in an unexpectedly slow privatisation and a surprising electoral comeback of reformed communists, we have witnessed the bold Russian liberal attempt praised by various authorities or specialists (Aslund, 1995 ; Layard, Parker, 1996) tragically give rise to a grand failure, we have seen the initial « Czech miracle » (good macro-economic performance, fast mass privatisation, low unemployment) reversed after 1997 in the very example of what ought not be done, ... Simultaneously, efforts were made to avoid any substantial comparison between the apparently paradoxical Chinese (and Vietnamese) experiences and the evolution of East Europe and the former Soviet Union, or to minimise their originality and predict their future inevitable « convergence » with Eastern Europe (Sachs, Woo, 1994 ; 2000).

Formal and informal rules in systemic change

The relation between formalisation and informalisation processes in systemic change appears as highly complex, at any rate more complex than most theories would acknowledge. The transition doctrine implied that clear (i.e. formal) rules following the standard model of the market economy, as well-delineated property rights, a proper corporate and trade legislation would suffice to put incentives right and give rise to appropriate behaviour of economic agents. But economic systems are based on highly complex and interdependent configurations of rules, at two levels: the institutional level and the organisational level, respectively above and within organisations (Chavance, 2001). Systemic transformation creates differential reconfiguration of various levels of rules, with different temporalities of change and numerous frictions for individuals and organisations. The change of formal rules, especially constitutive rules, is of great importance, but does not represent the totality of the transformation process. Its effects depend on two accompanying changes: in the quality of the enforcement of formal rules, and in informal rules.

Douglass North (1994, 1997) has criticized the standard approach as relying exclusively on the change of formal institutions, thus forgetting the strong inertia of informal institutions and the role of enforcement characteristics. The qualified transition doctrine partially conceded that this had been a mistake, admitting the importance of cultural legacies, and even insisting (quite late) on the « rule of law » (Sachs, Pistor, 1997). North's view of the different temporality of change in the formal and the informal constraints, which is in tune with a traditional institutionalist argument stressing the hysteresis of habits or routines, is however one-sided and captures only one aspect of the problem. Gradual change or discontinuous innovation in informal rules often takes place within stable or rigid formal rules. In the case of radical systemic transformation (or

crises, or wars) the change in informal rules, either institutional or organisational rules, may in given instances be relatively fast, even sometimes faster than the change in formal rules.

A variety of changing configurations of rules at different levels or for different actors, and of accompanying learning processes, has emerged in the transformation process, contributing to the diversity of aggregate (national) paths of change. At one extreme we can observe new formal rules that have been accompanied by a strong enforcement process and new complementary informal rules, giving rise to a rather coherent configuration. At another extreme we find new formal rules that have remained cosmetic as a consequence of weak or absent enforcement and of the development of contradictory informal rules: an incoherent configuration has emerged. Between these extreme cases, a great diversity of evolving figures of rules prevails, with many divergent configurations characterised by weak enforcement and relatively autonomous informal rules. In different cases, informal rules were sometimes inherited from the past, but often they were newly formed.

In summary, leaving aside the question of complementarity of formal rules in wider configurations, and considering only the relation between formal rules on one hand, and accompanying informal rules as well as enforcement of formal rules on the other, different figures have emerged:

Configuration	Formal rules	Informal rules	Enforcement of formal rules
Coherent	A	Complementary	Strong
Divergent	B	Autonomous	Attenuated
Incoherent	C	Conflictual	Weak

Examples of these different types can be just mentioned. A coherent configuration is approximately the case of corporate law in central Europe. Divergent configurations emerged with the Czech voucher funds, with Hungarian “recombinant networks” (Stark), or with the extension of barter in Russia and Ukraine. Incoherent configurations were observed in the development of tax evasion or inter-entrepreneur arrears in various countries, or in the case of corporate law in Russia during and after privatisation, or obviously in instances of criminalisation of economic activities.

Convergence or extended diversity?

Highly contradictory but entangled forces have been at work in the process of systemic transformation (Chavance, Magnin, 2000). Some of these forces were promoting institutional and macro-economic convergence

between different countries, e.g. the common socialist systemic heritage, the initial consensus to follow well-tried organisational and institutional solutions and to avoid any experimentation in this field, the following multidimensional imitation of advanced western economies, the impulse to join the European union (for part of these countries), trade integration with the West (especially EU), the influence of international organisations and of their “conditionality”, the powerful globalisation trends (extension of financial markets and of their efficiency criteria, foreign direct investment by large multinational corporations, influence of western consulting firms)... Other forces were furthering difference or divergence, e.g. diversity in initial conditions resulting from the history of socialist economies, variety of institutional external influence (US, German, British, French, Russian,...) in different fields, variations in the social and political scene (political forces and evolutions), diverging strategies and policies followed by successive governments in different societies, and principally idiosyncratic institutional bricolage, spontaneous adaptation and transformation of imitated institutions according to nationally specific societal contexts (*Id.*).

The overall consequences of these contradictory forces have been mixed, but it is safe to say that diversity has prevailed, as observed earlier. It is for instance a stylised fact of the first decade of transformation that from a macroeconomic point of view « economic divergence and increasing disparities in per capita income » have prevailed in the group of transforming countries as a whole; on the other hand some convergence has taken place within three subgroups: central Europe and the Baltic states, south-east Europe, and the CIS countries. While the overall trend for transition economies has been a growing divergence from the average GDP per capita of European union, the central European group has been an exception with a small convergence in the years 1991-2000 (ECE, 2000, p. 181). Turning to structural change in the last decade it can be observed that large scale de-agrarianisation, de-industrialisation and tertiarisation have dominated everywhere, but there is a considerable diversity in the national patterns of industrial restructuring and of trade trends with the EU (Hungary, the Czech Republic and Slovenia have increased their specialization advantages in R&D -, skill - and capital - intensive areas; Bulgaria and Romania have kept the specialization profile typical of less developed countries; Poland occupies an intermediate position) (Landesmann, 2000). Finally, emerging national capitalisms, or “institutional matrixes” (to quote North), have strongly differed and sometimes even contrasted, in the post-socialist world. Financial markets have gradually developed in Poland and Hungary, while they collapsed in the Czech republic (McDermott, 2000) and Russia. Different “ownership trajectories” have formed (Vincensini, 2002), etc.

National emerging capitalisms in an era of europeanisation and globalisation

These country differences have been strongly influenced by national features of the process of organisational, institutional and systemic change. The basis of variety in the national trajectories of post-socialist transformation lies in the enduring *national* character of the state, of the polity with its underlying social relations and compromises, and of the legislation (formal institutional rules). Legitimacy remains principally formed and sustained – or questioned – on the national level. Even though the 1990s have been a decade of intensive « globalisation », and the role of external forces has been great indeed on the new emerging capitalisms of the region, the development of the latter has retained a fundamentally national basis. For many countries of central Europe or former Soviet union, the end of socialism has also meant the recovery of national sovereignty. Post-socialist economies thus bring their contribution (Magnin, 1999) to the renewed national variety of capitalist systems, which is paradoxically conspicuous on a world scale (Boyer, 2001).

Absence of convergence in EU

Even though the process of European construction has significantly and growingly influenced polities and economies in the existing member states, it is striking to observe how the evolving national types of capitalism have endured. The constraints of european legislation notwithstanding, it would be a great exaggeration to speak of institutional and organisational, let alone systemic, convergence as a dominant trend between the European member states economies. The reason is that national configurations of institutions and organisations, shaped by history (including history of pre-Union interactions between various national capitalisms), are incrementally adapted to the europeanisation process principally by the mediation of national-based and legitimised polities, that will remain so as long as they are not predominantly superseded by a new supranational polity. The historical link that was formed between capitalism as an economic system and nation-states is assuredly changing in the last decades, but it is not likely to be severed soon (Boyer, 1997).

European tropism : should similarity grow ?

The explicit objective of integrating the European Union, notably accompanied by the implementation of the enormous (and evolving) body of *acquis communautaire* represents a genuine force of institutional convergence in the pre-accession period for candidate countries. This is a

form of conditionality pushing in a similar direction of systemic change. Nevertheless the very process of enlargement is also a source of diversity. Rule-absorption is differentiated and gives rise to various hybridisation processes, or discrepancy between formal and informal rules. Behind the general consensus about integration, there is no clear agreement among member states of the UE about the way and consequences of this process. Even though a majority or a strong minority support the principle of enlargement, public opinion and political elites are divided on the subject among candidate countries – as among existing member states. The enlargement is bound to change the EU itself. And the diversity of national economies within it will be extended, not reduced (a positive development, probably). Europeanisation, along with other forces, as notably globalisation, has conditioned and redefined the differences between European capitalisms, including the latecomers, it has not abolished them, and will not abolish them in the near future.

Organisational and institutional variety

National paths of change and national forms of emerging capitalism are manifest at two related but distinct levels: the institutional and the organisational levels. Different countries thus exhibit different structures of capital ownership, diverse relations between industry and the financial system, and different forms of corporate governance, but they also show different types and populations of enterprises, different styles of business or financial groups.

Recent developments in institutional and evolutionary economics have stressed the role of institutional complementarity in general (David, 1997 ; Amable, 2000 ; Aoki, 2001) or of systemic coherence in great systems (Kornai, 1992). It should be added that the strong evolving complementarity of organisational configurations in the national sphere is a related and complementary cause of path-dependent diversity in emerging capitalist economies in the post-socialist world. Such complementarities are the origin of the irreducible variety of capitalist economies in the modern period, and they remain principally (although not exclusively) based on interdependencies formed at the national level. In a given historical period, there is no « one best way » or unique organisation or institution that can prevail or be independently « selected » by competitive forces, or imposed by hegemonic powers, due to interdependencies and complementarities that have emerged and evolved historically in various countries.

The notion of organisational complementarities can be compared to the concept of organisational isomorphism developed by institutional

sociologists to analyse intrasocietal similarities and intersocietal variation in organisations (e.g. business networks), when dealing with Asian types of capitalism. « Organisations in a common institutional environment begin to look like each other as they respond to similar regulatory and normative pressures, or as they copy structures adopted by successful organisations under conditions of uncertainty. » (Orrù, Biggart, Hamilton, 1997, p. 153)

National specificities observed in the evolution of organisations as firms, business groups, banks, investment funds, farms, generally validate path-dependent approaches. North's (1990) insight about the interaction between organisations and institutions, the former taking advantage of the opportunities resulting from the latter, and also trying to alter them with time, rightly stresses the co-evolution process between them. The notion of institutional complementarity or interrelatedness should be extended to organisational complementarities and, beyond, to complementarity between organisations and institutions.

Final remark

Diversity in national trajectories of post-socialist transformation has represented a major stylised fact of more than a decade of change. Diversity is a central question, but also a challenge (Delorme, 1994), for institutionalist and evolutionary theories trying to eschew the « barren universality » of the (fading) mainstream tradition and to face *theoretically* the problem of « historical specificity » in economics (Hodgson, 1991).

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Stylised trajectories in the first decade of post-socialist transformation : a comparison

		Euro-centered social-liberalism (Central Europe)	Depressive state crisis (former Soviet Union)	High growth gradualism (Asia : China, Vietnam)
<i>Politics and the state</i>	Mode of disaggregation of the institutional base (exit from socialism)	Sudden break (destruction of the political pillar)	Sudden break (destruction of the political pillar)	Gradual change (erosion of the ownership pillar, ideological accommodation)
	Political evolution	Democratic consolidation, alternating coalitions	Sham democracy	Authoritarianism (monoparty) with elements of informal pluralization
	Legitimacy of the State	Rather strong	Weak	Rather strong
	Administrative and tax capacity of the State	Rather strong	Weak	Rather strong
	Corruption, criminality	Extension, but limited	High	Significant
	Regional differentiation	Limited (small countries)	Very high, tendency to fragmentation	High but no fragmentation
	Institutional change (new formal rules, legislation)	Wide-scale and fast change : rules rather hard but unstable	Wide-scale and fast ; soft rules, very unstable	Wide-scale but gradual ; semi-hard rules but limited formalism
<i>Institutional and organizational change</i>	Privatization of the economy (privatization of states assets ; extension of new private enterprises)	Rather fast, legitimate enough	Fast, very low legitimacy	Gradual, no « large scale privatisation » of state assets
	Emerging ownership forms	Multiplies forms : insiders ownership, investment funds, banks, State. Frequent cross-ownership, fuzzy property rights	Insider ownership, financial-industrial groups	Large expansion of « non-state » but not strictly private forms, fuzzy border between private and public ownership
	Organizational change	Strong expansion of private SMEs (often micro-enterprises), restructuring of former SOEs	Limited expansion of private SMEs, slow restructuring of former SOEs	Strong expansion of « non-state » SMEs, slow restructuring of former SOEs
	Networks	Reshaped and transformed in the new environment	Resilient, expanded role as a coordination mechanism	Reshaped but significant role in emerging capitalist forms

<i>Macroeconomic trends</i>	Growth	Initial depression of about 3 years followed by resumption of fragile but lasting growth	Prolonged depression (cumulative reduction of GDP of about one half)	High and lasting growth
	Unemployment	Fast initial increase, stabilization near « European » levels	Low registered unemployment (but actual level higher : 10-15%), growing	High actual level
	Inflation	High initial surge in prices, followed by decrease of inflation rates, but still relative high levels	Prolonged mega-inflation followed by decrease to unstable levels. High proportion of economic barter	Middle-range inflationist tendencies
	Opening to the international economy	Fast reorientation of trade to the West (mainly EU). Significant FDI in manufacturing, but concentrated in advanced countries	Foreign trade strongly affected by depression. Low level of FDI, concentrated in energy sector	Gradual but intensive opening, strong expansion of foreign trade. High level of FDI in manufacturing
<i>Social tendencies</i>	Inequality, poverty	Big increase of inequality and poverty in the early transformation, followed by relative decline	Explosion in inequality, high level of poverty	Increase of inequality, reduction of absolute poverty
	Demography	Decline in fertility, increase in morbidity (also deterioration of HDI index in most cases)	Decline in fertility, increase in morbidity, sharp increase in mortality, decline of life expectancy (deterioration of HDI index)	(Increase of HDI index)
	Social protection for wage-earners	Socialised (externalised from enterprises). Significant level of protection, decreasing	Still partially internalised in large enterprises. Low level of protection	Internalised in large enterprises, gradual externalization. Low level of protection
	Relation between political and economic elites	Differentiation	Strong overlapping	Overlapping, partial differentiation

SMEs : small and medium enterprises

SOEs : state-owned enterprises

FDI : foreign direct investment

HDI : human development index

Source : Chavance (2000a)

An Approach to the Typology (theory) of Transition Economy *

Hiroshi Tanaka**

February 2002

Introduction

More than one decade has passed since the system transition in the former socialist countries. Some countries of these have completed the economic transition period, tracing the economic trajectory from recession to recovery, and then entering sustainable economic growth. On the other hand, other countries have not been able to recover their 1989-90 level of production and economic activity, facing the difficulty of market transition. How can we understand the typology of the transition economies?

The central theme of recent studies on transition is gradually shifting from the points at issue in the early stage of transition (transition goals, and degree of completion, privatization, speed of transition, sequence of transition measures and so on) to the problem of why divergence and diversification have occurred in the development of the transition economies, and what the main factors that hinder sustainable economic development are. It is natural in these circumstances that the above-mentioned academic trend, with arguments concerning types of transition economies, should develop.

However, creating and developing a typology theory of transition and discussing the types does not belong to the same dimension of thinking as

* This paper has been prepared for Evolution and Transition: Evolutionary Perspectives on Transition Economies, March 27-30, 2002, Kyoto University and Kansai University. The original paper (Japanese version) was presented in the main session of the annual meeting of the Japan Association for Comparative Economic Studies (May 2001, Slavic Research Center, Hokkaido University, Sapporo).

** Hiroshi Tanaka, Professor of Comparative Economic Studies, College of Economics, Ritsumeikan University, 1-1-1 Noji-Higashi, Ohtsu, Shiga, JAPAN 525-8577
Phone: +88-77-561-4849, Fax: +88-77-561-3947, E-mail: hirotana@ec.ritsumeai.ac.jp

examining the divergences and diversifications of the development of the transition economies, and comparing various countries with one another.

While the former should be based on the study of the latter, a still higher level of abstraction and thinking would be needed in the process of analysis.¹⁾ The former needs to change and develop the framework of the transition theory in order to grasp the realities and conceptualize the divergences and diversifications.

The purpose of this paper is not to throw light on the characteristic features of the transition economies in quantitative terms, nor to establish a general typology theory, either. This paper is intended as a tentative investigation of an approach to one typology theory of transition, along with a review of some typology-oriented studies.

For the present, to approach this problem, it is worth examining how these studies explain the diversities and diversifications of transition economies, which ought to indicate the typological characteristics. The first chapter introduces a simple analytical framework for the purpose of understanding how we should observe the transition as a whole. Chapter 2 is assigned to examining those theories which attribute the diversities and diversifications of transition to the inheritances from pre-transition period. Chapter 3 is devoted to closely investigating those theories that look for the principal factors in the transition process itself. Then, the final chapter summarizes the important points at issue that may be theoretically connected with typology theory.

By the way, what has to be noted before entering the discussion on the main subject is the following: the studies examined below do not necessarily expose the differences and diversifications from a single viewpoint, a single explanatory angle, or moment. However, there is a considerable validity to interpreting and examining a spectrum of them to some degree in order to arrive at a clear and distinct sketch of the points at issue.

1. From what viewpoint should transition economies be observed?

Argument has focused on the question: from what to what do transition economies move? Our observation and evaluation of various phenomena in the transition period depends on how we understand each "what". Hereinafter, we would like to set out the following abstracted transition analytical

framework in order to examine this understanding.

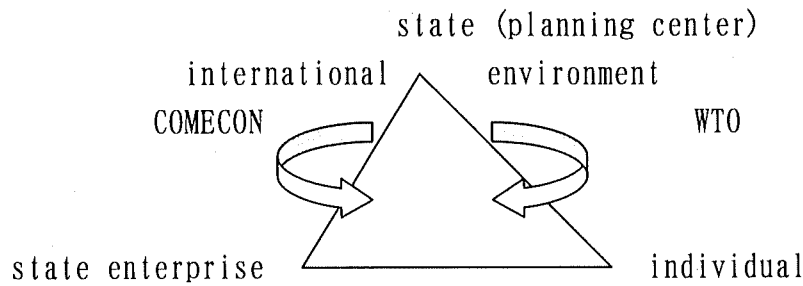


Figure 1 economic system model under the former system

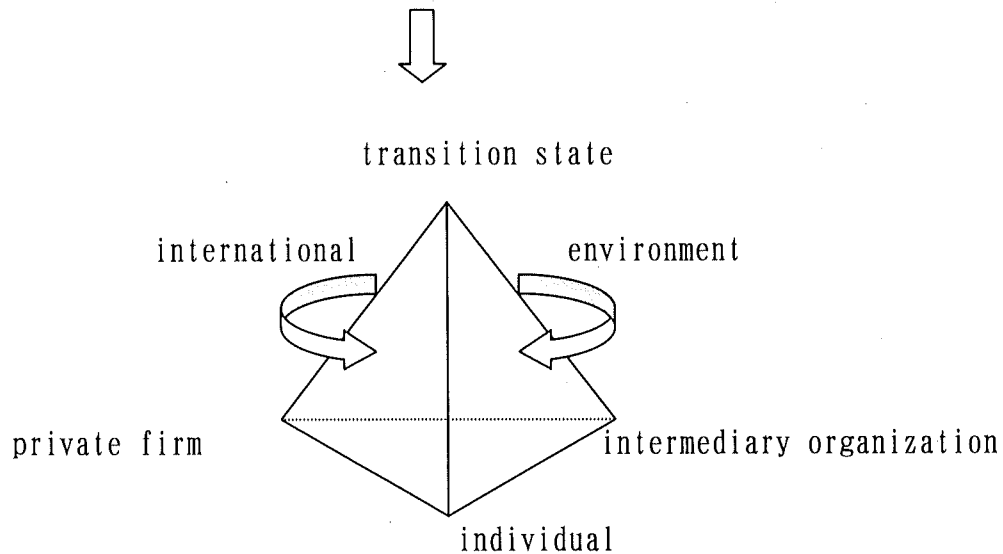


Figure 2 abstracted transition economic model

Figures 1 and 2 present the following analytical framework:

Under the state socialist system in Eastern Europe, three economic agents (planning center i.e. state, state enterprise, individual) repeat negotiations and adjustments, which can reproduce the whole relationship among the three, within a planned space (the triangular space which links state, state enterprise and individual) built on the systematic basis of the nationalized means of production and the one-party communist system, which is itself enclosed in an international autarkic environment (the USSR-led COMECON / WTO system and the closed economy).

In the transition economy, central planning institutions are abolished and substituted by the transition state, which proceeds to open the economy and engage in a regional integration in the international environment. State enterprise is on the way to being privatized. And the new private

enterprise is emerging as well.

The abolition of the old state system and the privatization of state enterprise promote the appearance and formation of intermediary organizations and regions as a new main constituent of the system. Regional and intermediary organizations undoubtedly existed in the former system, but with a derogated role. In the development of transition, they are given an aggressive and important role as the arena of reproducing of state, industrial and individual relations. The role as a bearer and agent of history, tradition, society and environment has been added. In market transition, these four main actors are transformed or newly formed, repeating reproduction and adjustment, while some of them developing their own roles and functions, and others are declining. 2)

2. Diversification of transition economies: inheritance-cause theory

The first study to be examined in this chapter is the joint paper of Bradshaw and Stenning (Bradshaw and Stenning (2000)). This paper shifts the main focus to searching for the relation between transition policy and system transformation.

It surveys the degrees of transition by using the report of the World Bank, the EBRD report and the degree of completion of the Copenhagen criteria imposed by the EU (Agenda 2000), analyzing them from the viewpoint of the choice of the system transition policies and their implementation (speed, sequence problems, liberalization of prices, privatization and corporate governance).

This analysis draws the conclusion that the initial conditions can explain the diversities of transition economies, but the choice and the implementation of the policies can not explain whether system transition in the post-socialist countries succeeds or not.

Patterns of reform and improvement are quite different, depending on the region, where various elements, such as the historical, economic and political structures, the geographical-cultural approximation to the West, political stabilization, the social and regional context of the reform, the degree of intervention and participation of the West in the transition of a specific country, the timing and technical means of implementing the reform policy, have played different roles in each of transition economies.

In a word, national character and local context have played an inevitable role in the building of new systems. The above-mentioned thesis can be called the history and geography theory, because the building of new systems is supposed to depend on nationality and local character. If we can attempt to put this conclusion in terms of the previously discussed analytical framework (cf. figs 1,2), we could understand the connections between the intermediary organization (region) and the international environment become factors diversifying the type under the initial conditions.

A similar conclusion can also be seen in the study of Roland (Roland (2000)).

Clearly, his book distinguishes between the transition theory based on the Washington consensus and the evolutionary transition theory. His argument emphasizes the important role of geopolitical elements, which had been ignored in the early stage of transition.

He confirms that the Washington consensus on the political economy of the reform and the strategy itself has been proven to be effective in the transition of Eastern Europe, while in the case of Russia, it has proved insufficient. On the contrary, the success of China justifies the evolutionary system transition theory.

One should not forget to point out that the political restraint on transition reform was looser in Eastern Europe than in Russia. Why? Eastern Europe, which was compelled to be a satellite bloc of the USSR, desired to enter the Western international community directly. Eastern Europe looked for an anchor in the EU. On the other hand, Russia could not be compensated for the loss of its empire with other economic benefits.

This argument allows us to accept that such geopolitical differences have led to the differences in transition.

In short, the factors of the diversification of transition come from the geopolitical international environment with its economical benefits, which can be called the geopolitical benefits theory.

It is Maria Lavigne who emphasizes the characteristics of development and modernization (Lavigne (1999)). While similarly recognizing geographical differences, she sees the transition not merely as a transition from plan to market, but also as one from a distorted, low level of development pattern to a development pattern within the European average standard. If

transition economies achieve the functioning market economy that is one of the conditions of joining to the EU, that means the end of transition. We can see the international development theory in the core of her argument. It is at any rate unclear whether or not her viewpoint can extend to recognition of the types or specificity of development.

We next turn to the Russian road to the capitalism by Kosals (Косалс (2000)), where there is, clearly, typological recognition of the transition theory.

He sees Russia as a different type from both Eastern Europe and China. According to him, the unsatisfactory results of the Russian reform and the financial crisis in August made the failure of liberal reform clear. Both the liberals and the opposition groups have argued for the necessity of the choice of a Russian-type road, or the choice of the third road. Russia has already chosen her own unique road, i.e. the road to clan capitalism.

In other words, Russia had been thought of as a country putting the typical model of transition economic policies into practice in the beginning of 1990's. However, thereafter, the abrupt and unprecedented collapse of the Russian economy brought about a compromise solution between the extreme variants of transition economic policies, giving birth to a hybrid system composed of mixture of institutions based on the concepts of the IMF and those maintained by the power of inertia from the time of the USSR.

Reform and liberalization have been minimized and the spontaneous market formation from the bottom has been restrained from the top since 1992-93. The characteristics of the hybrid systems are as follows; social stability in Russia has been destroyed, though not totally, as in Yugoslavia during the civil war. What is worse, system innovations such as the rule of economical responsibility and the protection of free competition have not been generated, either.

What is the real cause of the rise of such clan capitalism? Kosals stresses the inertia from the Soviet period, along with the flaws of the liberal reforms and lack of preparedness for them. Especially, he ascribes the fact that Russia could not choose any alternative other than the road to clan capitalism to the political, economic and social environment (the historic specificity) in the original take-off conditions of transition, basing his viewpoint on the role of the state (intervention in the market

infrastructure construction and economic life). 3)

The special characteristic of the argument by Kosals, clearly, lies in that the geographical term expresses the specificity of Russia and that the historic specificity of Russia transposes to the theoretical principle of the state in transition. From the viewpoint of the analytical framework, Kosals seems to be located in a Soviet historical specific state theoretical position.

It is not only Russia researchers who have paid attention to this kind of historical inheritance. Jakóbik (Jakóbik (2000)), in Poland, maintains that it is the political culture that has given birth to differences in the Eastern European countries. His concept of political culture is to be understood in a somewhat broader sense than the state, questioning whether the Eastern European countries have shared a political culture with western Europe in some historical period or not.

In other words, he recognizes that there could have been no suitable basis for the development of economic freedom in the absence of any tradition of maintaining a parliamentary democratic regime in the Eastern European countries. He could be called a political culture-cause theorist. His state-cause theory is different from Kosals in a wider sense, in that it goes back to the historical period before state socialism.

The above-mentioned writers still leave the points at issue related to the individual and the enterprise (for example, business ethics, entrepreneurial spirit, nationality and so on) un-touched.

3. Diversifications of transition economies; "transition process-cause" theory

This chapter brings us to those theories that attribute the diversities and divergences of transition to the transition process itself. The term "process" here does not mean the continuation of a state of affairs, but refers rather more to the actions executed and the conditions prevailing in the midst of transition.

Bunce deserves to be examined first, because he (Bunce (1999)) clearly problematized the thinking of transition typology. According to Bunce, it had been expected that the historical past of socialism and the homogeneity of the international standards for the emerging regimes might

make the conversion into the post-socialist economies trace similar courses. The actual reality was an intra-regional contrast in post-socialist politics and economies, leading to the emergence of the following three types of post-socialist course:

- (1) coexistence and harmonizing of capitalism and democracy, political stability and sustainable economic growth (e.g. Poland)
- (2) political authoritarianism coexisting with a partly socialist economy, relative political stability and economic growth. It is exceptional (e.g. Uzbekistan)
- (3) a medial course between (1) and (2): Something in-between democracy and dictatorship, mixed of capitalism and socialism, political instability, and poor economic performance (e.g. Russia)

What, then, could explain this divergence?

The policy problem hypothesis that the socialistic past has broadly created the subsequent political and economic regime, and the hypothesis that there is a correlation between economic reform and economic performances do not seem to fit. Bunce rather concentrates on the correlation between political democratization and economic reform, realizing the discontinuity and inconsistency between the style and form of the national resistance under the *ancien regime*, and the new political-economic regime. More concretely, he thinks it decisively more important how the first free general election after the system transformation was fought, and what result the general election brought about. He could be called a "discontinuity of the state" theorist.

However, it does not constitute the final conclusion. He keeps arguing as follows: Supposing that it is the democratization and the revolution that fix the pattern of transition, we should notice that history shows that they have taken various forms. This means that the argument partly turns the issue back to the starting point. Bunce leaves the future to answer the following questions: do the diversities shown by the twenty-odd countries indicate different points on the same trajectory or different types of transition trajectory? This, as well, seems to return to the starting point of the problem we posed in this paper.

It is the Polish economist, Kolodko, who, likewise, divides post-socialist economies into four groups from the viewpoint of catching up with the EU in the future. His paper extends the estimated economic

growth rate trend of 2003-2004 into the future, forecasting long-term economic growth to 2050.

It shows that out of 27 countries there will emerge the forefront runners, whose growth rate will be 7.5 %, exceeding the EU average by 3 times. The next group is winning countries, whose growth rate will be twice as high as the EU countries. The third group is consistent achiever (about 3% growth rates) and the sluggish countries with a growth rate lower than the former group come last. However, this is not a typological analysis.

What he is conscious of as the differences in the transition trajectory are merely one-dimensional, monotonous differences such as the difference of the depth of recession and the consistency of economic growth. How does Kolodko interpret the cause of these differences? The focus of his argument shifts to the problem of the speed of transition policy, pointing out that the economic policy lacking a system-construction problematic played a decisive role. This could be called state transition policy error theory.

Kornai (Kornai (2000)), likewise, pays attention to the economic policy concerning system construction. He reviewed his own book (the English version), published just after the beginning of the transformation. His paper intends to bring only two issues into focus: (1) the reform of ownership and the development of the private sector and (2) macro-economic stabilization.

Macro-economic stabilization could not be achieved by only one action. Macro-economic stabilization policy did not give sufficient consideration to the fact that sustainable economic growth could not be achieved without the continuation of system reforms. In other words, this means that the controversy of radicalism (shock therapy) vs. gradualism was the posing of a wrong problem.

More interestingly, the point we should pay attention to here concerns the former issue. He rejected, in the initial period of transition, the opinion that transformation should be viewed as a transition to market socialism. In this sense, there was no difference between western economists and Kornai in the proposal that the transformation should be a transition to the economic system where private ownership ought to be predominant. The difference between the each side lay in their understanding of the course of transition.

Kornai opposed the two unequivocal strategies.

One is strategy A, which could be called the organic development strategy. It contains: (1) creation of the conditions appropriate for developing a private sector from below, a great deal of new entries into the market, the removal of legal barriers to free entry, guarantees of private ownership, the establishment of taxation and credit policies, and affirmative action for the reinforcement of private ownership, (2) privatization of the state-run enterprises by sale, and giving importance to property sale to outsider, (3) promotion of the formation of dominant individual ownership, and avoidance of dispersed ownership structures, (4) tightening of the budget constraints of firms.

On the other hand, strategy B, which we will call the accelerated privatization strategy, has the following character: (1) Suspension of state ownership as rapidly as possible, (2) The free distribution of state assets, and promotion of privatization by management buy-out, etc., (3) The approval of dispersed ownership structures, and the realization of people's capitalism.

It goes without saying that the reality was that elements of both of these strategies were interwoven with one another in any transition economy. The point was which would become dominant. The result shows strategy A to be excellent in performance while the strategy B is recessive. Hungary and Poland adopted strategy A, while the Czech Republic and Russia adopted strategy B.

The framework of this analysis is different from the viewpoint in which Central and Eastern European countries could be analyzed as an undifferentiated group. The difference of the economic doctrine adopted produces differences in the transition path. Kornai could be called transition strategy theorist, which would place him near the transition state theory. But, on the other hand, he could be interpreted as an industrial transition firm theorist. This is because the type of transition depends chiefly on the differences in the state of the business and firm in the transition period.

Brezinski and Fritsch (Brezinski and Fritsch (1996)) have developed, in a sense, the organic development strategy (strategy A) of Kornai from the viewpoint of the evolutionary theory approach. Laying down a definition of economy as firm population, there could be only two choices facing

the post-socialist economy: the top-down and the bottom-up.

The bottom-up means the following strategy ; In developing small new businesses lies the central task of the state, institutions and the international authorities in transition economy. This concept derives from the expectation that the new small and medium- sized enterprises could solve economic, social and political problems more efficiently in the transition period. By contrast, the top-down type of privatization encountered more difficulty than expected in the early stages and financial support by the state to the older industrial sector has proven ineffective. This reality demonstrates that bottom-up transformation is a long-range process in transition economies. And it has not still developed so far as to activate the whole economy. However, it happens that converse is true. Transition is never able to give birth to satisfactory performance without any support from the state. The extension of small and medium-sized enterprise has been required to extend from the area of services and the commerce to the industrial sector as well. This sketch of the argument reminds us of the debate (typology theory) on two types of road to capitalism in Japan, a road to capitalism from the top or a road to capitalism from the bottom (Hara (2000)). 4)

Brunner (Brunner (2001)) proved that the bottom-up strategy is connected with the multinational corporations. It is possible to interpret the transition propelled by multinationals as not from the bottom , but from the side , i.e. cross-boarder. We could call it from the side strategy. And this is clearly enterprise theory.

There are other types of mutation of this enterprise theory. They are the lack of investment theory (Dyker (2000))), the corporate governance theory and the inter-firm network theory. Here let us introduce this last, interesting theory. Stark positively argues that the capitalism built by the inter-firm network found by him in Hungary and other countries, is quite unique and different from the European-type model. The point is that the system transformation makes development of the economic environment uncertain and incalculable, which moulds the dispersing property structure and network ownership in such a way to avoid serious risks and damage. The recombination of ownerships takes the form of a network. This type of capitalism could be accounted for as a possible typical model of Eastern European-type capitalism. This is critically

evaluated in Hungary (Tanaka (1999)). In contrast, Stark re-criticizes it. He points out the elasticity and non-fixity of the network as well as the turbulence of its forms. We can find here that the typical pattern of enterprise provides a logical explanation for the transition typology. Here, let us return to the argument on the main issue.

Balcerowics (Balcerowics (2000)) approaches the same aspect of the problem as Kolodko and Kornai from a different viewpoint. There are some steps in his recognition of transition typology theory. He makes four kinds of comparison about transition: (1) a comparison of five transition types from the long-range historical viewpoint stretching back to two centuries ago, (2) a comparison of transition economies among the socialist countries (especially China and Eastern Europe), (3) a comparison of transition economies inside Eastern Europe, and (4) a comparison of privatization methods.

However, the core of his argument lies in that the central problem of the economic system is to clarify the system theory for economic growth. It cannot be deduced from a single factor. He observes the degree in which the following fundamental conditions have been fulfilled: an open system of entrepreneurship, a capitalist ownership system, the flexibility of the labor market, the low tax ratio to GDP, the stability of the macro-economy and the stability of the political system. Among them, he stresses the different types of states of open systems of entrepreneurship. According to him, there are three: a closed system, an open system (the free system) and a limited system. His comparison with the four types of worldwide transition allows us to understand the four specific characteristics of East European transition:

- (1) the vast range and long duration of the change and the reform.
- (2) the synchronism between the reform of the political system and that of economic system, with the political reform coming first and the economic reform following.
- (3) the role of comprehensive market-oriented reform in the democratization process.
- (4) the nonviolent character of the transition with the specific phenomenon of the former elite and *nomenklatura* taking up new positions as politicians and capitalists.

Anyway, why have the transitions in Eastern Europe appeared through

system transformation? Because the policies (L policy) of reorganizing the system and mechanism were implemented in parallel with the microeconomic liberalization policies (I policy) in spite of the fact that the former is the basis of the latter. Especially, L policies were realized on an unprecedented scale and scope.

The realization depends on whether or not the fundamental reform can be completed in the abnormal political period of the early stage of transition. The abnormal political period refers to the time when a special mass public psychology was prevalent and the old elite lost trust among the people, while a common political capital was powerfully formulated between the new politicians/leaders and the people in the initial stages of democratization and liberalization. And this fundamental reform means shock therapy.

As for the question of the strategic alternatives of economic transition, the more radical and comprehensive the program of transition is, the more easily it can abolish the flaws and the structures taken over from the former system. And the more pains which can be endured in the early period, the more benefits are obtainable later in the transition period.

While Bunce paid attention to the result of the first free election, Balcerowics pays attention to the character of early-stage system transformation decreed by the state.

The examination so far in this chapter shows us that there are a group of studies problematicizing the transition state, and those relating to the transition firms. Next, we shall further examine a study of the former, whose direction of approach is completely the opposite to the ones discussed above. This is the state over-withdrawal theory of Poznanski.

Poznanski is critical of conceptualizing the substitution of capitalism, characterized as efficiency and improvement, for communism with ascribed characteristics of loss and degeneration. It unconditionally presupposes the construction of a positive system. It goes without saying that there is likely to be negative downgrading of the system in transition. The recession that hit Eastern Europe was, generally speaking, attributed to the inheritance from the communist era or the imbalance associated with it. But this is nothing but a partial explanation.

The operating of the market could not have caused the recession. In the early stages of transition, the market did not have a great influence

on the overall economy in terms of size and depth. If anything, the main problem lay in the situation in which the state, which was the principal owner of capital and played the role of coordinating and adjusting the economic mechanism, was rapidly rejected by the system and society, which, therefore, made the economic main actors subsequently unable to carry out rational decision-making. In other words, it is the over-withdrawal of the state or the crisis of the state that brought about the system transformation recession and retarded economic recovery. This explanation suggests that the differences between the regions and among the countries can be attributed to the different forms of the state crises. This has nothing to do with the strategic alternative of whether gradualism or shock therapy should have been adopted.

Table 1 shows that one axis of classification depends on whether systematic transformation was realized systematically or un-systematically (chaotically). The role of the state is a decisive factor in the process of its realization. The market itself could not afford to organize it sufficiently. Therefore, if the state loses control of the system change, the transition process inevitably becomes chaotic. The over-withdrawal of the state through a self-limitation process takes two forms. One is represented by Hungary and Poland, which shifted ideology radically, while maintaining political consistency in the form of the state. The other type is East Germany (the unification of Germany) and Czechoslovakia (in the case of spilt of the federation, Czechoslovakia is located near the middle point between the above two forms).

There are also two types of over-withdrawal of the state through un-organized self-destruction. One is the case that the state is eroded by corruption, which is true of Bulgaria and Romania. The other is Russia and the CIS countries, where the state organization is substantively dismantled and a part of the state power subsequently shifts to non-state agents. In such cases, the role of the state as the reformer is renounced, and it is reduced to the bare minimum functions. The more systematically the state is withdrawn, the smaller the degree of the recession is and the better the economic performance is. The logic of this explanation is clear in the interpretation of the present situation of transition in China and the former East Germany as well.

Poznanski differs completely from the transition state theories by

Bunce, Kosals and Kolodko examined earlier. His ideas are very suggestive of the process of transition typology logic.

Level of radicalism (and political circumstances)	Character of the process	
	Organized	Dis-organized
Less radical (Political continuity)	<i>Ideology shift</i> Poland, Hungary	<i>Corruption</i> Bulgaria, Romania
More radical (political discontinuity)	<i>unification / disunification</i> East Germany, Czechoslovakia	<i>Collapse</i> Russia, Ukraine

Table 1 Typology of state over-withdrawals

Source: (Poznanski(1999))p. 18.

It is, by the way, well known that there is a theory, which stands in powerful opposition to the school of institutional economics taken in the broad sense. It is the insufficient liberalization theory, arising out of the neoclassical economics tradition.

It is likely that it was the joint paper of de Melo, Denizer and Gelp, (de Melo, Denizer and Gelp (1996)), the study report of World Bank, that first made us conscious that there are various patterns of transition economies in the former socialist countries. They made a composite index of three dimensions of liberalization: internal markets, external trade and payments, and facilitation of private sector markets. This cumulative liberalization index classifies the transition countries into four groups: advanced reformers, high-intermediate reformers, low-intermediate reformers and slow reformers. This grouping and additional analysis (international comparative data, time profiles of transitions, growth pattern and inflation pattern) proved the hypothesis that economic liberalization is strongly related to political change. They posit causality as interactive, with economic liberalization having strong political implications, implying that to destroy the authority of the

existing structure is an essential action. This understanding demonstrates his similarity to Bunce and Balcerowics. Ultimately, his conclusion amounts to the fact that the differences of strength, endurance and speed of liberalization explain the differences in the transition pattern. The conclusion is likely to prove the validity of the Washington consensus.

According to Brada (Brada (2000)), this final conclusion proves the validity of neoclassical economics. However, arguments to the contrary have recently appeared, pointing out that adding initial conditions to the explanation variables modifies the conclusion that the index of accumulative liberalization statistically explains economic performance in transition. According to him, transition strategy is decided by the combination of economic, cultural, social and historical elements, and linkages with the Europe, and the desire and expectations of joining the EU have formed the last three elements.

If we realize that the desire and expectations of joining the EU play an important and decisive role in the political calculations of the citizens and peoples in transition, we can more easily understand why the policy pattern of liberalization was adopted and has been maintained in Eastern Europe.

If the desire and expectations seemed to be far from realization, another pattern could be chosen in transition instead of the economic liberalization model, i.e. the kleptocratic politics-type economic system or the populist-type economic system. This leads us to the conclusion that the political aim of joining the EU has imposed a series of restrictions, making a daring separation from the liberal economic model difficult as an alternative in the choice of the economic model. This also seems to be rich in implications for the elaboration of transition typology study.

It is Csaba (Csaba (2000a, p. 4-19)) who states the necessity of explaining the point at issue posed by Brada by using the terms and framework of economics. He argues as follows: the confusion between the scientific truth of the neoclassical economics and the normative statements of its representative theorists should be taken issue with. The success or the failure of transition can be explicated according to the same algorithm, in which only the country that has attained the four stages of stabilization, liberalization, privatization and the subsequent building a financial system can shift itself into the orbit of economic growth; the differences

in system transition can be attributed to differences of the path-dependence and the geographical position.

To explain the pattern of transition by an Eastern European model of capitalism (e.g., Stark) or a theory of political capitalism (e.g., Kosals) seems to be out of the rationale. It can be strictly characterized as a transitional phenomenon. It is difficult to identify and treat Ukraine and Poland in a single unit.

Is there no consideration of the typology of Eastern European transition economies other than understanding the variations of path-dependence and geographical position, as in Csaba? He proposes the impossibility theorem that economic growth, international integration and mass/popular democracy do not cohere at the same time. It was through the formation of consensus on the compulsory change of the distribution system and EU accession that allowed Central-Eastern Europe to succeed in the system transformation and continue to voluntarily don the golden strait jacket of achieving the EU accession criteria without any great discontinuity.

This consensus, which is different not only from European democracy, but also from the guild-corporative democracy of Latin America, was made on the basis of the destruction of the vested interests of the establishment and opposition parties, i.e. the sacrificing of the mass democracy as well as the power vacuum in the system. By contrast, Romania, Lithuania and Bulgaria were cases where international integration was compatible with mass democracy and Russia gives us an example of economic growth being combined with mass democracy, but not with international integration. The Russian pattern fits the case where the domestic market is enormous and has very low level of development.⁵⁾

This understanding would suggest that the success of market transition in Central and Eastern Europe was not a typical case, but a rather exceptional one, meaning that the theorems of neoclassical economics could rarely concur with the concept of path-dependency and geographical position. It could be concluded that Csaba, also, is observing the transition in the redefinition of the role of the state in a broader sense, as well as the international environment, including participation in regional economic integration.

4. Conclusion ---posing the new points at issue ---

So far, we have examined what gave birth to differences, varieties and diversities in transition, referring to various typology-oriented theories. What have we discovered? Our finding can be itemized as follows:

- (1) In comparing the two sets of theories on the emergence of differences, varieties and diversities in transition, the transition process-cause theory seems to be more persuasive than the inheritance-cause theory. The relations between intermediary organizations and the international environment, and the relations between the state and the international environment are objects of a special attention in the inheritance-cause theory.
- (2) In the transition process-cause theory, which explains the differences and diversities of transition, the various arguments ultimately seem to converge on the axis of the three dimension of exposition; the first axis measures the degree of liberalization as based on the accumulative liberalization index. The second is the axis whose ends designate the relative degree of system building by the state and system-destruction by state over-withdrawal. The third axis indicates the degree of participation in regional integration. The three axes constitute the three-dimensional space, in which every transition economy can be placed. This arrangement may be cable of completing the classification of transition typology.

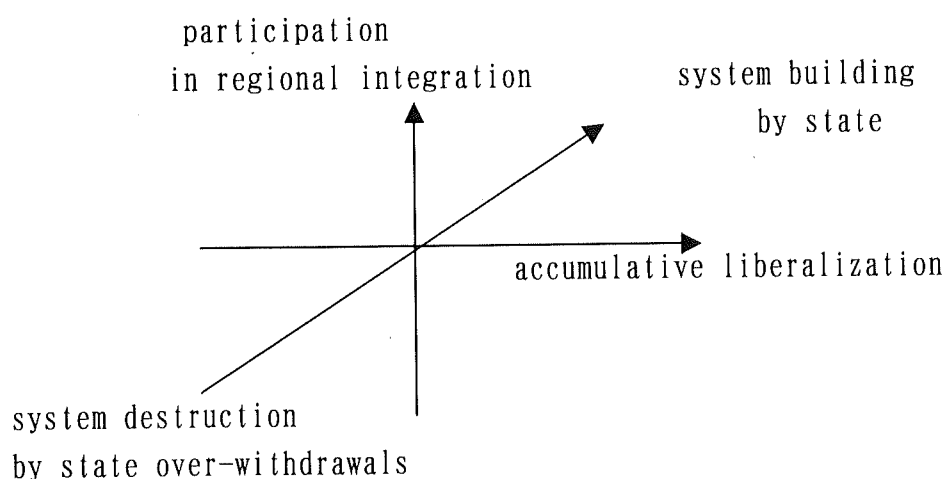


Figure 3 Framework of typology of transition

(3) This paper digressed in order to examine the relation between the firm and the characteristic differences of transition economies. This examination was partial; nor could the points at issue about the region and intermediary organizations, the individual, the culture and value systems be treated with. This is rather because my analysis has not yet reached problems of this scope, than a suggestion that these concerns are unrelated. I propose to further my research in precisely this direction.

1) Darwin clearly distinguished between species and mutation variety in the early stages of his research. He defined the former by the term reproductive isolation, but rejected it later. He tried to explain discontinuity as the result of the step-by-step application of natural selection. In other words, discontinuity shaded into a question for degree. This resulted in misunderstandings, giving room for interpretation that the species is not the product of various histories. (Nicita and Pagano (2001, p.5.)) This paper understands type as species (reproductive isolation).

2) In this model, the triangular space of state, firm and individual symbolizes market society; that of state, intermediary organizations and individual expresses reciprocal society, and that of state, firm and the intermediary organizations denotes controlled (organized) society. Civil society is suggested by the triangular space of intermediary organizations, firm and individual.

3) The characteristics of clan capitalism are as follow: (i) main actors of the system are socio-economic clans. Clans which are not private business owners competing in the free market are the state bureaucratic groups adhering to the criminal groups. Their characteristics are the monopolization of the market and unproductive activity; (ii) clans possess relatively advanced degree of economic freedom, which shows the backwardness of regulation by the state; (iii) post-Soviet monopolistic institutions; (iv) appearance of the *nomenklatura* entrepreneur whose business seems to be ambiguously connected with their administrative management; (v) existence of a large-scale shadow economy.

4) Yonosuke Hara (Hara (2000)) pursues the logic of type formation of the economic systems of Asian countries like Japan, China, India and so on in the dual interactions of "the mode of capitalism" and "fundamental nature of the society in question called as a basic layer", posing the hypothesis that coming in touch with the cultural system of beliefs characterized by a regional personality evolves the economic system.

5) Csaba (Csaba (2000b,p.361-391)) investigates questions of the state being systematically separated from powerful vested interests, requiring the reorganization of the role and the functions of a state which has been freed from ideology, as well as the re-discovery of state regulations. He understands the transition as one proceeding overwhelmingly outside the formal institutional system (as does Hayek) while, on the other hand, he thinks the influence of the state on aspects of the transition such as executive ability, the supervisor ability, impersonality, rule of law and so on crucial.

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**BUILDING CAPITALISM
WITH COMMUNIST TOOLS:
EASTERN EUROPE'S
DEFECTIVE TRANSITION**

**Kazimierz Z.Poznanski
University of Washington**

Evolutionary thinkers made warnings that the region might be heading for another delusional disaster very early in the process of reforming what was left of communism (Murrell 1992; Poznanski 1992). At the center of these warnings was the view that one should never disregard the utility of preexisting institutions. They also warned against the possibility that such utility may be easily disregarded if the communist ways of thinking is allowed to continue. The one way that evolutionists stressed most was constructivism, i.e., imposition of untested systemic ideas.

Constructivism is what Haeyk (1999) considered the major error of socialism, or one of its forms – communism, both being an expression of a “fatal conceit”. This thought has guided most evolutionary economists writing about transition -- they fear that “fatal conceit” may also be a major error of post-communism, or, post-socialism. “Fatal conceit” has indeed become a birth defect of the transition. This overconfidence in untested institutional designs has again lead to poor results, with high costs being paid by experimented upon societies.

The constructivist mistake of post-communist economies that evolutionists were most concerned with is the dismantling a functional state too rapidly for markets, which require time to become functional. Consequently, evolutionists advocated, that however compromised, communist-era states need to be slowly reformed rather than quickly abandoned. Though attacked as a hidden endorsement of communism, in reality, this cautious approach to the state has been the only sensible way to effectively move a system away from communism.

In their distaste for constructivism, evolutionists argued that economic reforms should never be allowed to become a state objective that is superior to its “normal” economic obligations, i.e., supporting production growth and ensuring

that growth is widely shared. The only sound justification for reforms must be that they serve both growth and equity constantly, and not in some distant future. When the order of priorities is reversed, reforms may hurt growth and/or equity, precisely what has transpired in post-communist Eastern Europe.

Evolutionists were concerned not only about economic performance being hurt by the excesses of reforms, but that reform experiments are likely to produce some deviant systems. Instinctively, they warned that the more systemic change post-communist reformers assume themselves, the less they would achieve and more of communist elements would be retained (Murrell 1995). And, in this prediction, they are proven to be quite right again. Though nobody, including myself, was insightful enough to predict that something this defective would materialize.

It's politically correct to pronounce success for the post-communist transition in Eastern Europe. While some claim the success is complete, others say success of reforms hasn't arrived without sending the region into an unavoidable recession. I understand the demand after decades of communist failures for a positive account of transition. But the post-communist reforms have also failed completely. The recessions are a result of some major reform mistakes. Moreover, a recognizable capitalism is not emerging, rather its caricature.

Recent reforms have rapidly delivered ownership relations where most of the national capital, especially in industry and banking, has fallen into foreign hands. This form of capitalism is not recognizable, because one does not find a similar property structure in any well-developed capitalist countries, including those in neighboring Western Europe. The foreign-dominated property structure that one finds in today Eastern Europe is not in any important way superior. It is a systemic pathology, which has emerged under some pathological conditions.

That recent reforms have produced systemic pathology is unacceptable to the mainstream analysts, as is the idea of an unnecessary recession. They see the massive transfer of domestic capital to foreigners as a blessing, since foreigners are going to more efficiently make use of capital. Are we supposed to judge economic systems in terms of factor efficiency alone? There is an important welfare aspect to

be considered as well. Under the newly emerged property structure, Eastern Europe is left without one basic source of wealth: profits from banks and factories.

The pathological nature of transition becomes even more apparent when examining the conditions of asset transfer to foreigners. The evidence shows that Eastern Europe gave away its title to these profits without receiving from foreign buyers a real price for its capital. On the contrary, the assets were sold at a small fraction of their actual value. Some mainstream analysts try to defend this practice by claiming that communism left capital goods of very little worth. But whatever the remaining value of capital, it was sold at incredibly discounted prices.

The negative welfare effects of deflated asset pricing are possibly worse than in the case of profits from foreign-owned capital. With profits, one could make an argument that, absent of monopoly power, they represent a deserved payment for services that foreign owners render. But selling way below the value represents a pure disservice to the region. Windfall gains to foreign buyers represent windfall losses to the selling countries in terms of region's welfare. By reinvestment, the forgone state revenues from asset sales could have augmented the region's capital stock and both create jobs and enhance wages.

All these developments are so unprecedented that it is difficult to determine the best point of reference for judging this foreign-dominated property structure. Since Eastern Europe moves from communism to capitalism, it would seem appropriate to follow the mainstream approach and take superior capitalism as a reference point. But, if transition is not producing ownership relations that resemble known capitalism, it could be that inferior communism is a better choice. My preference here is to take the latter road, which I call the "communist metaphor".

Pursuing this avenue, I show that post-communist reforms have produced failed results because capitalism has been built, so to speak, with the "tools" of communism. Rather than to instantly fade away like a stain treated with a strong detergent, communism has retained a strong hold on the emerging capitalism. In my view, this is the true, or at least the most relevant meaning, of the "path-dependent" nature of transition that unfortunately so few area scholars have focused upon in all the years that have since passed (see: Stark 1992).

The continued influence of the communist patterns on the emerging capitalism is particularly evidenced in the fact that, as a cornerstone of transition, property reforms have been handled by the state in a fashion that imitates the old communist schemes. Not only has the state acted with minimal supervision, but, while nominally state-owned, assets have continued to be treated as a resources belonging to no one. This explains why capital was not only sold by the state mainly to foreign buyers but also that it was sold without any effort to secure full prices.

The wrongs of communism do not make this negative systemic outcome inevitable. This is a post-communist failure, though stemming from misconceptions quite similar to those that failed communism. The view of the nation-state as an anachronism, typical of communism, has resurfaced, facilitating massive sales of assets to foreigners. By adopting another version of moral relativism, where collective primacy is replaced with unrestrained selfishness, the wide-based corruption was allowed, facilitating unreasonably high discounts on sale prices.

Finally, my analysis suggests that the capitalism of post-communism built with the communist “tools” seems to retain important features of the original communist system. A capitalist way of building institutions leads to genuine capitalism, but building its institutions, such as private property, in a communist way will not lead to such a desirable outcome. This is exactly why, similarly to communism, the deformed capitalism of Eastern Europe lacks a viable domestic capitalist class and why local labor is vulnerable to the threat of a wage dictate.

1. ACTIVIST STATE-AGENCY

It is logical to start my “communist metaphor” with the question of the state’s role in the process of asset divestment, since it is largely the state’s behavior that defines the communist-type economy. There are two features of a state’s behavior that characterize communism; it’s critical role in allocating resources, and the preference for imposing its “model” of a desired economic system. As an initial proof that the communist metaphor works, I will show that both defining elements of communism have been present in the process of post-communist privatization.

Recharging State. Taking the issue of allocation first, one finds the state has moved away from some routine resource allocation decisions. But the recent collapse of communism has not put an end to a mass-scale allocation of resources by the state. Simultaneously with the release of some controls over resources, the state engages in certain new forms of allocation of economic resources. We see that the heavy-handed state involvement in allocation has not ended, rather that there is a serious regrouping of state functioning as an allocation agent.

Under the communist system, the state is fully involved in the allocation of resources for current production (e.g., energy, materials) and also in the expansion of production through capital-formation. With the advent of transition, almost all of this state's activity has instantly ceased, leaving the private sector with authority over both allocation areas. At the same time, however, the state quickly opened a completely novel allocation function of asset privatization, creating a huge venue for the state to allocate an already accumulated stock of capital.

This move by the state to start massive divestment represented an enormous empowerment of the state as an allocation agent, yet this has been disregarded by mainstream scholarship. This omission stems from the fact that privatization is judged primarily in terms of results, not process. Of course, the transfer of state-owned assets to private users reduces the state's holdings and the scope of its economic power. This, however, does not change the fact that in the process of such divesting, as long as it lasts, the state agency has enormous power over resources.

One could argue that, on balance, with moving away from current production and instead focusing on the disposal of accumulated stock of capital, the power of the state in allocation has greatly increased. Under communism, the state was limited to the allocation of annual surpluses of production -- left after the labor was paid off -- for capital expansion. In contrast, under post-communism, the state gained the ability to allocate mountains of capital accumulated not in any single year, but over many decades of communist-style heavy investing.

The most striking case of a further empowerment of the state has been in those communist-era economies, which were most altered by reforms. These are of

course, Hungary and Poland, where, over two decades, communist reforms completely redesigned the original system. Towards the end of communism, only a marginal segment of production was subject to strict state control (primarily “strategic” products, like energy and basic foods). In addition, capital formation by companies was left mostly in the hands of credit institutions.

Hungary and Poland both chose to privatize capital mainly through sales, therefore are also the most vivid examples of an overall increase in the state’s power. In countries that adopted free-of-charge distribution, it took less time for states to dispose of their assets. But nowhere did such methods involve all capital assets, including the Czech case. There, less than half were given away to the citizens. Importantly, the Czech state largely regained power over the freely divested assets, since state-owned banks collected most of the giveaway shares.

The fact that the state instantly engaged in massive privatization does not mean it was an absolute necessity to do so. It is not because communism was abandoned and capitalism had to be ushered in that the state had no other choice but to undertake a full-blown privatization. Theoretically speaking, capitalism could have been built without the state disposing of its accumulated capital assets. The way to accomplish this goal is by permitting new entries into the system by private parties, in order to eventually marginalize the state sector (see: Kornai, 1990).

Of course a total rejection of privatization would leave the majority of assets controlled by the state, but this does not mean that no reform within the state sector would be possible. While retaining state-owned status, the traditional control of current production could have been limited and replaced with general financial control. To ensure stronger motivation for efficiency, the state could have curtailed its practice of unconditional bailing out distressed companies and/or provided managers with generous long-term contracts.

Besides, by allowing an unrestricted expansion of private businesses, the state-owned sector would have been exposed to a healthy internal cost-cutting competition. But even if state sector were both exempted from reforms and insulated from the private sector, this would not have to completely undermined transition to capitalism. Presumably, the expanding private sectors could have

provided sufficient momentum for the economy to grow at the pace that would more than compensate for the inefficiencies of the retained state-owned sector.

Redefined Constructivism. Maintaining, or increasing, vast allocation powers by the post-communist state represents one important communist feature of the transition. That the state employed this power in a way typical of communism is another proof of the validity of my “communist metaphor”. The post-communist state did not allow economic agents to reshape property rights themselves. Instead, continuing with the communist pattern, the state chose to forcefully implement its own vision of what is right for the economy.

With this kind of activist attitude, the state under communism placed too much hope in systemic reforms to solve outstanding economic problems. In fact, the whole communist system was introduced out of a hope that by changing the system drastically economic problems of the region – those of backwardness – would go away. Later, after political consolidation, communist leaders engaged in an endless process of adjusting the system, with the result, that reforms, rather than be stifled, became almost endemic.

This particular feature of communism, aptly labeled by Hayek (1988) as “constructivism”, stemmed from a philosophical conviction that if approached properly -- in a classless fashion -- society’s leaders are empowered to reject a traditional system for any one they consider superior. Hayek found this particular way of thinking to be a recipe for disaster, and was convinced communism was surely heading for one by taking this road. This did not happen immediately, though his view has been recently vindicated.

At the start of post-communist reforms, the communist ideal economy was long forgotten, but not the hope that with a radical systemic choice problems would vanish. The post-communist reformers have again taken this type of constructivist road. Although this new breed of radical reformers has been seeking capitalism, they have also exposed themselves to a considerable risk of seriously failing at the end. The risk has been that they would finish their own over-ambitious systemic project with some type of caricature of capitalism.

The major sources of legitimacy claimed by communist leaders and the respective parties has been a commitment to thoroughly reforming the whole world and similar claims to legitimacy are made by the post-communist reformers. Though operating with a very different vocabulary, recent leaders have also made radical reforms their principal claim to political power. They chose not to call themselves revolutionaries out of fear of association with their earlier counterparts. But, at least in their own eyes, they rationalized themselves as such.

In fact, these were not just empty announcements. Post-communist reformers are comparably more aggressive activists than their immediate communist predecessors. True, communism was undergoing frequent reforms, but towards the end communist leaders were becoming increasingly timid (notable exceptions are both Hungary and Poland). Institutional change was more a result of party/state's weakening grip over the economy, rather than an outcome of official reform programs.

This retained activist attitude made the post-communist state proceed with a full-scale privatization while using wholly new or hardly tested approaches. Actually, the incredible pace of divesting itself represented an unprecedented approach. Partly because of such a storming tactic, experimental methods to privatize massive stocks of capital have been given a preference over tried methods. The states decided to build a common capitalism using means not previously used by any economy that has successfully build genuine capitalism.

In their extreme activism – or rather arrogance – many, if not most of the post-communist states came up, for instance, with the never before implemented idea of rapid free-of-charge (voucher-type) distribution of their assets to all citizens. In the Czech case, or in Russia, where this method was tried first, the approach was justified as the best practical response to the obvious shortage of savings for citizens, to buy state assets immediately. However, this shortage represented an obstacle only because the state assumed a short timetable for privatization.

Another equally experimental model of privatization has been to seek an answer to the lack of internal resources – savings – for citizens to buy assets, by turning instead to foreign investors. Many states, including the well-developed

capitalist ones, look for external sources. Not one has tried to improve the national formation of capital by offering most, or even all of their capital for sale to foreigners. However, this is the road Hungary chose: the first one in the region, followed by almost all other transition countries.

Table 1. Communist continuity: process of privatization

ASPECT	Model communism	Post-Communism	
	<i>Principle</i>	<i>Application</i>	<i>Outcome</i>
POWER	a. Centralized control of economy	shifting from production control to privatization	preserving intrusive state
STRUCTURE	b. Mobilization with radical techniques	extremely fast-paced privatization	gaining false state legitimacy
ALLOCATION	a. Public property ("abandoned" resources)	selling "abandoned" capital	engaging in price discounts
METHODS	b. Inadequate accountability of officials	independent privatization agencies	selecting mostly foreigners
UNDERLYING	a. Neglect of nation-state (=worker internationalism)	"capitalist internationalism" (globalization concept)	accepting foreign domination
IDEOLOGY	b. Moral relativism (collectivist morality)	public disinterest (personalist amorality)	accepting fraudulent pricing
ECONOMIC	a. Missing capitalist class (party as a substitute)	"imported" capitalists (as a substitute)	profit drainage abroad

SYSTEM	b. Factors' imbalance (party/state domination)	foreign capital domination	local wage dictate
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Yet another experiment, tried by Poland, was to rapidly channel assets through the stock market to domestic buyers. This was a “fresh’ idea indeed, since stock markets are extremely complex designs and cannot be formed right away. Usually come very late in a process of building any financial sector, and seldom are they a centerpiece of such a system anyway. As became clear right away, Poland could not rely on its newly found exchange, and amid the major delays and rampant speculation, the whole project had to be drastically trimmed down.

2. ALLOCATING “ABANDONED” ASSETS

While the utterly intrusive – and radical -- state activity as a privatization agent is one very visible reminder of the communist scheme, a further important overlap are the actual procedures adopted for allocating specific pieces of capital. Here, are the two most critical elements. The first is the nature of property rights, for they motivate decision-makers on how to use resources. The second element, also critical for motivation, is the system of responsibility, or – rather -- accountability for the outcomes.

Nobody's Capital. Possibly the most convincing argument in favor of my “communist metaphor” for post-communism is to look at the question of property rights. There can be no doubt that under communism, resources – except for labor – were almost entirely publicly owned. But, more importantly, there is also little doubt that capital assets slated for post-communist privatization also were publicly owned. There has also been little positive change from communism in the nature of public – state – ownership of capital.

The limitations of public ownership are known, as was made very clear by Schumpeter (1942), when he speculated on whether socialism, in any form (including “real communism”), is feasible. His major concern was that by shifting resources under state ownership, the true sense of ownership is lost, since public – collective – ownership is largely a fiction. When, by law or custom, assets belong to many or even all individuals, they are actually not proprietary, for in reality they belong to nobody, and cannot be treated as property.

While public assets have no well-identified owner, in reality, they’re always assigned to someone who is put in charge of them. But being put in charge is not the same as owning something, and there are some critical consequences for how assets are treated in both cases. As a rule, assets that are ascribed to a private party are treated with greater care than those left with somebody in charge. In the later case, the motivation may be so weak as to lead to an outright misuse, or waste of apportioned “collective” resources.

The above point was made by, Mises (1951), who argued that the communist system is not feasible, due to the lack of private ownership. The reason is that for any economy to persist, those who make the choice on the use of resources have to have access to “rational” or competitive prices. Such prices, which correctly reflect opportunity costs are possible only with private ownership, where actors are interested in making sure that lowest possible prices are paid for inputs and highest are sought for outputs.

The observation made by Mises applies to post-communist privatization. By definition privatization has to be conducted under the condition of nobody’s property. Opportunities for incorrect pricing, and related misuse of assets, are therefore permanently built into the divestment process. But both private and public ownership come in different forms depending on how broadly or narrowly a given asset is attached to an individual or a group. Accordingly, it follows that opportunities for wrong pricing, and poor use of resources should differ as well.

Consequently, various opportunities exist for the state to make sure that before divested its assets, they should acquire at least some attributes of private assets. For example, by bringing public capital into the securities market in limited

quantities allows for more accurate pricing of those state assets that remain with state privatization agencies. Non-state-shareholders, by gaining a stake in the state-owned firms, are likely to make sure that further sales by the state are properly priced.

There is another solution, going back to Mises (1951) and his remarks on the possible ways for communism to improve its performance in the absence of private property. He argued that while communism is hampered by the fact that it cannot generate “rational” prices for goods, it can “borrow” them from capitalism. In the same fashion, the state sector may “borrow” prices for divested assets, e.g., by going to its domestic stock market for assets of similar companies, or by relying on prices of analogous assets traded abroad.

Reformers have taken no such steps and the worst abuses possible have been allowed, mostly without any public knowledge. Moreover, those who have been engaged in privatization decisions, and thus in asset pricing, may not possess a good sense of what is the general valuation practice. Until very recently, there have been no systematic estimates of prices East European assets. Instead we had to rely on sparse circumstantial evidence, which most of the time suggests that industrial and banking assets are sold at a very cheap price.

I have made the first attempt to get at least a general sense of actual pricing and can confirm the existing feeling that drastic under-pricing is a common practice (details see: Poznanski 2000). Although, because virtually no sound official data exists, my calculations are only preliminary they seem to offer a reasonable picture of the pricing practices in Hungary and Poland, where foreign sales are most advanced. There is no reason not to generalize these findings towards other East European countries, where sales to foreigners have been moving at a slower pace.

My calculations indicate that assets offered for sale -- and in most countries most of the assets are subject to sales --, are priced at one—tenth, or at best one-fifth, of their actual value. One way of getting this figure is to look at the total revenues from sales of all state assets in industry and banking, where the majority of deals have taken place. In Hungary and Poland, extending the revenue figures to account

for remains to sell, the final revenues represent almost an equivalent to the yearly savings, or twenty percent of the annual national product.

If we take 50 billion dollars as Hungary's national product for the mid-point of her privatization, then, at the one-fifth savings ratio, the annual savings are 10 billion dollars. In 1999, with almost nothing of importance left to sell, state revenues from sales to foreigners reached 10-12 billion dollars. For Poland, the mid-way level of national product would be 160 billion dollars. Assuming the same saving ratio of one-fifth, we have 32 billion dollars in yearly savings. But, at the best the final proceeds from asset sales to foreigners could reach 28 billion dollars.

For this "price tag" to be equal to the real value of assets, it would have to be possible to use one-year national savings to generate all this capital sold. But, there cannot be any doubt that it had to take many years to produce such a stock of capital. Any quantitative attempt to prove that selling industry and banking at an equivalent of annual savings was rational has to fail. No one can demonstrate this to be correct without producing some absurd results about the growth potential of an economy that would have such ability.

If all the capital sold by the countries in question is truly worth only one-year total savings, then of course, theoretically speaking, it should take just one year for Hungary and Poland to build their entire capital stock accumulated in industry and banking. It would have to be so, since the value of the existing capital stock has to be equal to the value of savings that financed its formation in the first place. Therefore each year, if all national savings were devoted to capital build-up in these sectors, their capital stock would have to double.

Here we are approaching the absurdity. For any economy with such an ability to expand yearly its capital of both industry and banking, the related national product would annually have to expand at an impossibly phenomenal rate. Since industry and banking in both economies are responsible for about half of national product, with the yearly doubling of capital stock in these sectors, the national product would be growing annually by fifty percent, which is an impossibly phenomenal rate indeed.

If annual savings are not sufficient to create the inherited from communism capital stock, the question remains, how many years would it actually take to create it? Without making things very complicated, we may try to answer this question by asking first what a realistic rate of national product growth would be. Probably five percent, or ten times less than the hypothetical rate just mentioned. It follows that these countries needed at least ten years to form their capital, and, therefore, that it has been sold at one-tenth of its value.

This one-tenth is a ballpark figure to be further examined, taking into account some details of privatization. Assets are purchased not only directly from the state but also through other channels, such as the stock market (e.g., as frequently done with Polish banks). In addition, the state retains some control in many entities classified as privatized. While the “price tag” is actually steeper, the actual stock sold is less than assumed. Including these factors, the figure will be not one-tenth, but one-fifth, by any stretch of the imagination not more than that.

Unsupervised execution. As far as allocation is concerned, the model communism is characterized, not only by the fact that the state is dealing with abandoned capital but that there exists a lack of a clear-cut accountability of those left in charge. They lack the economic accountability that comes with private ownership, therefore the only meaningful accountability is the political one. As another aspect of continuity, this lack of economic accountability also characterizes post-communist privatization, were everything is subject again to political control.

Judging by the communist experience, political accountability is never clear-cut, due to its personal nature and fluid criterions, it allows for extreme subjectivity. In an authoritarian environment, in “real” communism, such accountability becomes particularly questionable. It assumes a sort of self-control. The party/state, while in charge of resources, also determines whether a specific use of these resources is appropriate. And, if it is not, the same party/state determines whether any punishment for resource misuse is deserved.

Since the transition began by dismantling this authoritarian system, the majority of transition scholars assume that in a process called “democratization”

these countries moved from the politics of few, to the politics of many. As expressed in countless accounts, this “democratization” represents to them the true essence of transition and is a political gain more than compensating for whatever economic loss appears along the way. These accounts of “democratization” assume state officials are politically more accountable than their party/state counterparts.

This may sound quite counterintuitive, and may appear even anathema to some within the mainstream, but unfortunately, the reality is different than the “official” picture. There is no risk in saying that, at least with respect to privatization of state-owned capital, the post-communist state seems to be enjoying more leeway than the communist party/state before in those areas which the communist officials used to concentrate upon. It is particularly true when you compare the early communist party/state to the early post-communist state.

Almost invariably, divestment has been delegated to newly created agencies given an enormous administrative autonomy, such as no economic ministry possessed in the past. Quickly set up, and anchored in poorly prepared legal and procedural settings, such agencies have been also given a super status limiting the inter-ministerial “competition”, which existed under the communist system. Given this status, as in the case of Poland, they have been taken out of the jurisdiction of special – comptroller -- agencies supervising legality of ministerial work.

In the past, the party/state would not be exposed to parliamentary control, since these bodies acted mainly as a facade. But while new parliaments have been activated as a legislative body, privatization agencies have been effectively removed from the prerogatives of legislative control. Whatever the law, the practice is such that parliaments are out of the process, at best simply reviewing annual reports on total proceeds from asset sales. Or in a twisted way, they become an integral part of the process as willful allies of privatization agencies.

Under “real” communism”, but not under its model, the party/state is subjected to one external form of supervision, which is labor. Such control takes place not so much at a central level, but down at the company level, in part through its party membership. As a sign of deterioration, privatization agencies in all countries have been able to shield themselves from labor, though not to the same

degree. In Hungary, labor was made irrelevant, while say in Poland, at least part of the labor had to be co-opted, with preferential shares.

It is not that the post-communist reformers were doomed to conduct their business without much political accountability, even less than under the old regime. True, at the end of communism the state was in some disrepair and the ground was fertile for further deterioration of accountability. Given this erosion, rebuilding the state would be an obvious priority for starting reforms. It would take an extended period of time, and, thus, cause a delay in privatization, at least in the case of larger “pieces” of assets.

The fact that states have chosen state-wide asset sale rather than state-wide reform reflects the inherited quasi crisis of state agency. With personal concerns overriding public interest, divestment promised opportunities for private gain incomparably greater than any incentives to “fix” the state. Once the choice was made, the state agenda rapidly gives way to a struggle for gains related to the asset sales. As a result, in great need to be rebuilt, states have lapsed into an even greater state of disrepair – from quasi into open crisis (e.g., see: Burawoy, 1996).

A more muddled accountability allowed decision-makers to engage in enormously under-priced sales benefiting mostly foreign buyers. Any number of reasons has prompted officials to choose this path, including securing access to illegal gains, or “retainers” for themselves. Unsure of the tenure of their positions, officials welcomed foreigners capable of quickly raising funds. Seeking good cover, officials found foreigners particularly experienced in hiding “retainers”, usually treated as legal by respective governments for tax-deduction purposes.

Under these circumstances, most assets of the region were sold to foreign owners. Hungary, the fastest moving country, had already allowed seventy percent of industry and banking respectively to pass to foreign control, and what remains is largely money-losing, i.e., state subsidized. In Poland, banking is already seventy percent under foreign control, while industry quickly approaches this level. In the Czech Republic, half of each sector is foreign-controlled, and, except for Slovenia, the rest of Eastern Europe is rapidly moving in the same direction.

Selling some assets to foreigners would be an approved practice by any liberal economic theory. But selling most national assets to foreigners is generally not. Even less justification exists for selling such quantities abroad at grossly discounted prices. The reason for such disapproval is that selling assets of industry/banking at one-tenth of the actual value as in Hungary and Poland, accompanied by the adopted strategy of placing assets mainly with foreigners, would have to produce enormous "windfall gains" to foreigners.

To make it more tangible, if we assume that the ratio between price paid and real value is one-tenth then the "windfall gain" by foreign investors in Poland can be calculated as follows. If annual savings are equal 32 billion dollars, and if it really takes ten years of investing all savings to built the capital stock in its industry and banking, the value of this stock will be at, 320 billion dollars. The loss, representing nine-tenth of this value would then be 288 billion dollars (similar calculation for Hungary shows "windfall gain" totaling 90 billion dollars).

These foreign gains mean losses to Eastern Europe, since if "real" prices had been charged for capital assets, the state would be left with means to beef-up existing national capital stock. Theoretically speaking, for each factory/bank sold to foreigners, the state should be able finance an equivalent facility to double the capital of industry and banking. And, with industry and banking contributing one-half of national products, there should be a permanent jump in the level of national product also by one-half.

The calculated loss of resources should be, in my view, treated as a tangible proof that indeed post—communist privatization was to be conducted under conditions similar to those of communism. With assets more "detached" and with looser accountability, resource waste appears worse today than what has taken place under communism, at least in a comparable timeframe. As much as this sounds improbable, given the legitimately very negative assessment of communism, this eventuality cannot be ruled out.

Under "real" communism, due to costly delays during investment and because of machinery underutilization, capital was badly wasted. To compare communist-era deviations from perfect efficiency, ninety percent of what went to

capital building under communism would have to be wasted to match the level of loss created by the post-communist capital under-pricing. This is totally improbable, since at this level of waste in using capital not only the communist capital stock would not have grown as fast as it did, but no economy will last even briefly.

4. UNDERLYING IDEOLOGICAL SETTING

Eastern Europe did not have to privatize by selling assets largely to foreigners, it was a matter of choice that this course was taken by reformers. Thus, the next question is: what kind of justification has been provided for doing so? To follow my “communist metaphor”, I ask, whether this particular way of thinking, or ideology would have any relation to the ideology that drove the communist system. Specifically, at issue is whether post-communism retains communism’s two fundamental perspectives – moral relativism and internationalism.

Moral Relativism. Moral relativism refers to the position that there are no unchangeable rules of good/wrong behavior to provide for continuous human survival. These rules are not given or handed over by tradition, and people have a free choice to determine what is right and what wrong. Tradition does not define proper morality, rather mind and reason, determine the rules of proper conduct. Rules change when something is thought to be better, or even ideal so that chances for survival improve as well

Communism is an example of a social system based on such a relativist notion of morality as a matter of choice. This is made clear in the communist interpretation of capitalism. Morality is seen here as a matter of choice in the sense that it is claimed to be formed by an identifiable agent, the capitalist class, and, thus, morality reflects its narrow interests. By removing this class, in a communist revolution, an opportunity is created for a “better” choice of morality, to be founded by the only remaining class, labor, representing its interests.

It should be clear by now that the moral relativism of communism does not mean that it dispenses with morality. No social system could survive for any

extended period without some system of stable moral rules. Here, the free choice is not between morality and amorality, it is between various versions of morality. The choice of communism is to adopt a collectivist interpretation, in which the interests of a collective supersede the interests of an individual, or, in other words, a morality of ultimate individual sacrifice or subordination.

In contrast, capitalism is based on a system of “natural” morality or moral tradition, and a careful balance between collective needs and those of individual is maintained. Phrasing this general observation differently, such a unique balance is maintained between individual commitments – or responsibilities -- and individual freedoms. If one takes this particular tradition as the only genuine, and thus lasting expression of morality, then – and only then -- communism can be called an amoral system.

Hayek warned that moral relativism is dangerous, since any escape from tradition into reason ultimately leads to the subversion of the “natural” rules that assure survival. Relativism, indeed, is a threat to any form of morality that is reasoned-out in opposition to the rules handed over by tradition. Therefore, once tradition is rejected, no solid ground remains to stand upon, making any “invented” morality so much more easy to challenged and defeat. Consequently, relativism ultimately leads to moral degradation, or immorality.

That communism did not last very long as designed, and failed even after its framework being frequently “reinvented”, may be seen as a proof that relativism is fatal, and, that, specifically, collectivist morality is not viable. With the recent collapse of communism, this collectivist morality -- actually what was left of it -- has been abandoned. To many observers, including the politically correct, this rejection of moral collectivism is interpreted as a return of these societies to the moral tradition of capitalism.

But, while it is true that collective morality has been abandoned, moral relativism, which communism was a product of, has not been rejected. It has assumed a different form. Those societies have not moved to the “natural” morality of capitalism, but instead have assumed a form of relativism under which a person – a single being -- is creating its own rules. Morality is chosen by the apparently high-

minded party for a collective use under the previous form of relativism. Now each person has a morality fit for one's personal use.

The result is another moral extremism, upsetting the balance between collective and individual set by moral tradition. While under communism extreme status was afforded to a collective, the new system affords an extreme status to a person. The result, best called personalism, is amorality which places no serious value on the collective need. As such, personalism is opposed to individualism, which typifies the capitalist society as we know it, where each person is free to act but with a well-developed sense of responsibility to others, the collective (Jowitt 1998)

With the advent of this new – personalist rather than collectivist – type of moral relativism, morality disintegrates, making it impossible for the two basic capitalist institutions, the market and of the state, to operate in a normal manner. It could not have been any other way, since institutions operate according to how their members act, and, thus, in accordance with the morality that informs their actions. When morality is defective then so are actions, and as products of actions, institutions become defective (see: Soros 1999).

Markets cannot work normally unless their centerpiece, ownership, assumes a normal form, i.e., that while seeking protection for themselves, actors recognize the right of others to have their assets protected as well. Ownership should not be confused with possessing, for the former is a legal, or semi-legal, concept, which presumes compliance, while the other is not. The existence of moral ambiguity, with morality made from public into private, does not permit the sense of ownership to fully develop, and thus the market assumes only an abnormal form.

Most important is the fact that the same attitude of unrestrained self-interest -- “personalism” -- has penetrated into the state institutions. It is more important in part because, being in a public arena, where opportunities for abuse are greater than in a market setting, the state requires much more disciplined and restrained actors, i.e., officials. Also, transition in general, and privatization in particular are basically state-type affairs, and outcomes depend mainly on the behavior of state officials.

For societies that have not fully developed, or have just largely forgotten the norms of “natural” morality, in its capitalist embodiment, anti-capitalist personalism is easily confused for capitalist individualism with anti-capitalist personalism. Personalism comes much easier than individualism, which itself is a product of self-imposed restraint. When such substitution prevails, personalism can easily borrow justification for its set of “designer” rules, and the vices it inevitably produces, from “uniform” individualism.

Among the most hurtful effects of this recently resurfaced form of relativism is the widespread acceptance of corruption, including the common practice of asset under-pricing occurring within the privatization process. Officials do not feel much apprehension about their behavior, since they rationalize it on the grounds that capitalism was built in this manner. That is a false reading of history of building capitalism, as Weber (1976) makes clear, when attributing much of the early success of capitalism to protestant zealots.

Those who do not personally benefit from setting prices too low, adopt a similar view that there is no reason to morally condemn the behavior of state officials. Presumably they are envious, but also resigned, since they think that capitalism, or – market, as a matter of practice, provides only limited opportunities, regardless of whether reward is well deserved or not. This is also a wrong reading of capitalism, since it offers limitless opportunities, unless markets permit undeserved actions – and rewards – to go unpunished.

It is a harsh judgment to blame the state for under-pricing and the related loss of wealth to foreign buyers, but there is no other credible explanation, certainly no explanation that is offered by some mainstream economists. Certainly, nobody should excuse these kinds of fast-and-cheap sales on the grounds that, as it is often said, nobody was willing to pay more. This is a totally superfluous argument, since it is hardly possible that with assets offered at one-tenth of their real value, scores of potential foreign buyers should be expected.

If, as widely reported, very few foreign buyers have entered into negotiations, and related price-setting, in most of the transactions, it is not because assets were worthless. The “rules of the game” set by the officials made open bidding simply

impossible. For officials, to make personal gain, they had to assure deflated asset prices, and to make this happen, they had no other choice but to “fix” the race so only one buyer was in the running (with other parties, if at all admitted, working only as convenient cover).

Also, it is not credible to argue that deep price discounts were necessary, because the officials were pressed for time by the dire economic conditions. This argument clearly does not hold for Hungary and Poland, which entered divestment only when their economies emerged from the early recession. They have been growing fast enough for scores of economists to call Hungary and Poland success stories. Consequently, these economies should be less pressed to divest, but facts prove otherwise, since, as already indicated, both have been the fastest sellers.

Capitalist Internationalism. Communist ideology is a multifaceted ideology, defined not only by moral relativism but a number of claims, including the claim that national economy, as much as the nation-state, are artificial. Left to themselves, people will not congregate in locations defined by a national identity, or by state sovereignty. They are forced into such locations when, similar to morality, modes of association are imposed by a proprietary class, such as the capitalist under the system of capitalism.

As much as morality should be left to the labor class, it should be also up to the workers to decide on how to associate, and being a property-less class they know no national borders. Workers share the same class interest and feel solidarity with each other, so that if really allowed to shape society, they will abandon national borders, along with the state. This concept of internationalism, let’s call it – “labor (or -- worker) internationalism”, became the principal element of the communist vision of a world free of capital and capitalists.

While “worker internationalism” was made the central element for the communist program, it quickly proved its naiveté, beginning with the fact that giving the only voice to workers proved unworkable. Whatever the worker class instinct, it was never allowed to surface enough to affect the course of state actions, even less to make it fade away. To the contrary, at least initially, as in Russia under

the “war economy”, and then, with the advent of Stalin’s industrialization, labor was forced into submission, further deprived of some earlier existing freedoms.

With the working class subdued and without a capitalist class, states had not engaged in any acts of worker solidarity on their own, but focused on the pursuit of national interests. For the Soviet Russia, this interest became hegemonic, or imperial. These imperial objectives had been resisted by national parties throughout Eastern Europe to the point of each eventually assuming its own road – to communism. Most of them tried to follow their national agendas within the Soviet bloc, while a few even engaged in some sort of emancipation (e.g., Romania).

A close examination of national issues, or nationalism under communism reveals that similar to its other target for destruction – “natural” morality – communism gave way to nationalist tendencies. As much as the striving for individual freedoms finally crashed the collectivist morality, national instincts proved equally mortal to communism. Some scholars will go as far as to argue that communism was mainly defeated but its archenemy – nationalism (in particular see: Kolakowski, 1992).

Given the above developments, one could expect no illusions of internationalism left after the collapse of communism, but this is not the case. The idea of the national economy and nation-state as anachronisms, almost instantly captured post-communist minds, though in a changed form. Labor internationalism carried by workers, as espoused by communism, has been substituted under post-communism with what I like to call “capital – or capitalist -- internationalism”, carried by capitalists.

This post-communist ideology departs from the communist prototype not only in the choice of the main carrier for internationalism, but also in its conceptualization. To begin with, instead of internationalization, the different term “globalization” has been adopted from recent worldwide political debates. Other references to Marxism are dropped as well, including the notion of classes. Capitalist, as the carriers, is not a class with its own – class – interests, but is a market’s creature, which -- in the name of efficiency – is forced to pursue profits.

While there is no room in this “capitalist internationalism” for the solidarity of the communist ideology, a very similar claim is made, namely that as much as markets benefit all, capitalists as their animators, work for the a common good as well. Since additional profits translate into expansion of capital, any gains from efficiency that those profit-seekers produce, improves the lot of the whole society. And, higher efficiency feeds not only the profits that go to capitalists, but also wages of workers.

The archenemy in the pursuit of such efficiency is the nation-state and national economy. Both are said to restrict markets, and, therefore, these barriers should be eliminated. There should be no fear that local interests will be jeopardized by permitting the entry of capitalists, who are foreign citizens. They know no concerns other than efficiency and have no national affiliation or loyalty. They are ready to move their capital wherever greater efficiency is to be accomplished. And, they will share any gains that are made with whoever works for them.

Unlike the “worker internationalism” of communism that was never seriously practiced, the “capitalist internationalism” of recent Eastern Europe has become a powerful guide. This is not necessarily to say that the current leaders believe in “capitalist internationalism”, but that leaders make endless references to the notion of the nation-state as passé. Common people seem to be going along with these pronouncements, without asking themselves whether the leaders are using these arguments to illuminate them or to cover up questionable sale practices.

That “workers internationalism” never materialized may be a result of communist countries entering their systemic experiment with the idea of a forceful building-up of central power, the party/state. Engaged in such an effort, communist party/states were understandably hostile to the idea that communism means an end to the nation-state. The post-communist project, however, involves the systematic ruining of the state, leaving no political force in place with sufficient interest in defending the nation-state.

While the ideology of “globalization” is spreading widely throughout the world, it assumes many shapes, the most extreme of which can be found in Eastern Europe. Building capitalism, the region has not only recently put the moral concept

of individualism on its head by adopting personalism, but it also twisted the meaning of globalization beyond recognition. While, for instance, in Western Europe, globalization is seen as an opportunity for national economies, in Eastern Europe it is seen as a substitute for national economy.

Following its interpretation of globalization, Western Europe has spent the last decade or two relaxing the rules governing capital mobility, and cross-border transfers have intensified accordingly. There has been no justification found for a massive sale of national assets to foreign hands in Western Europe, with banking largely excluded from such transactions. However, as it should be clear by now, the East European version of the ideology of globalization has facilitated a massive sell-out of capital to foreigners, especially in banking.

This version East European modification of “globalization”, with its notion of “capitalist internationalism”, has facilitated not only the recent transfer of ownership over capital to foreign investors, but also the major loss of capital through fire-sale prices. This staggering outcome should be enough to prove the poverty of the “capitalist internationalism” ideology, since this transfer of property titles to foreigners at “artificial” prices has nothing to with the presumed pricing rationality of the unrestricted working of the markets.

5. RETAINING COMMUNIST FEATURES

Continuing with the “communist metaphor, one would assume that if capitalism is really being built in a communist manner, where the state is firmly in charge of allocation and capital assets are “abandoned”, it is very likely that the product of change will therefore resemble communism, where there is no capitalist class and wage conditions are dictated. This should be pretty obvious, since capitalism, as we have known it for centuries, with a strong capitalist class and equally strong worker (labor) class, can be built in only one way -- the capitalist way.

Class-Less Society. Communism is best seen as a social engineering project aimed at remaking class structure, obtaining the so-called “class-less” society by

eliminating capital owners, or capitalists. This is accomplished through ownership changes, namely by abandoning private property and making the remaining class -- workers -- collective owners of capital. Thus, the communist system is characterized by the simultaneous lack of, rather than ban on private ownership and the absence of the capitalist class.

This, by all means, represents the most important departure from capitalism, as well as the most striking expression of the experimental nature of communism. Unlike communism, which is class-free by design, capitalism is class-based as a matter of destiny, or better -- it is the unintentional result of endless individual trials. Social hierarchy, with various classes, including those referring to property, is "natural" to humans, in the sense that it is a precondition for survival. And, in this sense, the class structure of capitalism is a "natural" ordering system, or order.

To move from the communist system to the capitalist one, it would be necessary to restore private ownership of capital but a capitalist class would also have to be recreated. If given a chance, citizens would make sure that available state assets are put under their ownership, as a source of personal income and of material security. Gaining such security is a "natural" motive, since everything that contributes to human survival is "natural", and as long as this is true, seeking private ownership of capital is "natural" as well.

The state, by turning the majority of capital assets over to foreign owners, has denied societies emerging from communism the opportunity to acquire ownership of capital. This is the case cross the region, though diverse methods of privatization have been applied. Since all the methods eventually led to a massive foreign takeover, these countries have failed to create their own -- genuine -- capitalist classes. And, for this simple reason, as societies, they have retained the major feature of communism, i.e., classlessness.

The above insider perspective of these economies that have emerged from transition is that of a communist-like society. However, to an outsider observer they do not look this way. These countries have become capitalist, and consequently they contain a viable capitalist class, though it is foreign not domestic. But this, in itself, makes the resultant capitalist system a strange form of an absentee ownership. It is

an absentee ownership in the sense that owners of most of the local capital are foreign residents.

This foreign capitalist class has been “imported” through the privatization process that made local capital available to them. Like in any foreign trade, imports that are coming in are paid with outgoing exports. Here, what is “exported” is the privatized capital stock. The pathological capitalist system that has been brought into Eastern Europe came about by exchanging local physical capital for the foreign human capitals. Given the deep under-pricing of assets, this “import” of human capital was attracted at an extremely high cost off “exports” of physical capital.

One could ignore the fact that the capitalist class is “imported” on a number of grounds, not simply because apparently capitalists know no borders. Besides “capitalist internationalism” one can resort to various theories of modernity that claim the capitalist class – like the nation-state -- is an anachronism. One argues that capitalists, as owners, are being replaced with capital-free managers as a capital-free class. Another theory posits that a different class structure prevails, now, with professionals as one class and those without highly paid skills as another.

I find these arguments for the vanishing capitalist class fantasies, since as long as capital exists and its profits are privately held, those who benefit constitute a capitalist class. And if there is the intent to suggest that it is meaningless whether the ownership of capital is local or foreign, such intent has to be questioned. Regardless of how a current capitalist society is structured, the presence or absence of domestic-owned capital is of consequence. It is thus at least the economics of this sociology that cannot be ignored in the study of transition.

No doubt, any economist with liberal credentials, including evolutionary thinkers, would have to ask right away how a system in which foreign ownership is dominant promotes freedom. The freedom of personal choice, restrained by “natural” morals, represents the essence of capitalism, and also makes for its strength, its super efficiency. Moreover, where more freedom exists within a given capitalist structure, the markets become more competitive. And, consequently, stronger capitalist structure is created.

Importantly, freedom comes with possession, i.e., with personal ownership of resources. Devoid of resources to control, individuals cannot fully exercise its freedom. Aware of this relation between freedom and ownership, liberal economists, starting with almost all the classical giants, would justify private ownership mainly on the grounds of securing, or expanding freedom. Therefore, liberal thinkers have no choice but to question a system's capitalist credentials, where capital is mostly foreign-owned..

What Eastern Europe is attempting is a trade of actual freedom for a promise that with the transfers of titles abroad an increase in local efficiency of capital will be created. This, however, is a very complicated operation to conduct, since freedom has an intrinsic value difficult to calculate. Any gain in efficiency does not diminish the interest in freedom, the opposite could occur. With such a scenario, the economic system based on foreign capital, however efficient, may be suddenly rejected.

Moreover, even if efficiency gains materialize, they should not be confused with the gains that benefit local actors. By trading their capital assets away, local actors transfer abroad the title to income from capital, i.e., profits. In an economy where capital is foreign and labor is local, profits are subtracted from the national product. An economy that is "free" of own capital is also "free" of profits – a point missed by many economists, who strangely enough assume capital for life remains in a host economy to make more profit.

This is a naïve assumption, particularly when some economists argue that capital moves in the today world so freely it is nation-unbounded. Following this argument, any misfortune in an economy dominated by foreign capital leads to a risk of a drastic flight of capital, including by cashing profits. Even with a steadily encouraging performance, profits will leave abroad eventually, since the ultimate purpose of creating capital is consumption. And, to be consumed profits have to be transferred abroad, where the owners reside.

States may move to restrict an outflow of profits to foreign owners, but it is difficult to do so, when foreign capital dominates to the extent it does now in Eastern Europe. To make matters more complicated, the foreign owners are by and large

cross-national, and there are operations scattered throughout the world. For this reason, foreign-owned companies possess enormous ability to globally shift their capital, combined with superb ability to hide their transactions from the state, so that profits cannot be easily traced for the purpose of banning their outflows.

These are not pure speculations, as evidenced, for instance, in Hungary. During the last two-three years, a huge stream of capital-income flow abroad has emerged. Reportedly, as much as 1.5 billion dollars has flowed on an annual basis as income from capital. This has been quite a lot for an economy with 50 billion dollars in national product. Coinciding with a near-end to privatization, the inflow of foreign money has declined, and barely covers the ongoing huge outflow of income from capital.

Poland is rapidly reaching same point. The capital balance may soon become negative as well, although it is much harder to estimate the actual outflow of capital income – profits – for Poland than for Hungary. The size of this stream can be estimated by the extent to which foreign-owned companies hide their profits away from the treasury. It appears, that, based on such estimation, Poland, with almost the same amount of capital already sold in dollar terms, permits an annual outflow of at least 2-3 billion dollars (compare Laski 1999).

Subordinate Labor. Drainage of profits from the national economy is one risk that a massive capital sell-out brings in, but there exists another one. One must recognize the fact that perfect markets, with the power factor completely absent, do not really exist. Whenever power – economic superiority -- does interfere, prices are not perfect, so that factors of production – capital and labor – are not perfectly priced. In other words, capital may seek rents from labor, or otherwise labor may seek rents from capital.

In communist system, the presence of power as an intervening force is absolutely obvious. Indeed, this is an economic system of an extreme form of power systematically applied to affect the distribution of production effects between wages and profits, in accordance with the needs of those in charge of capital, the party/state. In fact, all the major elements of the system were employed to keep

wages – and consumption -- in tight check, maximizing the part of production directed to capital-formation, or investment.

This was quite a twist considering communism is founded on an ideology claiming that the party is a vanguard force representing labor, including labor's interest in wages. The same ideology, however, claims that communism will produce an economic breakthrough and required wages to be sacrificed first. By sacrificing wages profits increase and allow for faster expansion of the capital needed for the promised breakthrough. Therefore, the communist party/state sided not with labor, but with capital, as a vanguard force of the just dismissed capitalists.

This bias in favor of capital lasted through the end of the communist system, though it was somewhat relaxed partly in response to the fact that modernization seemed to succeed. Labor for its part, disappointed with its "role" in this modernization "script", strengthened its power and applied pressure on the party to favor wages. Early examples of such shifts are Hungary under Kadar, where the party used wages to calm the population, and Poland, under Gierek (Ekiert 1996; Poznanski 1996)).

Nowhere, however, were unions allowed to genuinely represent labor. Official unions, bureaucratic structures dependent on the party, were allowed to openly operate. An exception was Hungary, where, following Kadar's concept of multi-polar balance of political power, trade unions tended to follow their own line. Another, even greater exception was Poland, where for the last ten years, unofficial unions, opposed to the party, were tacitly tolerated as an alternative to official, pro-party unions.

Growing labor pressures clearly played a role in undermining the communist system. One could, therefore, assume the ultimate collapse of communism will further relax the wage dictate. But the ownership structure that has just emerged does not seem certain to facilitate such a power shift. The latest reforms largely transferred assets from the party to foreigner owners, and, presumably, the power imbalance has not disappeared. Instead, most likely, with this title transfer, power to dictate wages has been shifted from the party to the foreigners.

The power over wages that has been shifted into new --foreign -- hands, is now exercised within a production structure set up by the communist party/state. Production was conducted mainly by monopolists, which increased the power of the party/state to dictate wages. This structure remains after privatization, and is preserved, and even strengthened by the foreign owners, who most often have added their local acquisitions to their even stronger mother-organizations, operating as multinationals.

The monopolistic production structure has been retained along with the special position of capital but the departure of the party/state has not created an increase in the power of labor. On the contrary, freed from party/state's intrusion, unions have been allowed to deteriorate, both in terms of total membership and political resolve. Even post-communist Poland, with her strong labor movement tradition, has seen its unions greatly weakened. Such development has further increased the probability of another wage dictate.

If the communist-era wage dictate really continues, it would be largely due to the state's failure to properly structure both capital and labor. More precisely, it would be another negative outcome of the state's deep crisis. That monopolistic structures have been left unbroken stems from state's preoccupation with selling assets. Since this highly monopolized structure has been retained, for capital and labor to be balanced, the state would have to ensure that an equally powerful structure is put in place for the labor, but no such concern has been on state's mind.

No steps to empower labor have been taken in Eastern Europe, ignoring the fact that at least in Western Europe, where modern capitalism is a corporate system, states maintain a proper balance between capital and labor. This balance of power is actually a cornerstone of what is called the "welfare state", since only under such a balance a fair – socially acceptable – distribution of wealth is assured (an example is, largely admired in Eastern Europe, Germany, with its three-way wage negotiating system where owners, workers and state are involved).

The empirical question is, whether, by producing a greatly imperfect market and largely dysfunctional state, recent ownership reforms have left in place a mechanism under which capital earns rents from labor. No liberal economist, who

understands that institutions matter, and that power intervenes into economic affairs, can ignore this empirical question. Preliminary findings seem to suggest that, like communism, the post-communism indeed favors production over consumption, i.e., capital over wages.

Hungary and Poland are the most compelling cases, where production recently has expanded faster than in other East European economies, and labor productivity has shown gains exceeding those reported in most of the region. Accordingly, these two economies could, it seems, afford considerable wage increases for the local labor. This has not been the case in the most recent years. To judge the future on the basis of this most current would be premature, but the facts warrant our attention.

After the 1990-1993 recession, resulting in major wage loss, Hungary, in the last three years, has shown major production gains. But accompanying austerity program has cost labor a virtual wage freeze. Poland's 1990-1992 recession took away about a fifth of an average wage. The last three-year growth of production is not as impressive as in 1994-1997, but still very reasonable. Nevertheless, there have been no recent real gains in wages for the majority of labor (gains have been limited to groups that rely on profits from capital).

The future, long-term potential for wage gains does not look very bright either, since both countries' public debts have increased dramatically over the last decade of reforms, particularly in Poland. Poland's foreign debt – public and private – has almost doubled since 1989, approaching the alarming level of nearly half of its annual national product. The state, to service this debt, state will have to direct an even greater portion of its national product abroad, mainly by tapping into wages.

CONCLUSIONS

Eastern Europe, from 1989/1990, at the start of the reform process started, slipped into the midst of a seemingly unending economic recession. Many of the countries that managed to lift themselves from the initial slump are now in a second recession,

e.g., the Czech Republic, Bulgaria and Romania. Those that have avoided such a repetition are considered successful, but their economies rest on shaky foundations, including Poland, erroneously considered by mainstream observers as a model of transition success.

Because of its durability and incredible depth, this regional downturn cannot be called a regular recession. Eastern Europe, excluding the former Soviet Union, initially lost a quarter of its collective gross domestic product. In 1999, it was only few percentage points above the 1989/1990 level. In the former Soviet Union, the situation is worse, because it lost half of its gross domestic product in a ten-year long slide. At best, it will take these countries, along with Russia and Ukraine, another ten years to fully recover from this slump.

The post-communist recession, with its terrible record of production, is more accurately called an economic catastrophe, the worst in modern history, including the Great Depression of the thirties. This particular point has been stated on a number of occasions but to no real effect, since most writing about the transition considers it a success anyway. The existence of the recession is denied, or, more frequently, claimed to be a statistical illusion obscuring a remarkable renewal of all these economies.

The popular perspective (e.g., Balcerowicz 1997; 2000) holds that no one should be misled by official statistics, including the fact that right after 1989/1990, the region's industry lost about one third of its output and in 1999 was still a few points below 1989. Apparently, this is not a sign of recession, but of renewal, since under communism, due to its political nature, industry was overgrown and market reforms cut it down to the right size. How can this really be the case, since the region remains semi-industrialized, and, thus, presumably, lacking capital goods?

Some analysts who applaud ongoing de-industrializing also claim there is no reason to worry about the recent plight of another major sector, agriculture. After 1990, the loss was so deep, that by 1999, the combined region's output remained more than ten points below the 1989 level. Agriculture was not overgrown due to some communist obsession, but this decline is called a renewal anyway. As a

backward sector, its output should decline, under market regime. But, if forced by the same market to restructure, agriculture should see a definite increase in output.

Among transition experts are these who acknowledge the existence of the regional recession, but offer yet another positive spin. Namely, they forcefully argue that while the decline in production is real, it simply represents a cost of setting up a capitalist system. Everything comes at cost, including changes in economic systems, and the more courageous the effort, the higher the costs to bear. But, the reality is that in the switch from communism to capitalism, a degenerate form of capitalist system has emerged.

The same analysts distorting the picture of recession also accept as normal a system where capital is mostly foreign and labor remains local. They assure that systemic change is positive on the grounds that markets, as superior mechanism, are expanding and that the progress of private ownership is the best evidence of this happening. They are unmoved by the fact that the emerging property structure denies societies opportunities to keep profits for themselves and to form their own strong capitalist class.

Supporters of systems, where capital is foreign and labor is local, seem to believe some forces of history – reason – create the system. Neither in their analyses of ownership changes, nor in their examinations of the recession, do they pay any attention to the state's critical role in causing both. While markets expand, states decay, and, because states are central for any system, the system as a whole falls into disrepair as well. This systemic failure is the explanation for both economic catastrophe and systemic pathology.

The ongoing transition to capitalism is an important lesson on economic reality seriously deviating from economic accounts. It is also a lesson on how mistaken accounts hurt an economy. More, this is also a lesson that no lessons have to be drawn from some already experienced painful delusions. This is the case of Eastern Europe, which is already in another transition, from communism to capitalism, but there no evidence that with its post-war experience the region is wiser that during its earlier transition, from capitalism to communism.

The communist experiment, initiated decades ago, was based on two misconceptions, first – that progress requires a wholesale denial of tradition, i.e., dispensing with existing institutions, and second – that to assess change a new set of indicators must be used. This way of thinking prevented the leaders from realizing they were actually pushing their societies backward economically. The outright rejection of tradition destroyed systemic foundations, preventing their economies from breaking out of backwardness.

The post-communist situation is not much different. Existing institutions of communism were destroyed on a massive scale in order for communist tradition to make room for progress. There should be no doubt that some institutions worked reasonably well under communism, because communism survived several decades. Many useful institutions, including communist takeovers from capitalism, were allowed to decay anyway. As a result, economies suffered tremendous damage, which went largely unnoticed, since again, newly invented indicators obscured the real picture.

In a capsule, the communist experiment represented a radical assault on one central element of tradition -- the market, and the market provides superior economic cohesion. In turn, the post-communist experiment represents a radical assault on another principal element of tradition – the state, and the state provides superior political cohesion. Economic cohesion is not possible without political cohesion. The market and the state complement each other. The more carefully these two institutions are weighted against one another, the more efficient a given society becomes.

The post-communist reformers missed this elementary truth, instead perceiving the ongoing decay of the state as a sign of progress. Reformers have largely downplayed the damage the state decay caused to the economy, calling production losses a “necessary” cost of progress. The ongoing economic difficulties mean, to the reformers, a success because of undeniable structural changes. Though, in actuality even this restructuring often reflects regression, since production and employment in major sectors, industry and farming, are stubbornly down.

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Lessons from Economic Transformation:
Economic Actors and their Behaviour in Russia

Satoshi Mizobata*

Kyoto University, Institute of Economic Research

Paper for the international conference "Evolution and Transition"

Kyoto, Japan, March 27-30, 2002

Introduction

Throughout the ten years of market transition, all transition economies have shown economic recovery. In contrast with the recession of the world economy, these countries have shown stable economic growth since 1999. EBRD (2001) estimates 4.3% GDP growth in 2001 and 3.4% in 2002. Particularly, after the Russian financial crisis, the recovery process in Russia has been drawing attention. Currency devaluation and the rise of oil prices gave a boost to the Russian economy. The recovery is accompanied by changes in the economic structure. Since 2000, rising domestic demand, the investment boom in the petroleum and gas industries, increasing investment in non-energy sectors, and the boom in consumer markets have become the driving forces of economic growth. Russia may change its growth path from a resource-dependent type to domestic market-dependent one with rich resource sectors (Ekspert, No.1-2, 14 January 2002). Moreover, Russia has been strengthening its efforts to achieve WTO membership.

On the other hand, the Russian economy shows its own peculiarities in transaction style, economic actors' behaviour and actors' interests. In spite of liberalisation, stabilisation and privatisation, budget and administrative constraints of enterprise behaviour have been kept soft (Y. Gaidar, 2001). Weak government and weak adaptability to market mechanisms can be also observed. At the same time, these features tend to be "normalized" as a result of the economic recovery, the strengthening of the state and the development strategy of the Putin government. Legal arrangements in taxation, social policy and some market institutions have remarkably improved in recent years. Normalisation and legalisation, however, cannot change economic actors and their behaviour at once. Radaev (2002) stresses some obstacles to normalisation and suggests it might take a longer time. In short, features such as the large share of the informal economy and widespread corruption cannot be in harmony with globalisation trends.

This paper examines Russian market mechanisms focusing on economic actors and their behaviour over the ten years of transformation. I also discuss some features of market institutions and rules, and draw lessons from the economic transformation.

1. Discipline-encouragement vs. Protection-discouragement

Generally speaking, the results of marketisation are measured by macroeconomic statistics. For example, the degree of economic recovery in comparison with the pre-transition level and duration of transition recession can be regarded as performance indicators. As for years of negative GDP growth during thirteen years from 1989 to 2001, Central East Europe indicates about 4 years on average, the Baltic countries 5.3 years, Southeastern countries 6 years, and the Commonwealth of Independent States (CIS) countries 7 years (EBRD, 2001). There is also a gap in performance judging from the GDP index compared to the pre-transition (1989) level. Central East Europe has exceeded the pre-transition level, the Baltics and Southeastern countries have achieved about 70%, and CIS countries except Belarus and Uzbekistan have recovered to less or about 60%. However, such a divide does not necessarily suggest markets perform better in some countries because countries like Belarus and Uzbekistan have shown relative high performance without implementing market-oriented reforms.

The World Bank (2002) surveys the ten years of transition in East European countries and the countries of the former Soviet Union and identifies two conditions necessary to realize the beneficial effects of reforms. The first is discipline "imposing hard budget constraints on enterprises, providing exit mechanisms for insolvent enterprises, monitoring and influencing managerial behaviour to reward efficient stewardship of assets and to discourage tunneling and theft, increasing product market competition, transferring social assets from enterprises to local governments, and using the social safety net as a cushion for displaced workers and other losers from reform" (xxix). The second is encouragement (encouraging new enterprises) which "requires establishing secure property and contract rights and providing basic infrastructure, reducing excessive marginal tax rates, simplifying regulatory and licensing procedures, and developing a competitive and efficient banking system" (xxx). The former means the degree of adaptation of old enterprises to the market environment, and the latter indicates the possibility of entry of new enterprises. When discipline and encouragement are not established, the modes of adjustment can be regarded as protection and discouragement.

The transition economies can be classified, based on different modes of adjustment (p.34). The first is the case of Estonia, Hungary and Poland, where discipline and encouragement have been strictly implemented. The second is the case of the Czech Republic, Lithuania, and the Slovak Republic, where softer budget constraints within the mode of discipline and encouragement can be observed. We can define the third mode as a failure to maintain discipline and encouragement (protection and selective encouragement), which is what happened in Bulgaria, the Kyrgyz Republic, Moldova, Romania, the Russian Federation and Ukraine. This mode has led to state capture. The forth mode is the case with no discipline and encouragement in Belarus, Turkmenistan and Uzbekistan, where the inherited mechanisms from the command economy have been maintained.

Differences in the share of small enterprises gives us a clue to the above-mentioned classification, because small enterprises enter markets in response to market barriers. The share of employment in small enterprises in Central Europe (more than 40% in 1998) is higher than that of CIS countries (less than 20% in 1998) (EBRD, 2001). In Russia, the share of small enterprises is not so high, and after a surge at the start of the transition, there is a tendency of decline both in numbers and employees. Table 1 provides evidence on the entry of small enterprises. In 2001, the share of employees in small enterprises was about 10%, and we can observe a decline since 1994.

Table 1. Share of small enterprises in Russia (end of the year)

	1991	1994	1996	1997	1998	1999	2000
number (1000)	67.0	896.9	841.7	861.1	868.0	890.6	879.3
percentage of enterprises	-	46.1	33.6	31.6	29.9	28.7	26.3
employees(1000)	2344.6	8479.9	6269.1	6514.8	6207.8	6485.8	6596.8
percentage of employees	3.2	12.4	10.0	10.9	10.6	10.3	10.2

Source: The Goskomstat RF, *Rossiiskii Statisticheskii Ejegodnik*, 1992-2001.

Market transition indicates clear differences not only in economic performance but also in responses and modes of actors' behaviour. By analyzing economic actors and their behaviour, I discuss the evolution of the path to a Russian market economy.

2. Economic actors and their interests in Russia

Market transition has simultaneously created both winners and losers, and privatisation can be regarded as the process of their separation by gains and losses in income and assets. Below I examine economic actors on the case of privatisation in Russia.

The Russian privatisation has two main features: populist voucher distribution, and insider ownership and control (by employees and managers). As a result of populist privatisation, about two thirds of shares became owned by insiders, and this ratio was as high as a half of all shares even in 1999. The high share of employee ownership reflects the adopted methods of privatisation. However, on the whole, insider control has been diminishing, and employee shareholding has decreased while manager shareholding have grown bigger. Therefore, insider control means management by managers themselves. While at the initial stage of privatisation, managers' control was based on a compromise with the employees, recently they have increased their shareholding in order to stabilize their control.

Since 1995, outsider ownership has grown through the following ways. First, due to the shares-for-loans privatisation, which was prohibited in July 1997, large banks and enterprises obtained

controlling stakes in large state enterprises based on negotiations with political elites. As a result, outsider ownership increased, and the so-called “oligarchs” and their networks were formed. Secondly, the spot privatisation, which meant the transfer of large state enterprises (decided in 1997), stimulated outsider control and the formation of large-scale business groups -- so-called “oligarchs”. Restrictions on foreign investment were also relaxed. Thus, integrated business groups (Ia. Pappe, 2000) were established, and close ties with the government strengthened their economic and political power. At the same time, as the financial institutions had an inclination to speculate in state bonds, the proportion of their shareholding in total assets was insignificant (3.9% at the beginning of 1998). The financial crisis has brought a drastic change in ownership, control and management. Table 2 indicates the change of ownership structure.

Table 2. Ownership of the Russian Industry

(according to the Russian Economic Barometer Monitoring, 1995-2001 , %)

	1994	1995	1997	1999	2001(forecast)
Insiders, total	65	54.8	52.1	46.2	45.5
Managers	9	11.2	15.1	14.7	18.2
Workers	56	43.6	37.0	31.5	27.2
Outsiders, total	22	35.2	38.8	42.4	44.9
Non-financial, total	-	25.9	28.5	32.0	31.9
Outside individuals	-	10.9	13.9	18.5	16.9
Other enterprises	-	15.0	14.6	13.5	15.0
Financial, total	-	9.3	10.3	10.4	13.0
The state	13	9.1	7.4	7.1	6.4
Other shareholders	-	0.9	1.7	4.3	3.2
Grand total	100	100	100	100	100

Source: S. Miaobata, 2001b, R. I. Kapelyushnikov, 2000, p.15.

Manager control does not mean there is no significant turnover of managers. While, on the whole, managers seemed to keep their control inherited from their previous position, 71% of the surveyed enterprises have reported the replacement of managers in 1992-1999. The share of traditional managers, who have controlled the enterprises since the pre-transition period, is just 24% (A. Radygin and S. Arkhipov, 2001, pp.121-122).

A. Radygin (2002) points out six features of Russian corporate governance:

- 1) Permanent ownership redistribution in the enterprises,
- 2) Specific motivation of many insiders (managers and large shareholders) with regard to the control of financial flows and the stripping of corporations' assets,

- 3) Weak role of outsiders,
- 4) Considerable share of the government in stock capital,
- 5) Active role of federal and regional authorities as independent actors in corporate relations,
- 6) Ineffective enforcement by the government.

The evolution of ownership structures and patterns of control in Russian enterprises reveals the instability of property rights, the government's role as an influential actor, insider control, and the strong power and opaqueness of powerful firms and financial institutions.

Next, I discuss changes in the financial institutions. Their number and scale increased rapidly (their number reaching a peak in 1995-1996). After the financial crisis, many commercial banks were liquidated, and 1322 banks were in operation in 2001. Although Russian financial institutions were more specialized in speculation rather than intermediation (S. Mizobata, 2001a), they played the role of centres or of main banks of integrated business groups. After the financial crisis, the commercial banks have not lost their role but the government has strengthened its influence on them. Both federal and regional governments have kept shareholdings in more than half of all commercial banks. The large banks and the government have been tied to each other through the Agency for the Restructuring of Credit Organizations (ARCO) and stabilization financing (S. Mizobata, 2001a). Though the Putin government wished to restrict the oligarchs' influence, the integrated business groups have kept their power.

As the government has kept its power as an economic actor, specific activities such as rent seeking have continued. Economic actors have drastically changed as a result of privatisation. The government, the large enterprises and their groups, and insiders have behaved as winners in the Russian transition. The World Bank (2002) suggests that the attitudes of three constituencies -- state sector workers, potential new entrants, and oligarchs and insiders -- toward the liberal economic transition have differed (xxii-xxiii). Next, I examine the behaviour of economic actors on the cases of specific transactions and the informal economy.

3. Behaviour of economic actors in Russia: Survival and negotiation

In order to study the behaviour of economic actors empirically, we draw on research made by "The Russian Economic Barometer", Institute of World Economy and International Relations, Russian Academy of Sciences. S. P. Aukutsionek and A. E. Batyaeva (2000) have presented the results of one empirical survey of enterprises. They indicate the following three characteristics of Russian enterprise behaviour: production in loss-making enterprises, overmanning (labour hoarding), and barterisation (non-monetary transactions). The above three can be observed as follows. First, the contemporary unprofitable production is different from the phenomenon that can be found in the socialist economic system, because the former is the result of independent enterprise behaviour. It

occupies 14-15% of total production, and even taking into account loss reduction after the crisis, the absolute volume of losses has been kept. Secondly, labour hoarding can be observed even in Eastern Europe. In 1994-1996, about 60-70% Russian enterprises kept excess workers, and more than 7% of production costs was directed to overmanning. As a result, almost all enterprises pointed out that the primary goal of production was not profitability but supporting the workers. Thirdly, non-monetary transactions increased in 1990s irrespective of the hardness of monetary policies. The above three phenomena are not the result of a cyclical crisis but of the behaviour of economic actors. While normal market actors aim at profit-maximization, Russian enterprises considered organization maintenance as their first objective.

The correlation between performance and the stock of finished products clarifies the response of industrial enterprises, which was inherited from the socialist system. "The more stocks of finished products deviate from the optimal level, the worse are the financial conditions of an enterprise" (S. Aukutsionek and A. Batyaeva, 2000). It is often pointed out that excessive inventories are used for survival (Table 3). The correlation suggests the internal values and motivations of the enterprises affected management stronger than demand constraints.

Table 3. Stocks of finished products, industry
(normal monthly level=100, end of the year)

1992	1993	1994	1995	1996	1997	1998	1999	2000	2001(Nov)
83	104	78	96	88	82	78	73	74	84

Source: *The Russian Economic Barometer*, 2001, no.1, p.43.

Usually, Russian enterprises would attach great importance to keeping production. Concerning the intention for barterisation, tax avoidance is secondary¹⁾, and barter becomes a method for production maintenance as well as arrears in incomplete markets. Even though it is difficult to seek transaction partners in barter, barter is the result of a subjective choice of survival-oriented strategies by producers and of the networks established in the Soviet era. During 1995-1997, two thirds of barter transactions were utilized for production (Table 4), and enterprises did not have strong motivation for resale and rebarter.

Table 4. Share of barter in sales, industry (% , end of the year)

1992	1993	1994	1995	1996	1997	1998	1999	2000	2001(Nov)
6	11	18	26	40	47	49	36	19	13

Source: *The Russian Economic Barometer*, 2001, no.1, p.43.

As for overmanning, Russian privatization stimulated labour hoarding because of insider control

and worker privileges. Two thirds of the enterprises regarded labour hoarding as normal behaviour, although it reduced labour utilisation level. After the financial crisis, an upward trend can be observed (Table 5). Employment maintenance has been the priority in many enterprises.

Table 5. Labour utilization (normal monthly level=100, end of the year)

1993	1994	1995	1996	1997	1998	1999	2000	2001(Nov)
75	79	73	72	78	78	85	88	88

Source: *The Russian Economic Barometer*, 2001, no.1, p.42.

The above three phenomena suggest that Russia has failed to enforce discipline through hard budget constraints, and enterprises have been adapting to survive. Russian enterprises have often preferred survival measures such as the sale of stocks and fixed assets, subsidies or other forms of financial support from the government, to bank credits, layoffs and wage cuts. Such behaviour is typical of almost all economic actors and does not indicate a clear correlation with efficiency. In short, some enterprises combined survival-oriented behaviour with high economic performance.²⁾

In addition, such behaviour has been sustained through negotiations with the government and lobbying. The influential integrated business groups affect government and politics through various channels. It is said that the typical lobbying has continued in the military-industrial complex, the fuel-energy complex, and the agro-industrial complex (*Izvestiya*, 19 October 2001). Here, I consider lobbying as a response of enterprises.

4. Behaviour of economic actors in Russia: The informal economy

The informal economy plays an important role in enterprises. Radaev (2000) analyzes the shadow market segments at a micro-level. The shadow economy, in its broader definition, includes legal, semi-legal (gray markets), and illegal economic activities (black markets). All of the above can be considered as informal economy. In its narrow meaning, the shadow economy refers to gray and black markets.

The informal institutions are interwoven in economic regulation even after the introduction of advanced market infrastructure. "There exists in Russia an arena of continuous negotiation and renegotiation of economic rules among firms and state agents that is associated with differential benefits non-zero transaction costs" (p.65). The state does not lose its political and administrative advantages in bargaining with firms by its non-economic extensive status, administrative rents and political rents. Russia includes numerous and various kinds of bureaucratic procedures, which are not just the outcomes of the underdeveloped market conditions, but also of the determination of officials to maintain bureaucratic control over enterprises (p.66). "Trust among business partners in

Russia is not derived from the further development and additional enforcement of formal contracting but rather from the shadow, i.e. from the structure of informal relationships and implicit contracts" (p.67).

Radaev (2002) points to the evolution of informal institutions based on the tariff regulation regime in Russia. First, for the sake of the lack of high tariff barriers in the end of 1980s, enterprises enjoyed transparent rules. Secondly, the sudden increase of tariffs created competition for privilege opportunities. Thirdly, the abolition of privileges under high tariffs in mid-1990s created the gray structure which is different from official rules. Such evolution can be observed in the field of bribery too: development towards exchange of services based on more sophisticated ways, and mutual trust between entrepreneurs and officials like relational contracting or reciprocal arrangements (V. Radaev, 2000, p.72).

R. I. Kapeliushnikov (2001a) also analyses the informal economy as the fundamental feature of Russian markets. He emphasizes that Russian market arrangements are incomplete, and there exist some fields without common rules, where unwritten habits occupy higher rank. He points to the following phenomena of the informal economy: arrears, barterisation, budget expenditure out of the purpose, transactions over tax exemption and privileges, delayed wage payments, second jobs, hidden and unpaid work, and others. When state strength in Russia and Eastern Europe is compared, it can be said that there is more room for enlarging the informal economy spontaneously as the shock from the Russian state collapse is larger than that in Eastern Europe.

While the informal economy is in conflict with official market rules, it plays the role of a cushion of the shock in incomplete Russian markets. This means the Russian market is not a market system without institutions, but rather a market system with a retreat from official market rules. The hybrid of formal and informal suggests the following (S. Mizobata, 2002). First, the planned system itself included informal relations (such as *tolkachi*) for fulfilling the plan, and such relations spontaneously penetrated the official after the start of economic reforms. The contemporary hybrid has been based on experiences and inertia of the past. Secondly, the transition period is a groping process of the new balance between the formal and the informal. While experiences in Central Eastern Europe have brought the retreat of the informal because of EU accession, in Russia the informal economy has enlarged and some new market rules have been understood based on the new balance.³⁾ For example, when the law on bankruptcy was passed, many market actors regarded it as an instrument for property transfer. (*Kommersant*, 12 February 2002)

The informal relationships have strongly influenced Russian markets, and as official rules the planned and the market economies are remarkably different, the expected costs of adapting and learning the official rules will be very high. Therefore, in such a balancing process changes become sluggish. (J. Winiecki, 2001)

5. Normalisation, legalization and their costs

All transition economies have shown economic recovery not only in economic performance but also in establishing a more or less market environment. Russia can be cited as an example of "normalization" of markets.

The Russian Economic Barometer (20001, no.3) and S. P. Aukutsionek (2001a) empirically show that the capacity utilization rate, stocks and orders have increased, while barter dealings have declined. This means the market environment has improved, though change by industry has been uneven. Labour utilization has been kept high (more than 80% of the normal level during 1999-2001), and job creation has also been increasing. All these phenomena suggest higher adaptability to markets without any decisive changes in economic policy. Based on this, Aukutsionek insists that a "quiet" normalization process is underway.

Two legal changes stimulated the normalization process. One was the tax reform of 2001 (lower taxation of enterprise profits) which encouraged capital investment (S. Aukutsionek, 2001b, pp.6-7). The other was the revision of the law on bankruptcy, which removed the influence of faithless arbitration managers. This is expected to reduce the opportunities to use this law for tax evasion and ownership transfer.

However, the positive economic recovery does not necessarily lead to normalization. A. Batyaeva (2001) surveys industrial enterprises after 1998 and concludes on an optimistic note that a lasting stabilization of demand develops normal market behaviour, while pointing out some negative inertia like seeking support from the government. Other empirical surveys give a more cautious perspective.

Radaev (2001, 2002) emphasizes that entrepreneurs underestimate the normalisation costs and regards the normalization process as gradual. In spite of some indicators of market-oriented behaviour, we can still observe barter in the state sector, the lack of correlation between competition and economic performance, and a gap of response to taxation (S. Afontsev and R.I.Kapelyushnikov, 2001). Barter dealings also seem to be unstable, since the Russian economy has seen no other institutional changes, and the possibility of repeating barter cannot be denied because of the institutional niche (V. Tambovtsev and L. Valitove, 2001, p.12). In addition, during the ten years of transformation, inertia has affected enterprise organization, and members of enterprises have been separated vertically and horizontally (G. Kleiner, 2000). Such a separation may become an obstacle to normalization. Especially, some top managers cannot develop strategies adapted to markets (Iu. F. Mordashov, 2001).

As long as proper financial and legal formal institutions do not exist or do not sufficiently operate, the transition-original behaviour will continue to play a role to maintain production and employment, based on a kind of harmonization of interests among economic actors.

6. Factors affecting the behaviour and its influence on the Russian market transition

What factors affect the behaviour of economic actors? Generally speaking, economic policy has strongly influenced the outcome of the transformation. Therefore, the behaviour of economic actors can be regarded as a response to liberalisation, stabilisation and privatization policies. Particularly, since 1995 the impact of economic policy seems to be stronger than before. Moreover, another two factors have influenced the transition process.

The first factor is initial conditions. Even though initial conditions affected the initial output collapse, their influence has faded as time passed (The World Bank, 2002). They have a greater impact on reorganizing and building market institutions.

In markets, institutions with safety nets are indispensable. These institutions constitute not only the formal framework like laws but also the informal one with traditions and norms (A.N.Oleinik, 2000, pp.187-196). The crucial lessons from transformation are that liberal economic policy cannot automatically build market institutions, and that transition has been strongly influenced by inertia. The view of rational institutional building was criticized as follows. First, the capitalist system itself has experienced evolutionary changes. Secondly, some advisors apply the general model without considering historical approaches. Thirdly, "the collapse of communism" means not a vacuum of institutions but an adaptation process including markets, the plan, and other adjustment modes like traditions, networks, implicit social contacts and cooperation. This is due to the characteristics of the planned economy which originally included informality itself (J.M.Kovacs, 1994, pp.63-91).

Behaviour like rent seeking, barter and arrears has its roots in the Soviet era, and there exists a kind of continuity in transition. For example, barter has developed since the Soviet era, and while it occupied 2-6% of total industrial production in 1960s, this share sharply increased in 1980s, when shortages became more serious (V. Makarov and G. Kleiner, 1999). Labour hoarding was also typically observed in the Soviet era due to the shortage economy.⁴⁾ Arrears were the result of soft budget constraints. Therefore, contemporary behaviour was selected, based on inertia and the learning process (Y. Kusnetsov, 1997, p.171) and was affected strongly by the informal sector.⁵⁾

The second factor is government failure, weak state or the failure of transition from a government in the regime of planned economy to one in the regime of market economy. All economic actors consciously responded to the weakness of the state.

The declining role of the government has been correlated with the behaviour of enterprises and restraint by market discipline. First of all, though the state does not have enough credibility, it has a high capacity (a legacy of communism) to offer rents to economic actors. Secondly, as the state weakened, it faced difficulty implementing the liberal economic policy because of lack of trust and lobbying by various stakeholders. As a result, imbalances in the reform process have emerged, and such asymmetries have created a wide range of arbitrage and rent-seeking opportunities (The World

Bank, 2002, p.105). ⁶⁾ On the whole, access to such opportunities is uneven, and influential economic actors like oligarchs have an advantage. All this intensifies public distrust of politics. Thirdly, the weak state itself applies the brakes on reforms, because not only winners like insider managers and oligarchs but also workers have tried to gain from partial reforms. Thus, there exists a kind of vicious circle among the interests of economic actors, their peculiar behaviour and the weak state.

Here I consider three factors -- the liberal economic policy, initial conditions and their institutional legacy, and the weak state -- as the main causes of Russian type of economic behaviour.

Next, I discuss the meaning of economic behaviour peculiar to Russia's transition. As behaviour is based on legacy and inertia from the past, it may be regarded as non-adaptation to markets. In his analysis of Russian market environment, J. Kornai (2001) argues that in Russia "the soft budget constraint (SBC) syndrome reinforces itself like a spreading and deepening cancer" (p.1594). Then, he states that "the umbilical cord between the enterprises and the state was not severed" and that "these links between them are what preserves the SBC syndrome" (p.1590).

At the same time, as I indicated earlier, the peculiar behaviour is not necessarily associated with negative performance and does not reveal fragility, because of the vicious circle and partial satisfaction of economic actors based on inertia. Therefore, the above-mentioned behaviour can be regarded as a rational adaptation to the incomplete Russian market. For example, D. Marin and M. Schnitzer (2002) insist that such a result is "a response to an underdeveloped financial and legal system in which contracts and credit repayment are only weakly enforced" (p.179) and point out that there is an institutional trap in the economy. Moreover, R.I Kapelyushnikov (2001b) names the Russian original transition an "adaptation without restructuring" (p.156). While after the ten years of the transition, various kinds of market institutions and rules have started functioning, Russian markets have formed their own kind of actors and behaviour, which prevent complete restructuring. Such causality means that transition has made progress with an institutional trap for economic actors. As conflicts among economic actors are suppressed, changing the course to "adaptation with restructuring" needs relatively long-term motives and experiences in formal market rules, as well as a strong and reliable government.

Notes

* Associate Professor of Economics, Comparative Economic Systems, Institute of Economic Research (KIER), Kyoto University. 606-8501 Kyoto, Sakyo-ku, Yoshidahon-machi. Phone: +81-(0)75-753-7144, Fax: +81-(0)75-753-7148 e-mail: mizobata@kier.kyoto-u.ac.jp

1) The Ukrainian case (D. Marin and M. Schnitzer, 2002) indicates the same result. "Tax reasons are not the major motivations behind barter." (p.123)

2) In the Ukrainian case, the correlation between barter and efficiency is near zero and insignificant.

(D. Marin and M. Schnitzer, 2002, p.112) "Firms with total arrears of more than 25 percent of output did substantially better in terms of output than firms with total arrears of less than 25 percent. A similar picture emerges for barter exposure. Firms with a barter share of output over 70 percent did less well, and those with a barter of over 30 percent performed better compared to the economy as a whole" (p.135).

3) The western legal tradition in Central Easter Europe cannot be ignored (S. White, 2001).

4) In 1984, the average reserve of staffs was estimated at about 15-20% of all (S. Ohtsu, 1992).

5) I do not insist that economic actors have simply extended their traditional behaviour that existed under communism. Needless to say, there is a critically significant difference between economic behaviour in transition and that under communism. This view can be observed in W.L.Miller, Å.B.Grodeland and T.Y.Koshechkina (2001) on the topic of corruption. "Although the old communist system with its peculiar scope for corruption was replaced, the new post-communist system provided its own new incentives and opportunities."

6) Here I suggest the following as imbalances in Russian reform: price liberalization and the freedom of monopoly, privatisation and continued interference by the government, suspension of subsidies and informal or hidden subsidies.

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Economic Transition in Bulgaria from an Evolutionary Perspective:
The Currency Board and the Prospect of EU Accession

Dimitar Ialnazov (Kyoto University, Graduate School of Economics)

Paper for the international conference "Evolution and Transition"

Kyoto, Japan, March 27-30, 2002

I. Introduction

With the passage of time since the start of the transformation of former centrally planned economies, the number of researchers stressing the failure of the top-down, big-bang approach to transition has grown considerably. The "Washington Consensus" view of how these economies should be reformed is emblematic of the top-down approach to transition as it emphasizes institutional change "from above". This approach fails to distinguish between formal and informal institutions, i.e. formal and informal rules and their enforcement mechanisms (North, 1990). Formal institutions are laws and regulations that can be introduced rather quickly and should be enforced by the state, whereas informal ones are composed of habits, customs, beliefs, and norms of behavior, which change very slowly and are self-enforcing.

In particular, many authors argue on the case of privatization in former socialist countries that the adoption of formal institutions from the West has not achieved its intended results (Boyer, 2001; Engerer, 2001; Hedlund, 2001; Ovin, 2001). Privatization has served in most cases just to transfer formally state assets to the private sector, failing to stop rent-seeking activities and produce secure property rights. This has strengthened the realization that institutional change in transition economies is not the outcome of top-down policies, but rather a gradual, incremental and evolutionary process. Hence, the evolutionary approach which focuses on the change of informal institutions, as well as on the interaction between formal and informal institutions, may be seen as a more appropriate theoretical framework for understanding the post-socialist transformation (Stahl, 1998; Mummert, 1999).

This paper represents an attempt to apply the evolutionary perspective to the economic system transformation in Bulgaria with an emphasis on the processes taking place after the introduction of the currency board arrangement (CBA) in July 1997 and the invitation for EU accession talks in December 1999. The reason I attach such importance to the CBA and the prospect of EU accession is that I regard them not just as tools for monetary stabilization and adoption of EU's legal framework, but also as factors contributing to institutional change (for a similar approach, see Nenovsky and Rizopoulos, 2001). Since 1991, the year when radical economic reforms started, Bulgaria

has shown a path-dependent response to the drastic change of formal rules “from above” and become locked in the path of soft budget constraints, rent-seeking and clientelism, which eventually led to hyperinflation and the economic crisis of 1996-1997. I explore how and why all this happened in the first section of the paper.

The next section deals with the implications of the crisis and of the currency board’s introduction for institutional change. I argue that there was a great deal of social learning as a result of the 1996-97 crisis and that the CBA was designed to avoid repeating costly past mistakes. The CBA’s launch also helped kick-start the transformation of the government into a rules-based institution, a gradual process that should take Bulgaria into a new reform path. In the third section, I suggest that this process is being reinforced by the prospect of EU accession that has become quite real over the past two years. The EU has certainly been playing the role of an “outside anchor” for reforms in accession countries (Berglof and Roland, 1997). Finally, I draw the main conclusions and discuss directions for future research.

II. Path-dependence and the economic crisis of 1996-97

It is now common to attribute the success or failure of transition in individual states on some combination of initial conditions, reform policies, and the nature of the political system. In its most recent report, the World Bank aggregates initial conditions into three categories: structure, distortions, and institutions (The World Bank, 2002). Structure encompasses variables such as the share of industry in GDP, the share of trade with other COMECON countries, and the initial income level, whereas distortions refer to repressed inflation, reform history, and the average growth rate in 1985-89. By “institutions” the authors of the report mean years under central planning (market memory), location in relation to Western markets, and experience with nationhood.

Next, transition countries are divided into several groups according to the extent of economic reforms and the type of political system. Radical reformers – to this group belong most countries where transition has succeeded – experienced greater initial adjustment costs but also fewer distortions and imbalances, i.e. opportunities for oligarchs and insiders to extract rents and strip assets. By contrast, countries, where liberalization and privatization were implemented without imposing financial discipline and without encouraging new market entry and competition, tended to fall in the so-called “partial reforms trap”: oligarchs and insiders as the short-term winners of partial reforms captured the state and prevented further reforms.

Finally, transition economies are classified into four types according to the extent of political contestability, that is the extent to which key political decisions are subject to challenge by freely organized groups in and outside the government. The four types are competitive democracies, concentrated political regimes, war-torn regimes, and

noncompetitive political regimes. Competitive democracies include radical reformers such as the Czech Republic, Hungary and Poland, whereas less radical reformers such as Bulgaria, Romania and Russia are classified as having concentrated political regimes.

The authors of the report conclude that initial conditions and the type of political system affect the likelihood that some countries will follow particular reform paths. In particular, the virtuous circle in Central and Eastern European countries may be explained by historical and cultural legacies that allowed for much higher government credibility at the early stages of the transition than anywhere else. This enabled them to build a broader consensus on reform and carry out more radical reforms than in Southeastern Europe and the CIS.

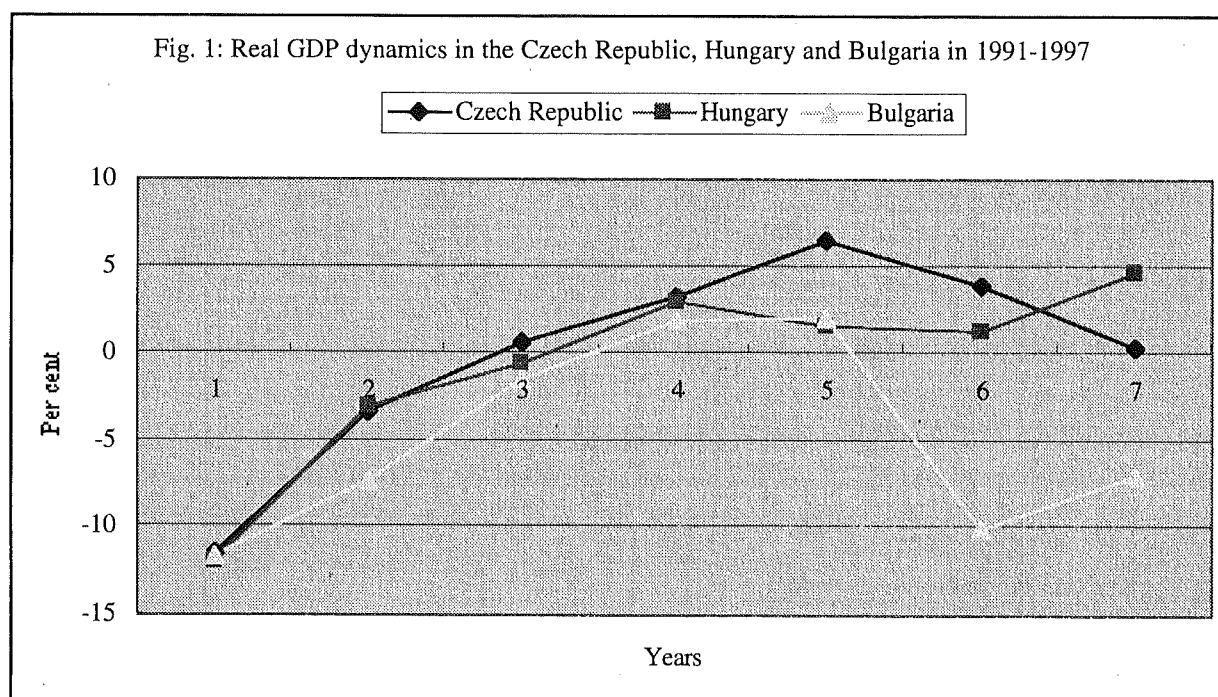
Explanations with historical and cultural legacies are consistent with the evolutionary approach to post-socialist transformation. However, there are at least two basic problems with these explanations. First, how far should we go back in the past to look for events affecting the current transformation? Some, like Stefan Hedlund, would go back as far as to the Middle Ages to analyze the role of law in Russian feudalism and link it to the rent-seeking and asset grabbing of the 1990s (Hedlund, 2001). Secondly, exactly which legacies of the past are responsible for the path-dependent nature of transition? According to Hedlund again, the fact that in Russia the law has always been an instrument of power in the hands of the ruler (unlike in Roman law) has led to a “deeply rooted pattern of rule aversion”. For others such as Richard Rose, for instance, it is the type of social capital that matters most. In anti-modern societies where the culture of trust and tolerance is underdeveloped, formal rules are commonly bent or broken, and people have to resort to bribery or personal connections to obtain access to government services (quoted in Hanson, 2000).

In the rest of this section I examine briefly the path-dependent development in Bulgaria in 1990-96 in the light of the above as well as some other hypotheses¹. Transition in Bulgaria formally started in November-December 1989 with the ousting of the former Communist party leader and the start of roundtable talks between the ruling communists (the BSP since March 1990) and the loose anticommunist coalition, the UDF. The first democratic elections in June 1990 were won by the BSP but radical economic reforms were not launched until the BSP and part of the UDF had agreed to form a non-partisan government in January 1991. The government reform program was backed by a IMF stand-by loan. In early 1991, prices were liberalized, the state trading monopoly was abolished, and liberal foreign trade and exchange regimes were established. The basic interest rate was raised from 2% to 45%. The small privatization started but the large-

¹ For a detailed examination of Bulgaria's economic transition, see, for instance, the OECD Economic Surveys of Bulgaria (OECD, 1997 and 1999).

scale one was delayed due to opposition from the UDF who insisted on carrying out restitution before privatization.

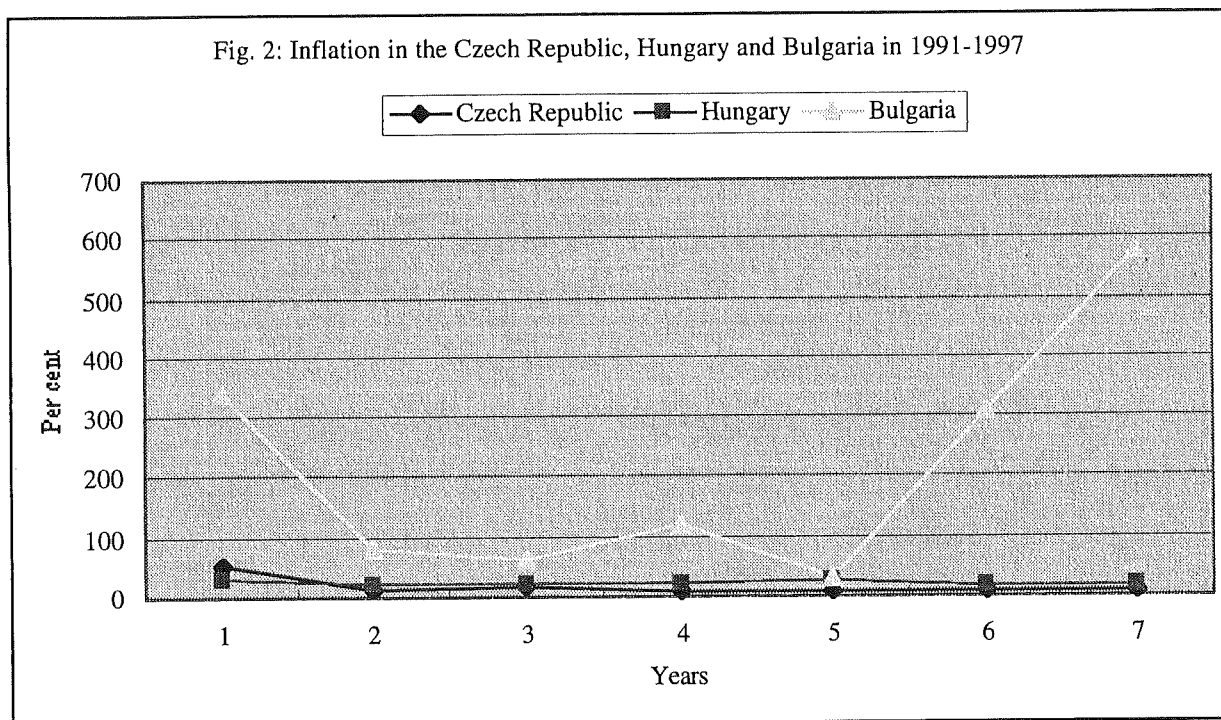
The struggle between the BSP and the UDF over who will be in charge during the large-scale privatization lasted until early 1997 and resulted in prohibitively high social costs of transition. Figures 1 and 2 illustrate the sharp decline in real output and the failure of macroeconomic stabilization in 1991-97. The biggest problem came from the loss-making state-owned enterprises (SOEs) which were kept afloat through bank loans, while the BNB, the central bank, kept refinancing the banks unconditionally and without limits. The delay of privatization, the maintenance of soft budget constraints, and the lack of fiscal discipline eventually led to bank insolvency, huge budget deficits and hyperinflation.



During the banking crisis of 1996-97, fifteen banks (about a third of the banking system) were closed, and the government expenditures needed to deal with the crisis (on a cumulative basis over the 1991-98 period) were estimated at 22 percent of GDP (The World Bank, 2001, p. 2). In early 1997 Bulgaria experienced a short period of hyperinflation and the collapse of its currency. Inflation was 43% in January and soared to 240% in February. The lev fell from 1USD = 350BGL in November 1996 to 1USD = 3200BGL in the beginning of February 1997. Real output, which had slightly grown in 1994 and 1995 for the first time since the start of reforms, contracted by almost 18 percent in 1996-97 (Fig. 1 and Table 1).

Bulgaria in 1990-96 is a glaring example of a country being locked in the “partial reforms trap”. After the stabilization and liberalization of early 1991, economic reforms stalled, leading to large opportunities for a small number of people to extract rents and

strip state-owned assets. The select few were either members of the former communist elite (the nomenklatura) or of the pre-communist elite whose properties were nationalized by the socialist government in the late 1940s, or ordinary people who managed to enter the patron-client networks of the early transition period. Coalitions of politicians, directors of SOEs, and private businessmen captured key state agencies and prevented reforms that would impose financial discipline and encourage new market entry (on the level of state capture in Bulgaria in comparison with other transition economies, see Fig. 3).



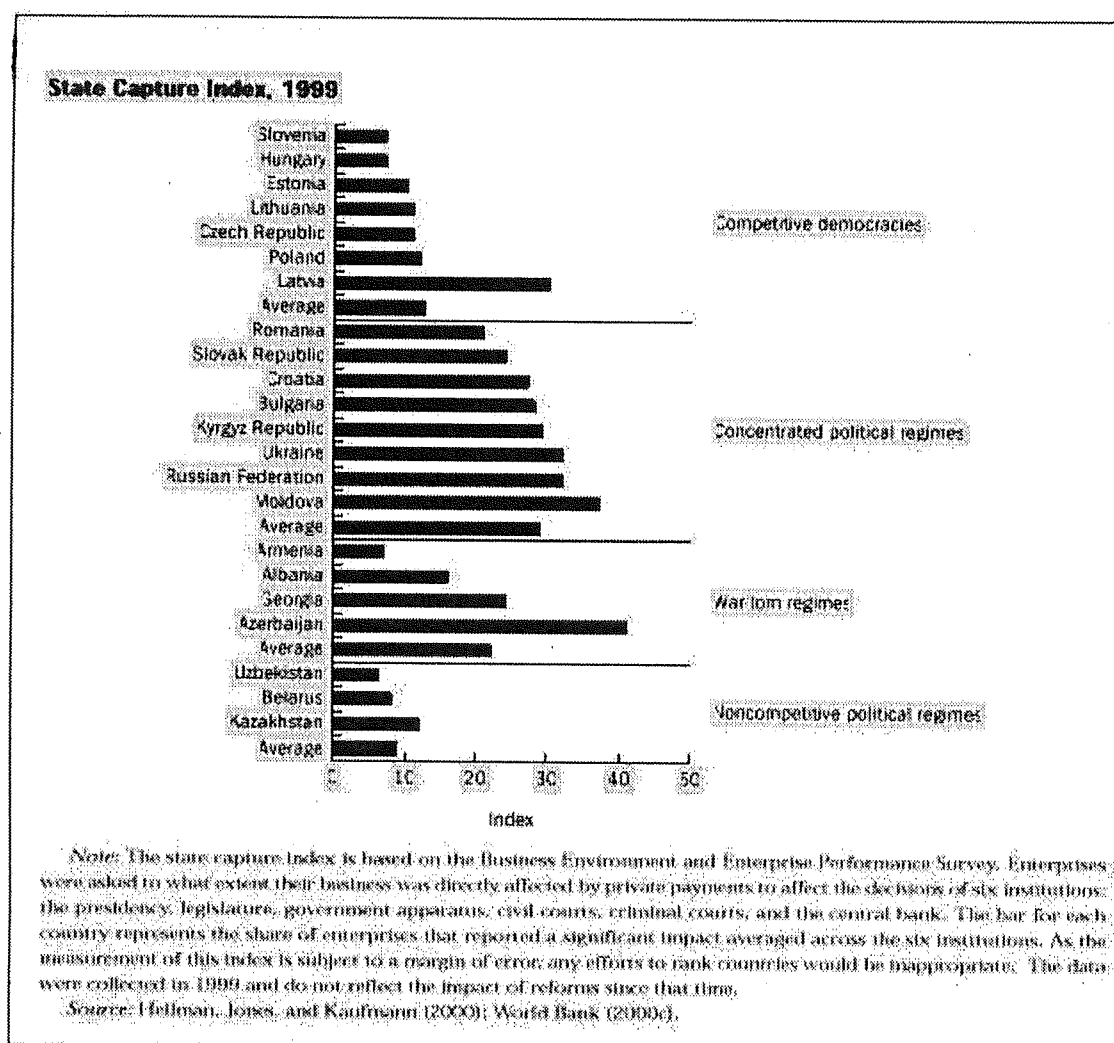
One such state agency was the central bank, whose independence from the government was legally guaranteed by the law on BNB, passed in June 1991. In spite of this, BNB's actions were heavily influenced by political pressure to refinance the banks, while the latter covered the losses of state-owned enterprises and speculated on the foreign exchange market (Vucheva, 2001). The central bank was part of, using Olson's terminology, a roving bandits coalition or a debtor-creditor coalition that redistributed wealth from households and a part of new private companies to bank managers, SOE directors, politicians, and related to them private businessmen (Nenovsky and Rizopoulos, 2001).

Which historical and cultural legacies have affected the Bulgarian reform path in 1990-96?² Hedlund's and Rose's findings for Russia seem to fit Bulgaria's case too. The

² Due to limitations of space, I do not consider here historical and cultural legacies stemming from the characteristics of Bulgarian early capitalism (1878-1944) and of the

mode of extrication from state socialism (Bruszt and Stark, 1994) which allowed the continuity of interest groups (distributional coalitions) from the old order (Olson, 2000; Hanson, 2000) is another similarity between the two countries. The fall of communism in Bulgaria in 1989 was not a popular revolution but a peaceful coup d'etat through which a part of the former nomenklatura of the Communist party took power. Between 1989 and 1991, these people managed to convert most of their informational and positional advantages into ownership of physical and financial assets.

Fig. 3: State Capture in Transition Economies, 1999



Source: The World Bank (2002).

Two seemingly major differences from Russia were the struggle between the two main parties, the BSP and the UDF, for power and the presence of a particular constituency (the pre-communist elite) that supported the latter. The UDF held office for

subsequent socialist period (1944-1989).

a short period of time (from November 1991 till December 1992), implying a higher degree of elite turnover than in Russia and the break-up of some inherited distributional coalitions. Most “red” directors of SOEs and top bureaucrats had to leave their posts to be replaced by people loyal to the UDF leadership. But all this could not change the country’s reform path, which was very similar to that of Russia.

In my mind, the key reason was the path-dependent disintegration of the state into a vast number of poorly interconnected personal networks (clans) having narrow interests (Hedlund, 2001). Sociologists have identified the phenomenon of “nashism” or “our people” as the most powerful anti-market factor in the Bulgarian society (Mitev et al., 2001). The tendency to surround oneself with one’s own “reliable” people is common in both Bulgaria and Russia. After the start of the transition, the borderline between “our people” and “others” was drawn on ideological and political grounds, serving to produce numerous patron-client networks (within both the BSP and the UDF) fighting with each other to redistribute national wealth.

What factors enabled these networks to capture the state? First of all, the mode of extrication from state socialism in Bulgaria. At the start of the transition, the direction of changes was quite unclear. Unlike the countries of Central and Eastern Europe, there were considerable doubts whether Bulgaria will be able to join the EU. Both the country’s elites and ordinary people were divided on how to evaluate the socialist past and on what type of market economy should be achieved. There was no common vision of the future that could unite various social groups and political parties. Hence, it was much more difficult to build a broad consensus on reform and carry out the necessary radical reforms.

The second factor was the precarious tenure of politicians, government officials and SOE managers, which reinforced their incentives to behave like roving bandits (Olson, 2000). In 1990-96, three parliamentary elections were held, and eight governments alternated in office: three BSP, one UDF, and four non-partisan or interim ones. After coming to power, each administration would lay off “others” and hire “our people”. This created a permanent atmosphere of uncertainty within state agencies. Since the newly elected/hired did not know how long will their stay in power last, they had the incentive to extract rents and steal assets as much as possible.

Finally, it was much easier for the entrenched interest groups discussed above to organize themselves for collective action and collude with politicians from the two main parties. The rest of the society could not be mobilized (except during election campaigns) fast enough to hold corrupt politicians accountable for their actions. The result was lower government credibility at the early stage of the transition, reinforcing past mental models

of formal rule aversion³. During the economic crisis of 1996-97, government credibility reached such a low point that to recover it, most radical solutions were needed. The country found one of the solutions in the currency board arrangement.

III. The currency board and institutional change

In the previous section I examined how Bulgaria fell into the “partial reforms trap” by emphasizing the country’s mode of extrication from state socialism and the nature of its political system at the early stage of transition. The question that arises is how a country can leave a particular reform path, or how can the vicious cycle of soft budget constraints, rent-seeking and clientelism turn into a virtuous cycle of entrepreneurship and productive investment. Several possible answers have been offered up to now, and all of them have one thing in common: they all propose to start with the transformation of the government and the political system.

One approach (The World Bank, 2002) stresses the role of new political leaders who can mobilize alternative coalitions to tip the balance of power in favor of further economic reforms. Such coalitions may be composed of broad range of social groups that have lost from the “partial reforms” equilibrium: consumers, savers, minority shareholders, new small and medium-size businesses and foreign investors. A higher level of political contestability should lead to reforms that limit the discretionary power of politicians and government officials to intervene in the economy. The expected result is stricter financial discipline, more new entry and economic competition.

Another approach argues in a similar vein for a certain type of government that will put an end to “market-contrary policies” and provide selective incentives to mobilize collective action for the “encompassing interests” (Olson, 2000). Such “market-augmenting government” is powerful enough to ensure property rights security and contract enforcement but is also constrained so as not to deprive individuals of their rights. It is not known exactly how this type of government may be generated but it exists only in countries that are “lasting democracies”.

Stefan Hedlund makes a similar point when writing that a credible commitment to a rules-based order must also include binding the state so it cannot extract wealth at will (Hedlund, 2001). If the government could gradually gain legitimacy as a guarantor of some formal rules, economic actors’ mental models should evolve in the direction of rule-abiding behavior and productive activities. However, it is unknown how such type

³ According to the most recent World Bank report, governments with lower initial credibility tend to choose the “partial reforms” path as the latter offers lower initial adjustment costs, but eventually end up with higher social costs due to getting locked in the “partial reforms trap” (The World Bank, 2002).

of government can possibly come into existence, having in mind that it will imply breaking away from the long established Russian tradition.

Before elaborating on my view of how the currency board in Bulgaria can contribute to the transformation of the government into a rules-based one, I provide a brief overview of the design and main characteristics of the country's CBA. The currency board was proposed by the IMF to the BSP government in November 1996 as a way to ensure financial discipline and macroeconomic stabilization. In spite of some initial opposition, the proposal gradually gained wide popularity because other stabilization schemes tried before had failed and because the design of the CBA would not allow political interference to block any further macroeconomic stabilization and structural reforms. Meanwhile, the economic crisis turned into a political crisis, which eventually brought the UDF back to power. A new stand-by agreement was signed with the IMF in April 1997, and the currency board was launched in July 1997 with a start-up loan from the IMF as part of its foreign currency reserves.

The principles of the CBA's operation were established by the law on the Bulgarian National Bank passed in June 1997. According to the law, the lev was fixed to the German mark (the currency board's reserve currency) at the rate of 1 DM=1000 BGL⁴, and neither the central bank, nor the government could change the exchange rate at their own will. This can be done only through qualified majority voting by the national parliament. In addition, the 1997 law guaranteed that 1) central bank liabilities would be 100 percent backed by CBA's foreign currency reserves, 2) the central bank would convert national and reserve currencies on demand and without limit at the fixed exchange rate, and 3) central bank lending to the government as well as refinancing of commercial banks would be suspended. The fact that the principles of the CBA's operation had been made explicit in the 1997 Law on the BNB helped ensure policy transparency and enhance the credibility of the new institutional arrangement.

The currency board in Bulgaria belongs to the so-called "new-generation" CBAs, which differ from the orthodox ones because they allow a certain degree of flexibility in case of external shocks and systemic banking crises. To start with, unorthodox CBAs preserve a traditional monetary policy tool such as commercial banks' minimum reserve requirements. Furthermore, they maintain to a certain degree the central bank's ability to perform the lender-of-last-resort (LLR) function, leaving room for intervention in the event of a liquidity risk threatening the banking system's stability. The central bank is divided into Issue and Banking departments, each of them having a separate balance sheet. The former is directly responsible for the CBA's operation, whereas the latter

⁴ Since the introduction of the European single currency, the lev has been pegged to the euro in accordance with the conversion rate of the German mark against the euro.

stands ready to perform the role of lender of last resort.

The third main characteristic of the Bulgarian CBA is the presence of fiscal reserves (government deposit) in the liabilities of the Issue department. Borrowings from the IMF and other international financial institutions, as well as privatization revenues, are accumulated there upon receipt. IMF loans also appear as assets (foreign currency reserves) on the balance sheet of the Issue department. The central bank can officially lend to the government the received IMF loans but only if the maturity of government debt to the BNB matches that of BNB debt to the IMF. If the government decides not use its borrowings from the IMF and other financial institutions, these may be amassed in the Banking department deposit at the Issue department, thus providing larger possibilities for the former to serve as LLR.

What effects have the 1996-97 economic crisis and the CBA had on institutional change? There is no doubt that they have had many beneficial effects. First of all, the discretionary power of the government (or clientelist networks) to intervene in the economy has been greatly limited thanks to the abolition of independent monetary policy and the establishment of fiscal discipline⁵. The refinancing of commercial banks by the BNB to cover SOE losses has been suspended. All large SOEs, with the exception of those in the energy, rail transportation, and telecommunication sectors, have been either privatized or liquidated. Overall, budget constraints have hardened.

Secondly, the CBA's launch requires a strong and healthy banking sector because the ability of the central bank to perform the role of LLR is restricted. This has prompted decisive government action to improve commercial bank solvency and liquidity. The capital adequacy ratio of the banking system increased from 5.5 percent in 1996 to 35.5 percent in the end of 2000, which is far above the minimum required 12 percent (BNB Annual Report, 2001, p. 80). Moreover, the share of loans classified as problem and non-performing declined from 56.3 percent in 1996 to 8.3 percent of the outstanding total loans (*ibid.*, p. 163). The BNB has considerably strengthened regulation and supervision of the banking system, thereby inducing commercial banks to improve their compliance with the main prudential requirements.

In a country with a recent history of banking crisis such as Bulgaria, government credibility depends on its ability to ensure the orderly exit of insolvent banks. The handling of two bank failures in 1999-2000 provides grounds for cautious optimism.

⁵ The CBA establishes fiscal discipline because deficits cannot be financed by direct BNB loans. Following the introduction of the CBA, Bulgaria has achieved fiscal balance. After registering a small surplus of 0.9 percent of GDP in 1998, the government managed to keep fiscal deficits in 1999 and 2000 at relatively low levels, - 0.9% and -1.1% of GDP respectively (Table 1).

These failures did not produce a loss of confidence in the banking system as policy actions taken by the BNB were based on clear and transparent rules. Deposits in the failed banks were paid by the Bank Deposit Insurance Fund up to the legally defined maximum limit.

Another area where there has been a substantial change over the past three years is bank privatization. After July 1997, the pace of sell-off of state banks accelerated. As a result, at the end of 2000, the share of private banks in total bank assets was 80.3 percent, and 73.3 percent of all bank assets were owned by foreign investors (*ibid.*, p. 76). The prevalence of foreign banks is considered important for countries under currency board regimes because foreign-owned subsidiaries can have lines of credit from their parent banking institutions in the case of liquidity crises (Miller, 1999).

In spite of unfavorable factors such as the Russian financial crisis and the Kosovo conflict, 1999 and 2000 were years of relatively large FDI inflows in Bulgaria (Table 1). Foreigners invested US\$1,001.5 million (8.4% of GDP) in Bulgarian enterprises in 2000, marking the greatest amount of annual FDI inflow reported since the start of the transition. Foreign investment has reached a certain critical mass, making overseas investors an important constituency pressing for further reforms.

Along with the above achievements, it should be noted that there has been little progress in terms of enhancing property rights security and establishing the rule of law. Privatization, in most cases, has failed to stop rent-seeking activities and produce secure property rights. Most SOEs, with the exception of companies sold to foreign investors, were privatized through vouchers or the Bulgarian equivalent of management-employee buyouts (RMDs). The latter has become emblematic of clientelism and corruption in the UDF government, which introduced the CBA. Most new owners and managers of the privatized enterprises ("our people") have just continued to strip assets and extract rents.

Other path dependent developments since the CBA's launch are the maintenance of soft budget constraints in the unreformed sectors (energy, rail transportation, and telecommunications), the relatively low growth of new private firms, and the lack of level playing field for competition. The state-owned gas, heating and rail companies are one of the biggest loss-makers that keep piling up debts to the state budget, the social insurance fund, and suppliers. The business environment is still rather murky, and new investors face a great deal of unfair competition and other uncertainties arising from corruption or weak law enforcement.

Apart from the agencies responsible for privatization, at least three other state agencies have spectacularly failed in 1998-2000: the courts, the judiciary, and the customs authorities. All of them have been well known as ineffectual and highly corrupt. It remains to be seen whether the most recent effort to reform the customs administration with the help of an outsider – a British consulting firm – will work out.

Table 1: Economic Changes Since Currency Board's Introduction in Bulgaria

	1996	1997	1998	1999	2000
GDP growth (percentage change in real terms)	-10.9	-6.9	3.5	2.4	5.8
Consumer prices (percentage change)	310.8	578.6	0.9	6.2	11.4
Interest rates (BNB base rate) (in percent)	435	7	5.2	4.6	4.7
Government budget balance (in percent of GDP)	-10.4	-2.1	0.9	-0.9	-1.1
Current account balance (in mln. US dollars)	16	428	-62	-681	-701.4
Current account/GDP (in percent)	0.2	4.2	-0.5	-5.5	-5.9
Trade balance (in mln. US dollars)	188	380	-381	-1,081	-1,175
Gross domestic investment (in percent of GDP)	8.4	11.4	14.7	19	16
Foreign direct investment (in mln. US dollars)	138	507	537	806.1	1,002
Gross reserves, excl. gold (in mln. US dollars)	518	2,121	2,679	2,892	3,300
Gross foreign debt (in mln. US dollars)	9,602	9,760	10,260	9,989	10,364
Gross foreign debt/GDP (in percent)	97.7	95.8	83.7	80.5	86.5
Gross foreign debt service/exports of goods and services (%)	16.3	12.8	20	18	16.7
Private sector share in GDP (in percent)	55	60	65	65.3	69.3
Unemployment (in percent of the labor force)	12.5	13.7	12.2	16	18

Sources: EBRD (2000), the Bulgarian National Bank, the National Statistical Institute, and the Bulgarian government's report for 2000 (<http://www.government.bg/bg/index.html>)

From the above it can be presumed that the 1996-97 crisis and the CBA have probably managed to introduce new formal rules and enforcement mechanisms in certain

areas of the Bulgarian economy but on the whole they have failed to transform the government and the informal rules. The government has recovered some credibility thanks to successful financial stabilization and economic growth in 1998-2000 (Table 1). But on the other hand, it has not gained the broad public trust required for the change of expectations and mental models. The main reason is that the nature of the political system has not changed. The domination of clientelist networks of roving bandits pursuing their narrow interests has continued. Is the CBA just another top-down attempt at institutional change bound to fail?

My answer is maybe no in a small open economy as the Bulgarian one. It is quite natural that external influences play a much bigger role in smaller economies. Moreover, external imposition of rules may have higher legitimacy there, especially after a crisis. The CBA is a monetary rule imposed on Bulgaria from the outside -- by the IMF -- in the interest of foreign creditors (Nenovsky and Rizopoulos, 2001). It is the result of the strong leverage the IMF had over the country in late 1996 and early 1997 when domestic political actors had realized it would be impossible to overcome the worsening economic crisis without external help.

The externally imposed solution in the form of the CBA, however, was welcome inside the country by a broad range of social groups who lost under the "partial reforms" equilibrium in 1990-96. Hence, the CBA (or the IMF) solution appears to be an imperfect substitute for the solution proposed by the World Bank: a new political leadership that should mobilize alternative coalitions of winners and losers to change the balance of power and implement further reforms. The CBA was introduced because the Bulgarian political class was unable (and unwilling) to take the necessary measures and because the Bulgarian civil society was too weak to mobilize itself for collective action.

The broad grassroot support for the CBA arises from social learning from the events in 1990-96 and is the factor that can help externally imposed change succeed. When encompassing interests are not represented by the incumbent government, they need some other organizational form that has the coercive power to implement the policies desired by them. One such form is the CBA created by an external power such as the IMF.

The momentum for a more transparent and accountable government created by the CBA needs to be supported by a whole set of interrelated changes. Further reforms are necessary to reduce government discretion in areas where this has not yet been done and to create a business environment more favorable to new market entry and investment. Increasing the extent of political contestability is also a very important factor. The emergence of a new political force -- the National Movement Simeon II, which won the last parliamentary elections -- in spite of its populist electoral platform, can be assessed positively as it brings more competition in the political arena.

In brief, the CBA can be regarded as an “external anchor” to the reform process that can pave the way towards a rules-based government⁶. However, the CBA itself cannot provide coercion for changes outside monetary and fiscal areas. This is where another “outside anchor” for reforms is needed. I consider the prospect of EU accession as such an anchor and examine its role in the next section.

IV. The prospect of EU accession and institutional change

Economic integration with the EU has been the goal of all Bulgarian governments since the start of the transition. The Europe Association Agreement with the EU was signed in March 1993 and came into effect in January 1995. By early 2002, Bulgaria’s trade with EU countries has been almost fully liberalized. Trade with EU countries has grown fivefold compared to the 1989 level, and exports to the EU area have accounted for more than 50% of all exports over the past couple of years. The country applied officially for EU membership in 1995 but was left out of the first wave of transition countries with which the EU decided to start accession negotiations in 1997. The decision to include Bulgaria in the second wave of countries to start accession negotiations was finally made in December 1999. It was regarded as partially politically motivated in view of the role played by the country in the Kosovo conflict.

Accession talks started in 2000, and by the end of 2001 twenty six chapters of the *acquis communautaire* were opened. Out of these, thirteen have been closed. Bulgaria has clearly been lagging behind other accession countries in the negotiations. The country’s assessment in terms of the Copenhagen economic criteria has also been quite unfavorable. In its Progress Report of November 2001, the European Commission has concluded that functioning market economy is not yet in existence and that the country still lacks the capacity to cope with competitive pressure and market forces within the EU (Regular report, 2001). The Commission has identified barriers to market entry of new private firms, unclear ownership rights, and weak contract enforcement as the main problems to be dealt with. All this has reinforced the prospect of Bulgaria (along with Romania) joining the EU much later than the rest of the accession countries. The present Bulgarian government has established as its goal to complete accession talks by the end of 2004 and join the EU in 2007.

Leaving aside the question whether this time framework is realistic or no, it implies that the country has to wait at least another five years until EU membership. Under the hypothesis proposed by Erik Berglof and Gerard Roland, the EU will have at least another five years within which it can exercise strong leverage over the reform process in

⁶ I have borrowed the idea of “external anchor” for reforms from Erik Berglof and Gerard Roland (see Berglof and Roland, 1997).

Bulgaria. Over this period, the EU can play an important role as “outside anchor” for further reforms.

First, in similarity to the Central and Eastern European countries, the prospect of EU accession can serve to weaken political resistance by vested interests to reforms. All main political forces in Bulgaria are now committed to the goal of EU membership, which helps them put behind many of their policy differences. It is clear that to be able to join the union, Bulgaria has to achieve stronger financial discipline, promote new market entry and competition. Thus, pressure from the EU can help create a broad domestic constituency for reforms because of the expected benefits from entry.

The EU, however, can only be an imperfect substitute for the weakness of civil society inside the country. The fact is that the previous government could win European Commission bureaucrats on its side, but failed to convince the mass media and the ordinary people of its righteousness. In other words, government credibility in front of EU authorities does not necessarily mean that the government can be trusted by its citizens. The latter is what really matters.

The second role the EU can play as an “external anchor” before Bulgaria joins the union is to promote the development of civil society. Presently, some NGO projects are financed by the PHARE program but that is far from enough. The EU must raise its support for independent mass media and organized social groups who can act as a domestic check on the government. Although Bulgaria already fulfils the Copenhagen political criteria, the EU has to continue monitoring the extent to which human rights are respected and the rule of law is enforced in the country, serving to prevent a policy reversal in these areas.

Thirdly, the prospect of EU membership can help align the incentives of individual government officials with further economic reforms. Bulgaria now receives around 300 million euro a year in pre-accession assistance, equivalent to over 2% of its GDP (Regular report, 2001). Most of these funds may help create jobs for new or retrain “old” civil servants who will therefore have a vested interest in the success of pre-accession projects.

Bulgaria has announced its intention to keep its CBA until the adoption of the euro. This implies that during the period prior to membership it can rely on two “outside anchors” to the reform process, namely the CBA and the EU. Externally imposed changes have received a wide legitimacy inside the country because of the social learning from the economic crisis 1996-97 and the expected benefits from EU membership. Yet, there may be doubts whether such changes will be sufficient to help the country break away from its path-dependent pattern of development, or whether they can really contribute to the transformation of the Bulgarian government into a rules-based one.

I do not suggest that within the 5-year period prior to membership Bulgaria can

achieve secure property rights and become able to fully apply EU legal provisions contained in the *acquis*. But I believe that “path-dependent” does not mean “path-determinant” (Stahl, 1998) and that informal rules may gradually change through social learning and pressure-cum-assistance from outside. Compared to its first modernization in late 19th – early 20th century, Bulgaria’s third modernization at the start of the 21st century has more chances to succeed because the transition to a more transparent and accountable government can be implemented with the help of the existing “outside anchors” as well as thanks to the gradual development of internal ones within the country.

Conclusion

The evolutionary approach to economic transformation has indicated the failure of top-down, big-bang style reforms to change informal rules in post-socialist countries and has argued that transition follows a certain path-dependent pattern. I have shown on the case of Bulgaria that historical and cultural legacies (or initial conditions) have greatly influenced the country’s reform path. The fact that communism in Bulgaria fell not as a result of a popular revolution but of a coup d’etat (or the mode of extrication) was the direct cause of lower government credibility at the start of the transition than in Central and Eastern European countries. Moreover, the struggle between the two main political forces, the BSP and the UDF, for power paralyzed state agencies and made them easy prey for distributional coalitions inherited from the old order as well as new patron-client networks. Polarization into “our people” and “others” strengthened, and as the prospects of joining the EU were unclear, there was no common goal that could unite both the elites and ordinary people.

The result was that Bulgaria fell into the “partial reforms trap” and the state became captured by coalitions of politicians, directors of SOEs, and related private businessmen (self-seeking, roving bandits). Privatization and structural reforms were delayed, the SOEs were stripped of their assets while their losses were covered by loans from the banks. The banks were rescued by the government at the cost of soaring government debts and dwindling foreign exchange reserves. Eventually, in 1996-97, Bulgaria experienced banking and currency crises along with hyperinflation.

Externally imposed change (by the IMF) in the form of the CBA helped achieve financial stabilization, a healthy banking sector and four consecutive years of economic growth (in 1998-2001). The CBA was successful not only because of the credibility of its design, but also because it became the organizational form that defended the interests of a broad range of social groups who had lost under the “partial reforms” equilibrium. Social learning from the 1996-97 crisis helped the change “from above” receive broad popular support from below.

Although the CBA reduced the discretionary power of the government (or clientelist networks) to redistribute wealth and hardened budget constraints in most of the economy, it could not stop rent-seeking activities and produce secure property rights. Government credibility has stayed at low levels. To transform the government into a rules-based one, the CBA alone is not sufficient. It needs a set of other related changes. The emergence of new political leaders and social movements, for instance, may increase competition on the political arena and change the nature of the political system. Further reforms to strengthen financial discipline, promote new market entry and more economic competition are also needed.

Apart from the CBA, I regard the prospect of EU accession as another “outside anchor” to the reform process in Bulgaria. Judging from the experience of Central and Eastern European countries, the likelihood of EU membership can relax political constraints and make radical reforms more acceptable or reform reversal more costly (Berglof and Roland, 1997). Although the changes are externally imposed and come “from above”, they can still garner support of both the country’s elites and ordinary people due to the expected benefits from entry. However, to break away from its path-dependent pattern of development, Bulgaria would need something more than “outside anchors”, namely a stronger civil society that can bind the government to some rules-based order.

The economic transformation in former socialist countries is an unique opportunity to grasp the mechanisms and driving forces of institutional change, understood as the change of both formal and informal institutions as well as their enforcement mechanisms. Based on the case of Bulgaria’s economic transition in 1990-2000, I have suggested some hypotheses about how formal and informal institutions can interact and how externally imposed and internally generated changes can reinforce each other. However, further research is needed to verify empirically the hypotheses proposed in this paper.

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Family is a Synthetic Symbol of Social Analysis in Transitional Economies

Etsuo Yoshino

Faculty of Economics, Hokkaido University, Sapporo, Japan
eyoshino@pop.econ.hokudai.ac.jp

In this report I want to introduce my methodology of the analysis on transitional economy.

First I would like to emphasize the manifold character of human activity of transitional economy. Transitional economies hold not only diversified processes of their development but also manifold fields of their activity for changing society.

In transitional economies, their performance is transformed not only in the economic field. In all fields such as economy, politics, culture, religion, and customs, the transformation has been generated. In order to understand transitional economy it is necessary to analyze various diversified process, which has generated in many manifold fields.

I pay great attention to family as a synthetic element of transitional economy. The reason why I regard family as a synthetic element of transitional economy is that the family behavior concerns not only with the economic phenomenon but also with almost all fields such as political environment, cultural transformation, religious value, etc. In this report, I would like to show some features of my method of family analysis.

1. Not active attitude but passive attitude toward family is desirable

I am an economist. One is a political scientist and the

other is a sociologist or a historian. When I as an economist observe a certain family in active attitude, inevitably I will pay attention to its economic side. The researcher who observes a certain family, naturally investigates only the particular side which relates to his specialty, although family is an object relating to many manifold fields. If we want to obtain the whole image of a certain family, then we must always keep passive attitude of observation. In other words we must throw out active attitude of gathering information.

When I investigate a certain family, I always draw a family tree or a genealogical chart. To genealogical chart relate various social factors and events, such as draft to the Russo-Japanese war, compulsive work by the German army, holocaust of Jews by Nazi, confiscation of land by the communist government just after the Second World War, suppression to the Catholic Church by the communist party, emigration to the United States, temporal foreign work in Western Europe, finding employment in foreign capital enterprise in the market economy and so on. These all elements are related to the history of almost all families.

When we gather information from family, it is not better to present question after selection of questions by active attitude of observation. The best way is to present no question. In my case firstly I always request to talk about his personal history and the memory of his parents. During first 2 or 3 hours I never put any concrete question to the member of family. Using this passive attitude of observation we can obtain fruitful information of family behavior in manifold fields.

The pattern of the family behavior has changed according to the age, for example the capitalism era in 1930 s, the German occupation period, the age of Stalinism, the reformative socialism in 1960 s, the age of the Solidarity movement in Poland in 1980's, and transitional period to the market economy in 1990's. The behavior of every family starts to diversify according to the characteristics of manifold fields of each period. Especially the economic behavior of family is closely

corresponds to the change of political environment, the change of cultural value and religious belief in each era.

The decision on house building is strongly influenced by his family relation and the social custom of cohabitation with their parents. This decision, in depth, inseparably relates to religious way of thinking. House building influences the saving level of family. Therefore, neither savings of a national economy nor religion is irrelevant to each other.

In order to understand synthetically the diversified behavior of people in transitional economy in manifold fields family is the best object to observation.

2. Any typical family does not exist in a society: parts and the whole

We cannot find any typical Japanese. We can find only a Japanese Mr. A or a Japanese Mrs. B. We cannot find any typical Japanese village. We can only visit the village C or the village D. In Japan there does not exist any typical Japanese enterprise. There exists only Sony or Honda.

Someone may ask as follows: By analyzing only one family in detail how we can understand the transformation of the entire society. This question hits a good point. As already mentioned various factors from manifold social fields exert influence upon family behavior and the manner of influence is quite different in every family. In my methodology by analyzing these different patterns of influence of social factors we can extract the essential characteristics of social structure with manifold fields. Observation of many numbers of family is the indispensable condition of may social research.

On the contrary to my method Prof. Oscar Lewis of the University of Chicago proposed one family observation method in his book *the Children of Sanchez* in 1961. This book is surely a pioneering work in the history of family study, however I have quite critical impression on his method.

In Poland I had 5-6 hours interview with 24 farmers. All

families were Pole. In Lithuania, 45 families were observed: 11 Polish families, 11 Lithuanian families, 8 Islamic families 10 Russian and Belarusian families and 5 Jewish families.

In my experience various elements of the society can be almost understood by 10 families interview. The observation of 24 families is sufficiently enough. It is very important that the influence of market mechanism or the influence of foreign direct investment exerts quite different effect upon family A and family B. By analyzing this difference we can extract the essence of transitional transformation of a society.

[figure 1]

[figure 2]

Now I would like to show an example of family tree. In Lithuania I drew 45 family trees. Looking at these 45 family trees whole image of one society can be built up in our mind, even though every individual family has their own different family history.

3. The most important factor in the transitional process is family relation

I do not deny that various economic factors make influence upon the transitional process. Also I do not deny that the initial condition of economy predetermines the path of economic development of transitional country. However, the initial amount of capital accumulation, the initial level of GDP and the level of foreign capital investment, in my opinion, does not have

any definitive meaning for the diversified path of economic growth in transitional countries. In my conclusion family and human relationship in society exerted the strongest influence upon the economic performance and growth path of transitional countries.

Now I present two surprising figures.

[figure 3]

The figure 3 concerns the support by the Belarusian people to President Aleksander Lukashenko. In general newspaper reports as follows: the farmer and the old generation in the rural area are supporting President Lukashenko and in the urban area there are a lot of critical citizens to the President. My understanding is different.

After World War II the Soviet government introduced extreme industrialization policies in Belarus, and a lot of rural residents emigrated to the city, as shown in this population pyramid. A lot of workers were separated from parents in their home village. The human network between brothers and sisters became cut off. The family relation of the city worker was destroyed in some extent. A lot of churches in the city were closed by the communist party. Inhabitant in the urban area became a small isolated being in the society and tied to the working-place. Even the football club was organized in the factory. Only small number of people participated in the human network inside the communist party.

For the Belarusian city worker the destruction of their working place and of the old regime is equal to the killing of their mother. Therefore the city workers, demanding the preservation of the old regime, strongly support President Lukashenko.

[figure 4]

On the other hand, the population pyramid of Poland is quite stable, and its family relation in the whole country has been maintained. Even if the enterprise goes bankrupt, his family supports the individual. Polish worker could begin to work in the foreign capital enterprise without changing his value of life. Polish family relation and their value of life has been relatively solid and stable.

Consequently the communist party of Poland was not able to introduce any radical social transformation, which required change of mentality and value of life of Polish people. The Polish government had to execute its socialist policy on the premise of the traditional family relation and the Catholicism. Moreover, after the Second World War the value of life in Polish society begun to receive the influence from the West-European life-style. The Polish society gradually has changed into the modern civil society after 1960's. New wine became unsuitable for old wineskin in Poland. The Polish people easily could put on a new dress of market economy by taking off their old dress of socialist economy. It is an important point that the Polish people did not need to change their family relation and value of life when they changed the dress. In Belarus the situation is completely different. I consider that this point is the principal reason by which the big difference between Belarus and Poland has generated.

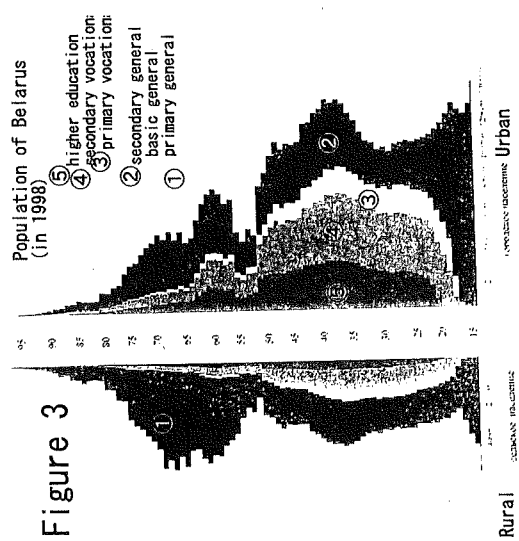
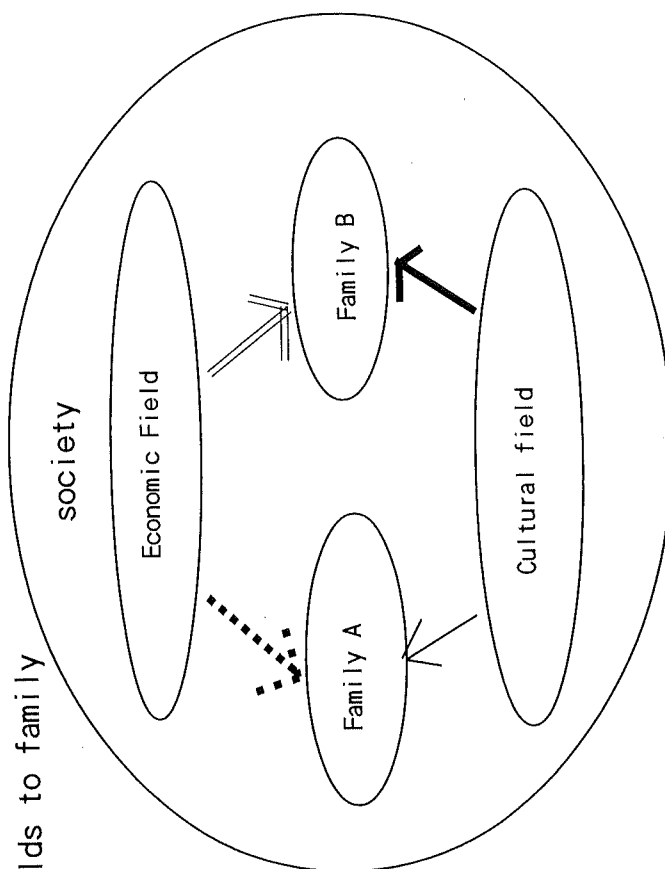
[figure 5]

Now I would like to present another astonishing figure, which suggests that family relation is an important factor in determination of social structure. This figure shows the legitimate child's ratio in 49 prefectures of Poland in 1997. The word legitimate child means the child who was born from

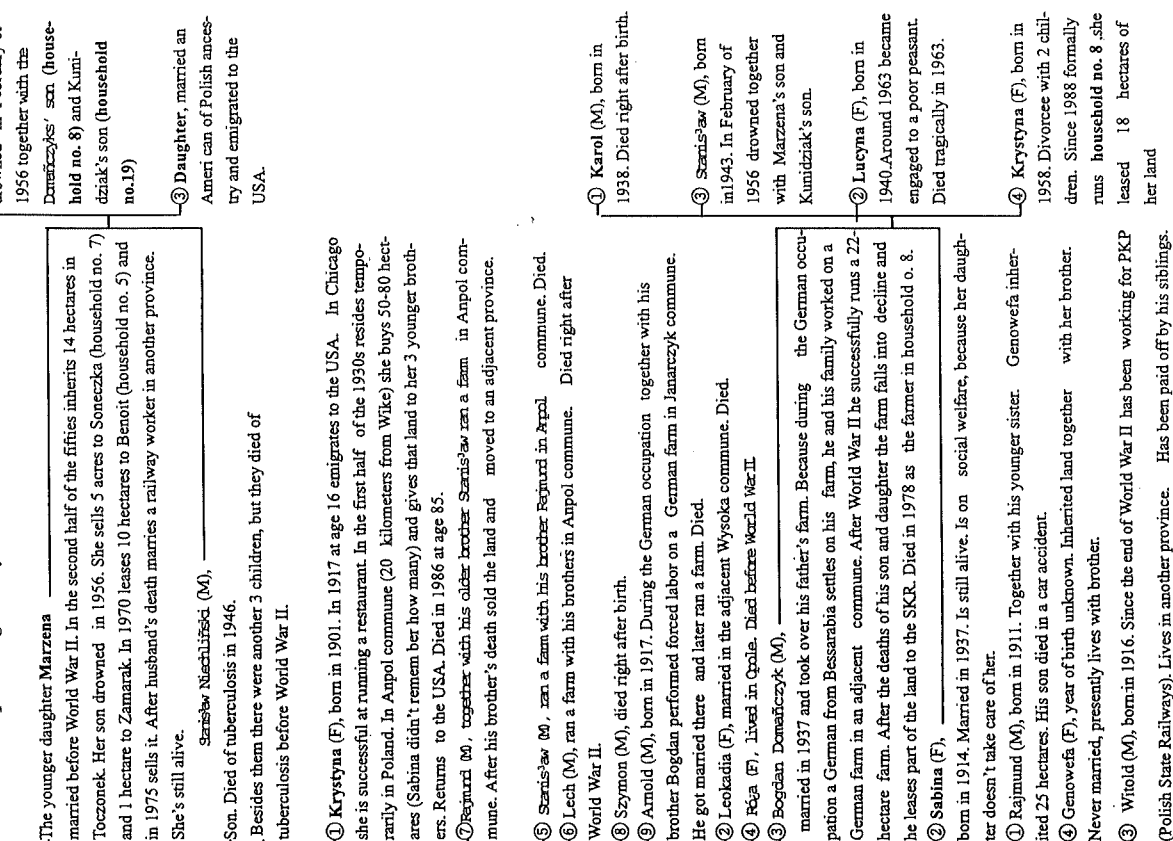
officially married parents. Using this ratio Poland can be divided into two regions. That is the region with high ratio and the region with low ratio. The region with low ratio completely corresponds to the New Land with thick (red) figures. New Land means the territory, which Poland received from Germany just after World War II. The region with high ratio completely corresponds to the Old Land with thin (blue) figures. The Old Land means the Polish territory since 16-th century. After World War II, Poland lost the territory of 190,000 the square kilometers. It was the west Ukraine, the west Belarus, and the east Lithuania. About 2,000,000 Poles who lived there had to migrate to New Land compulsively. Parents and children sometimes immigrated to different prefectures. The brothers and sisters immigrated to another villages. The family relation was cut off in this migration process, and the parent-child relation was destroyed in some extent. Their sexual behavior in the New Land became different one from the sexual behavior in the Old Land, although both inhabitants were Catholic. The ratio of the legitimate child is greatly different from 71% to 95% even in 1997; that is 52 years after the end of War. The sexual life, the marriage, and birth are the most basic behavior of mankind. This figure indicates that the difference of the family relation exerts a strong influence on social structure even when the half century passed.

In conclusion, when we analyze the economy in transitional country, it is necessary to pay sufficient attention to the family relation as well as to the economic indicator, such as the income level, the technology, the foreign direct investment, and the external debt of the country.

figure 1
The relation between families and manifold fields of
society: different way of influence of manifold social
fields to family



The older daughter Leokadia, her husband is killed by Germans. After World War II she marries for the second time. Her second husband is a farm-hand from the „German“ Henkler's farm. In the second half of the fifties she inherits 14 hectares in Gierów Dolny. That land was ~~was~~ inherited by her son from the ~~first~~ marriage. Bolesław. Clearly it is being leased by the SKR.



Rationality And Path Dependence
In Institutional Change:
The Case Of Agricultural Reforms
In Post-Mao China

by
Z. Jeffrey Shi

Institute of Political Economy
Fudan University

Jan. 2002

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I. THE RESEARCH ISSUE AND CONTEXT

Various theories of institutional change have been developed in economics and sociology with significant bearings on many difficult problems in the social sciences. The theories can be sorted according to whether or not they look at institutional change as being driven by a quest for economic performance. The theory that sees performance as the primary driving force is hereafter called the performance perspective, whereas the theory that looks at both economic and political forces is called the political-economic perspective

The performance perspective

The performance perspective. Is characterized by the assumption that economic institutions are products of the human quest for effective cooperation and efficiency (Demsetz, 1967). The logic is clear: change in task environment (resource or technology) leads to change in structure of cost and benefit which, in turn, leads to change in institutional form. To put it simply, organization seeks to improve performance (efficiency and/or effectiveness) by choosing the institutional form that fits the task environment. That is to say that institutional change is driven by the human desire for better performance

What mechanism insures that a change in task environment will be matched by a change in institutional form? The answer lies in competition and natural selection (Alchian, 1950; Hannan and Freeman 1989). Competition and the force of selection tend to eliminate those who do not maximize efficiency and those who do not know how to improve institutional fitness. This is to admit, however, that the performance perspective is better suited for certain institutional sectors where agents are driven by profit and competition. Empirically, we should expect the performance perspective to be supported in sectors where they, at least, meet the condition of a contestable market as defined by Baumol et al (1982) or have a "workable competition" (Clark 1940; Sosnick 1958). Otherwise, the performance perspective may not fit the evidence. This qualification is consistent with a great many existing empirical results

A political economy perspective

A political economy perspective. On institutional change is characterized by its recognition

of the fact that institutions are the products of human actions and the fact that since institutional change often has significant redistributive effects on the parties involved, interest groups and other collective actors are bound to make efforts to influence the change for its own good (Goldberg 1974; Knight 1990). Out of these interactions of different groups and parties emerges the institutional form. Therefore, institutions evolve as the result of group bargaining instead of economic rationality.

This leads to the concept of transaction costs and contracting failure (Libecap and Wiggins, 1985). According to this theory, the heart of institutional change will be devising mechanisms and formula for allocating the gains resulting from the institutional change in such a way that it is politically acceptable. This often proves to be difficult for various reasons. In addition to the problem of free-riding, information asymmetries among the parties regarding the value of individual holdings can cause honest disagreement. More importantly, distribution of power between the contracting parties may not be conducive to agreements. Transaction costs and payoffs from institutional change are embedded in *existing institutions* (North 1990). For one thing, existing rules may be biased against new groups trying to organize, or may not provide formal channels for change-oriented groups to bargain with other groups. Secondly, existing rules may affect private expectations of marginal costs and returns of alternative uses of resources. Costs and benefits are not only a matter of relative scarcity of resources and technology but are also defined by institutions.

To the extent that private contracting for rule change is embedded in the macro-institutional environment, the state and culture become important forces in determining institutional change. As actor, *state* organs can take actions with respect to the institutional arrangement. As institutional structure, the state defines the rules of the game for political participation, and facilitates or discourages various group formations (Skocpol 1985). *Culture* affects maximizing behavior of agents by providing legitimacy for some changes but not others. At the organizational level, the sociological theory of institutions (Zucker 1977; Meyer and Scott 1983; Meyer et al. 1987, Dimaggio, et, al, 1991) has labeled this type of rule change “institutionalization”—the process through which organization modifies its formal structure and rules by incorporating well-established norms, values, and practices that enhance an organization’s legitimacy and, therefore, effectiveness. Institutionalization operates mainly through two processes: ① Value

internalization, which refers to the process through which agents acquire the norms, values and conventions of the institutional environment, and ② External imposition, which refers to a situation where an agent is pushed or attracted by an external environment to adopt some internal rules which may reduce rather than enhance the organization's effectiveness. The existence of transaction costs and institutions suggests that institutional change may be historically path dependent.

Do initial conditions matter: The Research Issue

We should notice that the proponents of path dependence, do not necessarily deny self-interests and the role of maximizing agents. It might well be that the path dependence is precisely the outcome of maximizing efforts of the self-interested actor. As a matter of fact, both efficiency and new institutional perspectives regard the interests-seeking actions of competitive actors as the prime mover of institutional changes. But why do they hold different views on the resultant economic institution? First, because they have different assumption on how important the initial institutional conditions are. The efficiency perspective treats the self-interests of actors as something independent of the institutional framework. So, as long as there is competition among independent, interest-seeking actors, a rational institutional arrangement will finally emerge. On the other hand, institutionalists believe that the actor's self-interests are defined by a given institutional framework; Actors exhibit different interest-seeking behaviors in different institutional frameworks, sometimes productive, sometimes redistributive. When an institution induces actors to engage in redistributive efforts, competition among actors does not necessarily result in a rational institutional arrangement. It may even perpetuate the original inefficient system. Second, they differ because they have different assumption on the role of ideologies and past policy-preferences of economic actors. The efficiency perspective assumes people form their institutional preference by judging how much they can profit from the preferred institution. On the contrary, institutionalists pay attention to the fact that historically formed ideologies play a part in people's institutional choice. Therefore, to compare the validity of the two views, it is necessary to examine whether the initial institutional conditions and ideologies affect individual's institutional choices. We will examine the two key issues in a concrete case of institutional change in the Chinese agricultural production system from 1979 to 1984.

From Collective to Household Farming: The Research Context

From 1979 to 1984, there were fundamental changes in the basic system of Chinese agricultural production. In 1978, the production team under the commune system was the managing unit. By the end of 1983, household had replaced the production team as the main actor in agricultural production. The government initially opposed the household as managing unit. But after several years of hesitation, spurred by the initiatives of groups of peasants, the government changed its policy gradually between 1978 and 1982, leading to official universal acceptance of the household responsibility system (HRS).

Justin Lin (1988, 1992) was the first scholar who studied the change. Lin argues that the reform in rural China during 1979-1983 was the result of peasants' choosing to raise productivity. His statistical model included mainly economic efficiency variables. This study intends to extend Lin's economic model to include variables that represent elements from the institutional environment. This enlarged model will help us explore the relative importance of efficiency variables and institutional variables in determining the rate of change to HRS in rural China. This study intends to place the microeconomic in other words choice of peasants with regard to agricultural organizations in an evolving macro-institutional framework. My concern is not only how peasants at the village level arrived at their decisions about HRS. I also consider choices made in the political arena and the interaction between peasants and different levels of government. I will explain how macro-institutions enabled and constrained peasants' choices at the village level. But I will also explain how actions taken by peasants, however constrained, caused disequilibrium in macro-institutional arrangements, igniting demands for change and conflicts about policies in the political market. In order to better capture the anticipated complexity, I conduct a small comparative case study of seven provinces. The seven provinces are not randomly drawn: They were selected because I could collect additional information about them. Nevertheless, these seven provinces do provide a reasonable representation of rural China. They are located in every region of China, cover different agricultural conditions and crops and display different rates of change to HRS. Based mainly on personal interviews and documents, I shall offer an explanation for change in these provinces based on economic and institutional variables.

II. THE ENLARGED MODEL

Substituting the household responsibility for the commune system posed different issues for different people. It means a different economic and social life for peasants and a different way of controlling society for the government. Hence, there are both political and economic considerations in choosing different agricultural organizations. We will discuss these factors respectively.

Expected Economic gains

The Chinese peasants generally expected more output from the land because productivity would be increased. This knowledge of increased efficiency came from their own experiences. The production gains from household farming are determined by the extent of the inefficiency of the team-based mode of production. Lin (1988) suggested that the magnitude of inefficiency due to this lower incentive is related to the size of the production team. Larger teams would encounter more difficulties in supervision and coordination. *The larger the team, the more difficult it is to monitor and coordinate members' effort, therefore the more inefficient it will be.*

Risk in political punishment

Switching to HRS involved political risk because decollectivization was regarded as the prime political crime at that time. The cost might be determined by the expected probability of being politically punished. Peasants' choice of HRS is strengthened if they perceive the Party as more lenient and permissive. To measure the probability of being punished we need data on the party leadership's attitudes toward different provinces and, based on this qualitative information, assign index numbers to the provinces. The larger the index of political punishment, the more reluctant the peasants will be to adopt HRS. Furthermore, we assume the cost of political punishment is positively correlated with the standard of living of the peasants. The rich tend to assign higher cost to political harassment than the poor. Considering all these factors, *the cost of political punishment can be treated as a positive function of the income level at the time the event took place.*

Transaction Costs.

Switching to HRS involved negotiation costs since it involved the whole village. The cost of devising an allocation scheme was determined by: 1) the size of the village, and 2) the scale of nondivisible property such as agricultural machinery. While larger villages had more land to allocate, larger stocks of machinery caused even more problems. Therefore, peasants' propensity to change is negatively related to the level of agricultural mechanization and to the size of the village.

In summary, peasants' willingness to adopt HRS is influenced by the gain in efficiency, transaction costs, and fear of political sanctions. Let r denote the propensity to change, E the efficiency gain, T transaction costs, and L political legitimacy. Then the relationship described here can be expressed as : $r = f(E, T, L)$; $f_E > 0$, $f_T < 0$, $f_L > 0$

The Role of ideology and History

Each potential leader had to, in taking a policy stand towards HRS, not only consider how HRS would affect agricultural production and the Party's legitimacy but also how his personal political fortune would be affected. When a policy maker was certain of his mandate to rule he would concentrate more on evaluating the true effects of HRS upon agricultural economic development; in contrast, a policy maker whose power was weak would care more about building his political support by manipulating the issue of HRS. In this light we shall expect that one's personal history vis-à-vis HRS be the factor that mattered most. If one had voluntarily supported peasant resistance to agricultural radicalism in Mao's era, he was more likely to see the value of HRS in promoting agricultural production. If one had previously been active in Mao's agricultural radicalism, it would be hard for him to support HRS because to do so would undermine his credibility. In contrast, those who had previously resisted agricultural radicalism and been penalized would naturally demand personal rehabilitation and strongly support HRS. Thus: policy maker's current attitude towards HRS is positively correlated with his policy preference in the past. Historical activism in pursuing Mao's agricultural radicalism is expected to have negative impact on one's preference for HRS, and vice versa.

As lower levels in the hierarchy, middle level cadres can be regarded as bureaucrats. They get their resources through the budgeting process, and all revenues it collects go to the central budget. Thus, bureaucrats are more likely to benefit by investing in personal connections, lobbying

activities, and strategical manipulation of information. That is to say, rent-seeking, as defined in the public choice literature (Krueger 1974; Buchanan, 1980) is a more rational way for bureaucrats to advance their interests. Unfortunately, this standard theory of bureaucracy cannot be directly applied to our analysis. First, as far as HRS is concerned, only one or two central ministries were directly involved. Second, local leaders, particularly those at the provincial level, are not exactly the same as ministerial bureaucrats in terms of their institutional positions. To the extent that provincial leaders have a general interest in promoting provincial economic performance, their policy preferences can be analyzed in the same way as those of the central leaders. Thus with regard to the HRS issue, provincial leaders can also be approached either from an economic performance perspective or from a political strategy perspective. We also expect that, no matter what motive was more important, they had to draw heavily upon their past experiences and political associations to formulate their current policy positions towards HRS. Understandably, provincial leader's perceptions of relative economic backwardness were related to their preferences for HRS. *The more backward a province was believed to be, the stronger the support for HRS would be from the provincial leadership.*

In the above discussion, institutional factors become an indispensable part of the story. The actors are not just rural peasants, and interests of a variety of actors are more complex. Even in the case of peasants' choice, I assume they will consider the effect of HRS not only on agricultural production, but also on potential changes in collectively derived incomes and the political risks. As for the policy makers, the motives were multi-dimensional and often difficult to isolate. In particular, I expect ideology to be an important ingredient in the policy making process, and the history of one's prior positions.

III. CROSS-PROVINCE COMPARISON: SEVEN CASES

There were different attitudes and policies in various provinces with regard to HRS in this period. We may put them into several groups. (1) The forerunners. These were provinces where provincial leadership supported and led the reform, while peasants and low level cadres were enthusiastic in adopting HRS. These early supporters of HRS may be represented by Anhui and Gansu. (2) Effective resisters. These were provinces where provincial leaders opposed the reform

and resisted the change for political and ideological reasons, where the peasants and low-level cadres were less enthusiastic about HRS for economic reasons. In these provinces, the resistance to HRS was strong and effective. Among these “resisters” were such advanced areas as Shanghai, Jiangsu, and the three northeastern provinces. (3) The weak resisters. The third type was characterized by a conflict in attitudes toward HRS between the provincial leadership and the peasants. For example, in Guizhou and Zhejiang provinces, the peasants were among the most active in adopting HRS whereas the leadership tried to suppress the spontaneous actions of the grassroots. In this kind of situation, the provincial resistance to HRS was generally ineffective. The transformation from the commune to HRS in these areas, though a little slower, was nevertheless remarkable.

The forerunners: Anhui and Gansu

Anhui

It is now commonly recognized that Anhui province was the birthplace of the well-known household contract farming system (daobaogan). Anhui caught national attention by consistently violating the state laws on rural production systems from 1979 to 1982, and in doing so, triggered fierce, nationwide debates on some fundamental issues of socialist ideology. Moreover, its immediate success in raising agricultural production provided solid factual basis for reformers pushing for policy change.

Anhui had been affiliated with radical policy during the Cultural Revolution. But soon after that, Anhui was headed by a new party chief Wan Li and the provincial leadership was unmistakably reform-minded right at the beginning of the rural policy change movement. The first challenge to Wan was the drought in 1978 that broke a hundred-year record in terms of severity. Without decisive measures, the land would be abandoned and no harvest could be expected next season. Facing the record-making drought, Wan Li, as well as many others, knew that all policy measures permitted at the time (1978) were futile. At his suggestion, on September 1, 1978, the Anhui Provincial Party Committee convened an emergency meeting and made an unusual decision: lending land to peasants. It was de facto household farming on a limited scale justified on the ground of crisis management. As a matter of fact, Wan did not make the bold move in isolation; instead he kept his experienced eyes on the process of change in the political center. There are

three points to be noted: first, Wan had a reform-minded record; Second, he was well-connected to the central leadership and third, the conditions brought about by the drought in Anhui were favorable to the change. Thus, he was able to lead the policy change in Anhui one step ahead of the CCP's guideline and, in the meantime, kept the thrust not so far ahead as to provoke premature conflict.

Though the provincial directive allowed only task rate and other similar policies, the implementation in some place went far beyond the regulation. The most famous case was a village called Xiaogang. Xiaogang, a poor production team of 18 households in Fengyang County, Chuxian Prefecture, was the first team in China to abandon Collective agriculture on November 24, 1978 when they decided to go with the old way: go back to household farming. This choice was politically dangerous in the winter of 1978. Why did Xiaogang villagers choose to take such a great risk? Because they believed that household farming would bring them food and hope of survival. Twice in 1957 and 1961, Xiaogang villagers tried to restore some sort of household production, but all efforts were decisively suppressed. By 1978, the government had changed the head of the Xiaogang Production Team 15 times. Compared with 1955, the year before collectivization, grain output in Xiaogang had dropped 88% by 1968. Given such a bitter experience with collective agriculture, it is not difficult to understand why Xiaogang would choose to decollectivize when it proved possible.

Although Xiaogang villagers tried to keep their actions secret, the secret could not be kept long. This case posed serious problem for the leaders in the county and prefectural level. Fortunately, the upper levels in this case, i. e. the Fengyang County, the Chuxian Prefecture, and the Anhui Province, were all headed by pragmatists with solid knowledge of rural China. In October 1979, a team from the Prefectural Party Committee visited Xiaogang at its first harvest after switching to household farming. As expected, they found a remarkable jump in output and income (more than six times!). As the facts were so convincing, the Prefectural Party Standing Committee quickly reached a consensus and decided to permit Xiaogang to continue the "illegal experiment" for three more years.

In policy terms, Wan Li and Chuxian reformers adopted the renowned "Three Nos" policy (no propaganda, no promotion, and no prohibition). This noninterventionist policy was a de facto "let-go" reform measure, for it was in the peasants' interest to decollectivize. More over, letting

peasants choose what to do under this noninterventionist policy also served to postpone head-to-head confrontation between reformers and conservatives, minimizing the political cost.

With this noninterventionist policy, HRS spread to more and more areas by way of imitation. Stories by word of mouth, investigative reports and government documents were major channels of information. The trend was, from collective production to household farming in most areas of Anhui. Increasing popularity of HRS created its own legitimacy. Apparently, the introduction of HRS in Anhui took place much earlier than the formal endorsement from the center. Until September 1980, the state directives still prohibited “Da Baogan” which, however, was widely practiced in Anhui in the beginning of 1980.

Gansu

The switch to HRS in Gansu province was among the earliest and most sweeping in China . The reasons behind the Gansu’s quick and early change were similar to that of Anhui. The economic conditions were extremely suitable for generating peasant demand for change while the political leadership there was also supportive of the change. Gansu, located in the northwestern region of China, had been one of the least-developed provinces in China before and after Mao’s revolution. Agricultural collectivism worked much worse in Gansu than in such places as Jiangsu. The reason might be associated with the bad technological conditions that were not suitable for collective agriculture. First, agricultural machinery was scarce in Gansu; even when some machines were available there their use was severely limited by the geographical conditions characterized by mountains, canyons and bumpy and small fields. Second, education was very underdeveloped there. It was reported that in 1980 65% of the young and middle-aged peasants (16-45 years old) in a typical county of Gansu were still having no school education (Lu and Wang p.118). As a result, many production teams could not find an accountant who was able to maintain minimum standards of bookkeeping. Under this condition of poverty and financial chaos, corruption (stealing collective money, of course) was rampant, resulting in undermining the trust of the peasants on the collective. So, peasants in Gansu had very strong interest in abandoning the commune farming and shifting to the responsibility system. Fortunately, the new province leadership, headed by Song Ping, a veteran and pragmatist, adopted a rather permissive attitude toward peasants demand for change. Following the Plenum of December of 1978, Gansu

provincial leadership began to implement the new policies that emphasized linking income to performance, although limited to preliminary forms later, the province Party Committee convened a special forum in which party secretaries from six poor prefectures of Gansu participated and, after discussion, announced the policy of legitimizing HRS in those areas where collective economy was not developed, peasants' life was poor, and most peasants demanded for HRS. Then, the province agricultural commission promulgated a document which specified concrete regulations and procedures to guide the changes in the province. Prefecture and county governments in those areas which were designated as "poor and remote" quickly organized and trained special task forces to be sent to the grassroots, helping the peasants go through the process of partitioning land, state grain purchase quota, as well as animals and irrigation instruments, if there were any of these. Apparently, this type of organizational help from the governments was warmly welcome by the peasants. As a result, the shift from commune-based collective farming to household farming was implemented rather orderly and smoothly in Gansu province.

The weak resisters: Guizhou and Zhejinag

In these two provinces, peasants' push for HRS was met by, the provincial leadership's hostile attitude toward HRS. As a result of this peculiar combination of strong local demand for and clear provincial discontent with HRS, the shift to HRS in those two provinces was neither pioneering nor lagging behind; it lay between the couple of forerunners and many of the resisters and slow imitators.

Guizhou

Located in southwestern China and on the Yunnan-Guizhou plateau, Guizhou is among the provinces with the worst natural conditions in China. It is one of the least developed provinces with the lowest per capita GNP. As we may expect now, the shift to HRS in Guizhou was among the earliest. The peasants' drive toward household farming was particularly strong. As early as 1960, immediately after the disastrous experience of the "great leap forward" of 1958-1959, about a quarter of the production teams abandoned collective farming and adopted "responsibility field" which is the same as the HRS in the 1980s. The spontaneous de-collectivization of the 1960s was politically repressed. So when the Cultural Revolution was over and the Party announced its new

policy direction, peasants in Guizhou lost no time in pushing for household farming. Unfortunately, province leadership in Guizhou did not support the peasants at the very beginning. During 1977 and mid-1980, the province government was headed by party secretary Ma Li, who was personally connected with Hua Goufeng. He became famous for his “quotation-like” praise of Hua: “every word of Chairman Mao is truth, every word of Chairman Hua is as heavy as twenty million tons (zizi zhong qianjin)”. Under Ma governance, Guizhou provincial government strongly opposed grassroots action for HRS. The catch-words of the provincial policy during these three years were revealing: “resolutely rectify household farming and all forms of quasi-household farming” (1977), “resolutely fight against reversion of collective ownership” (1978), “partition of land for household operation must be stopped” (1979). Even in January of 1980, the provincial party document still demanded to correct the error of “household quota”.

But the restrictions from the provincial leaders were not effectively enforced, at least for two reasons. First, the peasants’ demand for household farming was too strong to be repressed without using high-powered political measures such as jail and mass struggle meetings. No one in the province leadership prepared to resort to the extreme political measures. Secondly, the government system in the province was highly divided. The lower levels of governments, namely the county and prefectures, were deliberately opposed to the restrictive policy tones of the province leaders and took their own actions to support the peasants. Moreover, they tried to weaken the strength of the province leaders by going to higher authority. A critical moment came at the spring season of 1980 when peasants in numerous localities participated in informal strikes, insisting that they would not plant any field without going to HRS. Given this high pressure from below, the provincial leadership was overwhelmed by the reformers in the government system. In March 1980, the provincial party committee called for “stopping opposition of the peasants” and four months later, it promulgated a new document entitled “instruction on loosening agricultural policies” (Guanyu Fangkuan Nongye Zhengce de Zhishi), allowing different forms of the responsibility system. By the end of the year (1980), more than 70% of the production teams had moved to HRS.

Zhejiang

In HRS reform, Zhejiang represented a new situation characterized by a strong confrontation

between the spontaneous demand for HRS from the peasants and harsh policy prohibiting HRS practices from the provincial leadership.

The roots of peasant individualism was deep in Zhejiang. Zhejiang, located south of Shanghai, was historically known for the entrepreneurship of its people. As early as mid-50s, resistance to collective agriculture occurred frequently in southern Zhejiang. Still, by the end of 1970, like the rest of the provinces, the agriculture in Zhejiang was completely collectivized in the standard form of commune system. As a rice-producing area, Zhejiang was slow in adopting agricultural machinery. Field work was still done manually with animal power in the later 70s. There was little economy of scale in labor organization. Rural industry and sideline production had some preliminary start, but it was far too small to have real impact on the well-being of peasants and grassroots cadres.

In the early years of rural reform, Zhejiang provincial government was in the hands of cadres who were against the coming changes. This had much to do with the then party chief Tie Yin, who used to be the political commissar of the field army stationed in Zhejiang. His military background contributed to the disciplinary and authoritarian leadership style and was at odds with grassroots spontaneity. Besides, he was related to the mainstream of Hua Guofeng.

The provincial conservatism ran in direct opposition to the strong household individualism of Zhejiang peasants. The pattern was: first, peasants in some areas adopted a form of responsibility system, prompted practicality as well as the perception of new favorable policy in the wind. Then the provincial government would issue instructions or send a task force to the trouble spot to correct problems. Later, directives from Beijing would legitimate some less radical form of HRS and permitted diversified organizational forms. By then, provincial leadership had to reconcile its stand with that of peasants as well as of the pro-change but sometimes ambiguous center. In the meantime, the peasant would take advantage of the ambiguity and move forward. In short, the whole process of change in Zhejiang was driven by peasants' enthusiasm in HRS in the face of opposition from the provincial government. Finally, the persistent efforts of the peasants, with the general tolerant spirit and experimentalism of the central government, made the reform prevail.

The Effective Resisters: Jiangsu, Shanghai, & Heilongjiang

These three provinces were among the slowest to move to HRS (table 3.1). By the end of

1981, the percentage of production teams in the household responsibility system was already 96% in Guizhou, 85% in Anhui, and 81% in Gansu. However, there was no single team moved to HRS in Shanghai's suburb and Heilongjiang province, whereas in Jiangsu province, only 7% of the 319,000 production teams had adopted HRS.

Table 3.1 HRS and Economic Conditions: Jiangsu, Shanghai & Heilongjiang

	Jiangsu	Shanghai	Heilongjian
Year of Shift	1983	1983	1983
No. of Teams	319,900	29,000	59,000
No. of Labors	20,345,000	2,103,000	4,001,000
Cultivated Land	69,910,000	5,400,000	137,690,000
Power (hp)	2,919,930	595,500	3,916,520
Per Capital Income (RMB)	977.98	1,912.51	1,737.82
Per Capital Collective Industry (RMB)	143,920	395,150	112,470
Political risk of shifting to HRS	high	high	high

Source: China Agricultural Yearbook, Beijing.

The relative slowness of change in those three can be traced to both economic conditions and political and ideological situations. Economically, their agriculture was more developed and the degree of mechanization was high; at the same time, the rural collective economy was stronger and able to provide additional income to the peasant family. Therefore, low-level cadres were hostile to HRS because they perceived HRS as undermining their ability to control the collective resources; whereas the peasants were less enthusiastic about HRS, for they had to consider the potential loss in security and additional income they were used to during the collective period. Politically, province leaders in the three regions happened to be little interested in the change, for different reasons. The combination of the lack of a strong local drive and a presence of leadership restriction in those provinces made the resistance to HRS more effective. So they stayed in the collective framework until the pressure for change at the national level became too strong to ignore.

Jiangsu

When the change in rural China began in the early 1980s, Jiangsu had established a solid track record in agricultural performance. Most land was intensively cultivated and the agrarian art in Jiangsu was historically high. All this meant less potential for increasing grain output by improving labor input. Jiangsu's rural industries had also established a high reputation, second only to Shanghai's suburb counties. Primarily for its excellent record in agricultural performance, Mr. Xu Jiatun, the provincial officer responsible for agriculture in the 1970s, was elevated by Hua Guofeng in 1978 to the post of first party secretary of Jiangsu. So in the eyes of Xu Jiatun the shifting to HRS were not particularly good for Jiangsu's interest. Politically, secretary Xu was promoted to the post because he did well in promoting the collective agriculture. Legitimization of HRS was therefore a self-negation. Economically, Jiangsu had been doing better than most other provinces under agricultural collectivism; it was hard for them to see the rationale to change the direction of policy. Given the existing stake Mr. Xu had, it was not difficult to see why he chose to be restrictive to the changes. At the grassroots level, the situation was more diversified. In the northern, peasants and low-level leaders were more active in pushing for HRS, partly because the north was much poorer than the south. However, in many places where rural industries were developed, agricultural machines were extensively used, and job and income from collective industries were important, peasants were reluctant to actively fight for HRS. More importantly, local leaders in these areas had powerful leverage to influence the peasants. So in later 1980 and throughout 1981, an increasing number of cases of shifting to HRS was reported from north Jiangsu. Many local leaders, aware of the provincial opposition, took various repressive actions, trying to block the spreading of the few who had dared. In one county, this even led to serious conflict between the county government and large numbers of unorganized peasants. One staff in the county policy research office did an investigation and wrote a sympathetic evaluation about the cases. In another place neighbouring Anhui province, peasants got the information about The central party committee's new policy as well as the impressive results of HRS in Anhui from listening to Anhui's radio broadcasting. So more grassroots actions and calls for change were cumulated in Jiangsu toward the end of 1981. Added to this pressure were the changes in central leadership. In 1981, Hua Guofeng, the man who helped to elevate Xu Jiatun, had lost his power

for ruling, Hu Yaobang and Zhao Ziyang had been promoted to head the Party and the State Council. Aware of the provincial restriction and increasing peasant discontent in north Jiangsu, Hu Yaobang, the new party chief, made personal talks with Mr. Xu Jiatun, criticized his “leftist error” and called him to respect the “desire of the masses.” After that, Xu Jiatun returned to Jiangsu and convened a provincial meeting on rural policy issues. Xu made a public self-criticism at the meeting and partly endorsed the new policies. In June of 1981, Secretary Xu publicly praised the introduction of HRS in northern Jiangsu. Following this more permissive attitude, more and more peasants in Jiangsu moved to HRS. The percentage of production teams in HRS increased from 7% in 1981 to 38% in 1982 and 98% in 1983.

Shanghai

The leadership in Shanghai upheld collective agriculture much longer than the country as a whole, even later than Jiangsu. The conditions behind the slowness in Shanghai were very similar to that in Jiangsu. Economically, Shanghai’s suburb (10 counties) was the most developed in China. Moreover, collective economy at the level higher than the production team was much more important than the team. For example, of the 1980 total value of net production of the three levels, the production team contributed only 32.4% (671,000,000 yuan), whereas the brigade counted for 30.2 (626,000,000 yuan) and the commune operation counted for the remaining 37.4% (776,000,000 yuan). Furthermore, mechanization and irrigation systems were quite developed in rural Shanghai and many fields had been reworked to create large-scale stripes of fields. The implications was that organizational forms of agriculture was less important for the well-being of the households in rural Shanghai. Higher degree mechanization and complex irrigation-field systems made it more troublesome to partition the land and irrigation facilities to different households, whereas the machines that were originally designed for collective operation would become useless for small scale household farming. In short, economic conditions did not provide much incentive for rural Shanghainese to push for HRS.

As in Jiangsu, the reason why Shanghai leadership opposed HRS in much of the period of the change was partly cognitive and partly political. Cognitively, Shanghai agriculture had been the best in the country for much of the PRC history; they did not see any necessity to change policy directions. Politically, Su Zhenhua, the party chief of Shanghai at that time, was originally the

political commissar of the Chinese Navy and had poor knowledge of economics. His policy stand was naturally formulated in political terms. He was promoted by Hua Goufeng and his loyalty to Hua Goufeng had put him at odds with Mr. Deng Xiaoping's new line of thinking¹. As for the second man, Peng Chong, his policy preference, much like Mr. Xu Jiatun, was rooted in his experience as the party chief of Jiangsu. Again, Mr. Peng was also promoted by Hua to Shanghai. Given this combination of economic, political and ideological context in Shanghai, it was not surprising to find the resistance to HRS was indeed effective. In fact, Shanghai continued to discourage household farming even after the Central Committee of CCP formally legitimized it.

Heilongjiang Province

Heilongjiang was unique in China in terms of its higher level of agricultural mechanization and heavy presence of state-owned, large-scale farms. The pressure for change from below was therefore modest. In the meantime, the provincial leaders perceived HRS as not suitable to the technological conditions of the province and opposed the de-collectivizing trend. Yang Yichen, the then first party secretary of Heilongjiang province, was widely known for opposing HRS. Secretary Yang was not organizationally connected to Hua Guofeng. This fact made him more open in justifying his position. For him, introduction of HRS was a temporary concession to the peasants in order to motivate them to advance the force of production. Since HRS was a temporary concession only justified by the low level of technology, Heilongjiang had no reason to adopt it, for Heilongjiang had already much mechanized and the operation had been organized in large farms. So Secretary Yang felt no need for change and no guilt for upholding the old policy, because his policy position was based on independent thinking instead of political calculations.

Secretary Yang maintained his policy position in the province quite effectively. The process of moving to HRS did not get very far until sometime in 1983 when Zhao Ziyang, the premier of the State Council, personally called Secretary Yang Yichen and Criticized him and warned him not to block the change anymore. Regardless of how he felt at that time, he knew from his experience in politics that he had to end his opposition. So he finally gave up and took a laissez-faire attitude toward the local changes. In a very short period of time after the fall season of 1983, much of the

¹ It was reported that after Mr. Su used his clout in the Navy to mobilize an unprecedented large scale of fleet to show loyalty and respect to Hua Guofeng in 1980 when Hua returned from his trip to North Korea, Deng Xiaoping commented to his friends: "isn't this a demonstration of force and a declaration of war (against us)?"

province shifted to HRS.

As described above, the three provinces were able to block the shift to HRS until the last minute because of a combination of technological-economic conditions and of political-ideological considerations. These three provinces shared, to some extent, the characteristic of a higher level of technological development, stronger collective economy based on prosperous rural industries, and more diversified sources of household income outside farming. All these conditions tended to reduce the intensity of peasants' demand for HRS while, at the same time, strengthen the interest of the local leaders in preserving the status quo. Political leadership in these three provinces happened to be hostile to the new wind of change, although for different combinations of reasons. It was because of the coexistence of weak grassroots initiatives and strong province resistance that made these province relatively effective in postponing the shift to HRS.

Contrasts and Summary

We now put the seven provinces discussed in this section together in a summary table:

Table 3.2 HRS reform & characteristics of the seven provinces

Provinces	progress	Poverty level	Pollitic risk	Collective economy	Mechanization	Province attitude	Peasant's attitude
Anhui	fast	high	No	weak	low	for	active
Gansu	fast	high	No	weak	low	for	active
Guizhou	fast	high	No	weak	low	against	active
Zhejiang	moderate	moderate	Yes	weak	low	against	active
Jinagsu	slow	low	Yes	strong	high	against	passive
Heilongjian	slow	moderate	Yes	moderate	high	against	passive
Shanghai	solw	low	Yes	weak	high	against	passive

From the table a clear pattern emerges. The areas where shifting to HRS was fast were those places where peasants were poor, collective economies were weak, degree of machanization was

low, and political risk of was not high. In these areas peasants were active in pushing for HRS. When this peasants' activism met with support from the provincial governments, the shift to HRS was quick and easy, as the cases of Anhui and Gansu indicated. When the provincial governments went against the peasants desire, the grassroot movement to HRS would experience difficulties. But that did not necessarily cause delay in introduction of HRS. As in the case of Guizhou, peasants activism prevailed despite of the province government only moderately affected speed of change. Provincial governments' oppositions of HRS were effective, as in Shanghai, Jinagsu and Heilongjiang, only because peasants did not actively demand the change. Therefore, level of peasants activism seemed to be more important than provincial governments' attitude. While the attitudes of the provincial governments were more difficult to account for, their policy-preferences were only one factor affecting the pace of HRS reform. Yet this dose not suggest governments were not important. One of the reasons why peasants dared to run counter to province governments, as in Zhejiang and Guizhou, was because peasants knew the central leadership were changing and the new tone of policies was more permissive. As a matter of fact, level of peasants' activism was correlated to degree of political risk of HRS. This suggested significance of the central State policies to the peasants' actions. Regarding the attitudes of provincial governments, it seemed not easy to predict. Leaders in poor provinces were not necessarily pro-reform, and vice versa. This indicated that government attitude was not determined by techno-economic conditions. From the limited information we gathered, it seemed that past policy-preferences, vested interests and identities of the heads of governments in current debate had more prominent roles in determining the policy orientations of provincial governments.

IV. CROSS-PROVINCE COMPARISONS: SOME STATISTICS

In Lin's model, the choice to move to an HRS system was modeled entirely on economic variables, such as the size of the team, and the level of mechanization. In my comparative case analysis of selected provinces in the previous section, I found evidence that forces other than economic efficiency were at play. Specifically, the economic gains from introducing HRS has to be weighted against factors such as rent-extracting motive of cadres and the political attitudes of provincial governments. The issue addressed in this section is how much of the description

generated from this comparison based on limited cases is representative of the whole picture of China. My effort to gauge how well our cases represent China as a whole, are limited by the rudimentary nature of the data available; and in important ways, will not meet some of the usual requirements of statistical modeling. Nevertheless, the results, when properly explained, may shed some light on our understanding of the process of change to HRS in China.

A Simple model: variables and measurement

The model described in section two was:

$$r = f (E, T, L)$$

Where r is an index of the rapidity of change from collective production to HRS, which is to be explained by efficiency considerations (E), transaction costs (T) and political legitimacy (L). This model covers variables that represent both efficiency perspective and institutionalist perspective. The quantitative measurement of these variables is understandably difficult and inaccurate.

(1) Index of rate of change (denoted as $RTCHANGE$). I will regard the year that more than half of the teams in the province adopted HRS as the turning point for the province. The difference between the year 1984 and the turning point year is the index of the rate of change for the particular province.

$$RTCHANGE_i = 1984 - Year_i$$

(2) Size of production team ($SIZELAB$). Following Lin's practice, the size of a production team is the average number of workers per team in a province. From the efficiency perspective, I expect this variable to be positively correlated with the dependent variable. But transaction cost theorists believe that large size means greater difficulty in achieving agreement. Therefore, there is a transaction cost reason to expect a negative correlation as well.

(3) Level of mechanization ($MACHINE$). Higher level of mechanization implies larger losses in abandoning big machines and higher cost of negotiation, therefore greater reluctance to change for HRS. So, I expect this variable to be negatively associated with the dependent variable for both efficiency and transaction cost reasons. Again I use the same measure as Lin did: the average horsepower of agricultural equipment per team in each province.

(4) Collectively-derived income ($PCCOLLEC$). Collectively-derived income is measured by

the average team income from TVEs and sideline productions. It is the source of rent subject to extraction by cadres. So an institutional perspective would expect a negative relationship between this variable and the dependent variable.

(5) Political risk (PRISK). Political risk, is measured by the probability of being politically punished for practicing HRS. One would expect a negative correlation between PRISK and the rate of change. Aware of some subjectiveness in assigning a value to each province to indicate their relative riskiness, I nevertheless construct a dummy variable for that purpose. A province is assigned a “1” if it is deemed highly risky, and a “0” if low risk. I used a simple rule to assign a value to the political risk in each province. For provinces “commonly perceived” as “poor and remote”, I assigned them “0”; and the rest were assigned “1”. I considered a province to be perceived as “poor & remote” only when there was explicit evidence found in authoritative sources such as government documents, party newspapers, and speeches of leading officials. After making my initial assignments, I showed the rating to over a dozen “insiders”¹ for opinions, and made one adjustment accordingly.

(6) The cost of political penalty (PCINCOME). The effect of a given political penalty depends on the living conditions of the punished. To measure this cost, I chose the average level of per capita income on the theory that a higher income family is more threatened than a lower income family by the same political risk.

In sum, a pure efficiency perspective expects to find positive correlations between SIZELAB and RTCHANGE; an institutional expects all the correlations between RTCHANGE and explanatory variables, including sizeLAB, to be negative.

Data

The data, as shown in the following table, includes all the provinces in China except for Tibet.

Table 4.1 Socioeconomic Conditions

¹ These included the people I interviewed from SAC, RCRD, RDG as well as several other agricultural agencies in Beijing.

	HRS Index	SIZELAB	MACHINE	PCCOLLEC	PCINCOME	PRISK
Anhui	4.00	3.7	1.93	26.09	509.70	0
Beijing	0.00	4.8	3.95	219.79	1356.18	1
Fujian	3.00	3.8	1.90	63.82	718.53	0
Gansu	4.00	3.9	2.93	35.77	518.68	0
guangdong	3.00	3.9	2.05	21.00	328.27	1
guangxi	3.00	4.4	2.48	38.46	545.03	0
guizhou	4.00	3.9	2.06	19.25	404.56	0
Hebei	2.00	4.1	2.59	153.68	925.45	1
heilongjiang	1.00	4.2	4.13	112.47	1737.82	1
Henna	3.00	4.1	2.50	68.70	602.62	0
Hubei	2.00	4.0	2.39	56.76	832.53	1
Hunan	2.00	3.3	1.51	66.79	980.88	1
jiangsu	1.00	4.2	2.30	143.92	977.98	1
jiangxi	3.00	3.6	1.86	37.01	721.07	0
Jilin	1.00	4.1	3.55	90.45	1282.93	1
liaoning	1.00	4.3	3.60	113.13	1098.71	1
neimong	3.00	3.6	2.89	65.86	1531.53	0
ningxia	3.00	4.1	3.65	32.33	596.85	0
qinghai	2.00	4.2	3.55	32.43	683.05	0
shannxi	2.00	4.0	2.64	47.08	616.99	0
shangdong	2.00	4.2	2.26	72.60	681.40	1
shanghai	1.00	4.3	2.97	395.15	1912.51	1
Shanxi	2.00	4.1	2.89	142.83	932.52	1
sichuan	2.00	4.2	1.67	22.69	444.04	1
Tianjin	1.00	4.5	3.49	551.26	2115.16	1
xinjiang	1.00	4.3	3.88	42.30	938.90	0
Yunnan	3.00	4.2	2.58	30.27	440.33	0
zhejiang	2.00	3.9	1.46	82.77	764.47	1

Results and Discussions

The following models were estimated:

$$(1) \text{ RTCHSNGE} = a_0 + a_1\text{SIZELAB} + a_2\text{MACHINE}$$

$$(2) \text{ RTCHANGE} = a_0 + a_1\text{SIZELAB} + a_2\text{MACHINE} + a_3\text{PCCOLLEC} + a_4\text{PRISK} + a_5\text{PCINCOM}$$

Equation (1). includes the two variables used by Lin in his model. It is used here as a benchmark to be compared with equation (2). the enlarged model, which include three more institution-related variables. Running a standard regression, we have the following results:

Table 4.2 The Efficiency Model

<u>Variable</u>	<u>Coefficient</u>	<u>t-stat</u>	<u>P-value</u>
intecept	9.14	3.54	.001
Sizelab	-1.47	-2.01	.005
machine	-0.37	-1.33	.194

$$R^2 = 0.32 \quad F = 7.49$$

Table 4.3 The Englarged Model

<u>Variable</u>	<u>Coefficient</u>	<u>t-stat</u>	<u>P-value</u>
intecept	10.219	4.675	0.000
sizelab	-1.594	-2.568	0.018*
machine	-0.037	-0.143	0.887
pccolec	0.003	1.707	0.110
prisk	-0.970	-3.814	0.001*
pcincom	-0.001	-2.647	0.022**

$$R^2 - \text{model 2} = 0.74 \quad F - \text{model 2} = 16.34$$

We find that:

(1) Model 2 greatly improved the explanation of the event than model 1. In model 1 where only two economic variables are included, we find only one of them to be statistically significant;

whereas in model 2 where new institutional variables are included, we got three of the variables statistically relevant. The adjusted R^2 increases from 0.32 in model 1 to 0.74 in model 2, indicating the overall explanatory power of the model is greatly improved.

(2) Results of each variable seem to be more in line with the institutional perspective than with the pure efficiency theory. In both models, the size of team measured in labor force is found negatively correlated with the rate of change. This is contrary to what efficiency theory expects and what Lin's model finds. From efficiency considerations, large size of a team means less efficiency and, stronger incentive to change. But from the transaction cost perspective, large size of a team implies greater difficulty in negotiation for change among team members, therefore, less incentive to change. To the extent that our results are indicative, the transaction cost explanation seems to be more plausible.

The variable MACHINE, measuring the level of agricultural mechanization, is found statistically insignificant in both models, though the sign is in the direction expected by Lin and this study. The reason of the weak presence of the variable may lie in the fact that overall level of agricultural mechanization in China was too low to make cross-province difference significant. My case comparisons do find some obvious correlation between higher level of agricultural mechanization and lower incentive to change.

Among the three institutional variables I added to the model, two variables representing political risk and consequences are statistically significant in the causal direction expected. The index of political risk and cost of political penalty both have a negative effect on the rate of change.

To the extent that results of our measurement of collectively derived income indicate anything, we have difficulty finding an explanation. The positive correlation between PCCOLLEC and RTCHANGE is contrary to our hypothesis. The two variables are not statistically correlated. But if there is any relationship as indicated in the results, we have to admit that level of collective economy either has positive impact or, at least, has no negative one on the rate of change. This throws doubt on the relevance of "rent-seeking" view of grassroots cadres. The derived hypothesis seems to be supported in some case analysis, such as in the suburbs of Shanghai. But data on the whole country does not confirm this.

Finally, I must point out that the key economic variable discussed in Lin's model is found to

be contradictory to his original results and explanations, where his other variable, mechanization, is statistically insignificant. I am forced to question the soundness of Lin's study. In Lin's work, neither the size of teams nor levels of mechanization were directly measured from the raw data provided by the agricultural Yearbook of China, but "estimated" from a model that included a number of other economic variables. Hence, the correlation found by Lin are really between the rate of change and some proxies for efficiency factors.

In conclusion, I reiterate that the statistical results discussed here should not be considered a rigorous statistical analysis. Our sample has only 29 observations. I present these quantitative results as a supplement to the comparative case analysis. Fortunately, when we put the case comparisons and statistical study together, the conclusions seem to be largely consistent. In particular, it seems safe to conclude that institutional factors did play an important role in the dramatic changes in rural China, which was not driven by efficiency concerns alone.

V. PATHWAY TO THE PRESENT: SOME CONCLUDING REMARKS

At first glance, the HRS reform in rural China seemed to lend more support to the performance model of institutional change. After all, HRS as a more productive system, compared with the Commune, and it finally made its way despite decades of political repression. But when we looked into the change process more carefully, we found the picture was much more complicated. Although the peasants and grassroots cadres dearly wanted HRS primarily for expected economic gains, they nevertheless had to balance the expected gains against collective opportunity and legitimacy. As for the government leaders, how to reconcile the idea of socialism with the practice of HRS was a serious challenge and ignited a painful soul-searching process in which the very concept of socialism came to be redefined. In the process of shifting from the Commune to HRS the search for efficiency went hand in hand with the search for legitimacy. It is the interaction between the forces of rationality and the forces of history that moved the process forward. The case of Chinese rural reform illustrates that there is much more to institutional change than the pure rationality model accounts for.

Rational Choice versus Relational Choice

The traditional rational choice approach usually begins with individuals maximizing self interest and acting independently from each other. Game theory introduces an important change to the rational choice perspective by treating the choices of multiple individuals as interdependent. In the arena of institutional change, this interdependence of multiple actors is more the rule than the exception. In our case, peasants, grassroots cadres, intermediate government leaders, and the top leadership were all related to each other. In their choices regarding HRS, they had to take into account the actions of each other. The peasants' decision about HRS was made by weighting economic gains against possible political losses that was controlled by government leaders. Similarly, government leaders at the intermediate level had consider both the peasants' desires for and the attitude of central leadership toward HRS in addition to their own policy preferences. As for the central leaders, they were by no means free of the constraints that were created by the actions of the peasants and intermediate governments. Each actor still has to do rational reckoning regarding his actions, but he has to calculate the costs and benefits in relational terms. The choice is both rational and relational.

This relational nature of choice in the institutional arena has many implications. The most obvious is that choices, once made cannot be undone without incurring transaction costs, for the new actions involve multiple interrelated actors. In essence, each round of actions involves an agreement among interdependent actors. To chart a new course of action means to change the existing agreement and the existing web of vested interests. The significance of this point may become clearer if we compare a consumer who discovers he dislikes the food he ordered in a restaurant and a Chinese peasant in 1980 who regretted his support for agricultural collectivization in the mid-1950s. The consumer can correct his mistake simply by going to a different restaurant next time. But the Chinese peasant could not so easily undo his mistake. To undo the collectives, he had to "offend" fundamental beliefs of other people and reorganize the distribution of power and wealth. So whether or not the Chinese peasants could undo his mistake did not depend so much on his own preference as on the interaction of related choices of all the participants.

Difficulties in undoing one's earlier choices is, of course, one source of path dependence. In the world of related choice, every round of interdependent choice results not only in policies but also vested interests. The particular structure of the vested interests will then have a significant bearing on the future interactions of the participants. Therefore, the relational choice today is always

conditioned by the relational choices yesterday.

Cognitive Limit and The Role of Emotion and Prejudice

In the institutional choice arena, rationality is limited not only by interdependence of actions but also by the complexity of the issues involved. Again let us think about the difference between a consumer who wants to buy a pair of shoes and a Chinese county official who had to make up his mind on HRS. The consumer, without much difficulty, can shop at several stores, inspect several brands, and make judgments about their comparative quality. Minimal investigation usually leads to a pair of shoes he will like. The whole process of searching, evaluating, and deciding requires nothing more than common sense. But for the Chinese county official, common sense was far from sufficient to make his decision for the HRS debate was framed as a multi-facet problem. On the one hand was HRS' effect on economic productivity and on the other hand, one had to consider HRS' overall impact on the socialist project. Neither determination was easy. Motivation was stronger for peasants under HRS, but that did not necessarily mean HRS was conducive to long term productivity gains for Chinese agriculture. The county official had to worry about possible negative effects of dividing the land on machinery use, on construction and maintenance of large irrigation networks, and on prospects for taking care of the poor. He might also ask why household farming had not worked in China's past. In short, although our county official might agree with the peasants about the short-run positive motivational effect of HRS, he still could have genuine doubts about the long term effects of HRS on the Chinese economy. The county official would predictably have more difficulty evaluating the political impact of HRS. Would HRS undermine the foundation of Chinese socialism? Or would it help the Party restore its legitimacy which was undermined by the Cultural Revolution? Or, was HRS a useful temporary policy only? All these questions had to be considered by our county official before he could "rationally" take sides in the HRS debate. Obviously, taking a position on HRS was different from choosing a pair of shoes.

The key is the complexity of issues. One source of complexity in institutional choice derives from the fact that the cause-effect linkages tends to be multi-level and multi-faceted and therefore uncertain and ambiguous. As a result, people cannot rely purely on their cognitive powers to solve many policy conflicts. As a result, they have to resort to ideology for making up their minds and

taking sides.

This is why ideology is indispensable in the process of making institutional choice for most social actors. As we saw, the Chinese debate about HRS was heavily influenced by the grand debate over socialism versus capitalism and conducted in the language of Soviet-styled Marxist political economy.

In the Chinese redefinition of HRS, participants attached great weight to proper wording for the changes. When household output contracts were first adopted by some Anhui peasants, many people quickly jumped to the conclusion that it would fail and be stopped by the government. Why? Because this was “dangan” (private work) and “dangan” meant to oppose socialism and go back to the old days of feudal China. To save household contracts, as we saw, the reformers made great effort to invent some theoretical arguments to distinguish household contracts from “dangan” and from capitalism. Finally, they adopted the phrase “household responsibility system linked to production”. The different wording, be it “dangan” or HRS, did not change what the peasants were actually doing in daily life. But the change of wording from “dangan” to HRS mattered a lot for both the reformers and the conservatives, simply because both sides needed to maintain continuity in an ideological attachment to socialism.

Unanticipated Consequence

Complexity also results from “unanticipated consequences”—a concept more often used in sociology. This concept, refers to the possibility that people often experience some unexpected results as a result of their decisions. That actors cannot fully anticipate the long run consequence of choices made at specific time is clearly linked to the complexity of the world. Moreover, people have a tendency to discount the future results compared to the more immediate payoffs. By downplaying the future, people may end up with a long term result they never would have accepted had they fully foreseen it.

Obviously, the HRS reform is an apt illustration of this phenomenon. At the beginning of the reform, probably on one, be hereformer or conservative, envisioned that Chinese agriculture would be based on household operation of the land for a long period. Deng Xiaoping, in his speech praising HRS in April 1980, explicitly defined HRS as a temporary measure to cultivate the forces of production so as to, in the future, establish more effective collective agriculture based

on a higher level of development. That strategic vision was widely shared by almost all reformers at that time. Conservatives were unconvinced because they had doubts about the feasibility of that strategy.

The conservatives were right. The Pandora box of private interest, once open, is difficult to close again. After the Tiananmen Square tragedy of 1989, a group of conservatives thought they saw a political opportunity to reverse the rural reforms so they tried some preliminary measures. But these attempts to turn back failed even before they started as peasants responded by cutting trees, slaughtering pigs, etc. The problem for these conservatives was that institutional context had changed so significantly during 1980s that it became virtually impossible to return to the era of "Commune". During the eight to nine years between 1980 and 1989, household had become the basic decision making unit in rural China, deciding what and how to produce and sell, how to allocate savings and other source of capital and etc.. At the same time, cadres and middle-level leaders had also changed their perception about HRS. Their concerns with the possibility of decreasing power and discretionary use of surplus did not materialize; to the contrary, they gladly found that HRS opened new way to private business and wealth; seizing on their political connections and administrative skills, these cadres and middle-level leaders had become more successful in developing private or quasi private business than peasants. Therefore, their resistance to going back to collective agriculture was even stronger than others. Finally, ideology had changed too. After an initial crisis in ideological beliefs in the early 1980s, most Chinese people settled to an indifferent attitude toward ideological issues. Pragmatism had become the prevailing tone of political discourse. All these changes made it impossible for anyone to bring the country back to what it was in 1970s.

How about the reformers? Did they have regrets? Interestingly, most reformers would say "no". They had, over the years, changed their ideas. Mr. Du Runshen, the only director of RCRD, explained why. In my interview with him, Du told me that in the beginning he, like many of his friends, supported HRS primarily because they saw that the existing Commune system had failed. At the time he thought the failure was due to low level of the forces of production rather than an intrinsic failure of collective agriculture. So he saw HRS as necessary because it would cultivate the forces of production and thereby eventually create suitable technological conditions for recollectivization. But as the process unfolded, Mr. Du's ideas also evolved. There were several

stimuli". For one thing, the opening to the outside world brought new information. For example, household farms had long been thought to be identical to small scale operation. But contact with friends from America created a new perception of modern family farms operating on scales larger than Chinese collectives! This new perception greatly reduced worries about the technical liabilities of HRS. More importantly, as SAC was reorganized into RCRD, numerous new college graduates were recruited. This young group was particularly reform-minded and possessed a remarkable capability to blend modern economics with the reality of rural China. By maintaining regular dialogue with these young people, Mr. Du continuously upgraded his knowledge of economics and other related subjects. In the end, he developed a brand new vision of the Chinese rural economy in which the household was the basic unit of operation. In other words, household farm in Du Runshen's perception was changed from a "temporary retreat" to a long run viable organizational form. Isn't this an example of "unanticipated consequence"?

The experience of Du runshen is representative of a large group in the Chinese Communist party. In the latter 1970s they regarded HRS as something alien to socialism and the only reason for temporarily accepting it was to use it to overcome economic backwardness. But by the middle of the 1980s, these same Party members and cadres came to see HRS in a new light. Not only was HRS suitable for short term gains, it was an indispensable cornerstone of any feasible form of socialism.

This story reveals an interesting phenomenon. Self interest may be time dependent. If we view choices as the expression of perceived self interest, then, we have to say that Mr. Du Runshen and his friends had very different perceptions of their self interest in 1979 and in 1984. Furthermore, since the perception of self interest can change with time, and so does institutional choice, the pattern of interactions and the balance of power among the relevant groups will also change with time. At one point, the majority of participants may favor one type of policy. But later, they may , based on the same principles of rational choice, favor a different policy. In terms of institutional change, this means that "the equilibrium institution" changes with time. In political market, a actor can fight against some institutional forms today but support the same institutions tomorrow, and the change may be based on a rational calculus of perceived self interest. In this sense, institutional equilibrium is shifting as the actors shift their perception of their interests.

The Puzzle of Communist-led Privatization

The concept of shifting institutional equilibrium may help explain one of the interesting puzzles about the Chinese reform: how could privatizing reform be led by a party that calls itself “communist”?

In the last twenty years China has come a very long way from the traditional vision of socialism. Many people even think, with good reason, that China has moved onto the road of capitalism. Of course, many others, particularly the old generation of reformers in China, would disagree. As suggested by this story, these reformers still hold onto the idea of socialism, but the content of socialism has been fundamentally redefined. Many of the elements and even principles that were once regarded as capitalistic are now thought necessary building blocks for constructing a socialist house with a Chinese character. But no one can deny that the emerging socio-economic systems in China is a direct negation of the socialist vision of the 1970s. Most Chinese, leaders and ordinary citizen alike in the 1970s would have labeled the Chinese system of the 1990s as “capitalistic”.

So this is the puzzle: how did a political party engineer a change where the end state that is now embraced was considered absolutely taboo in the beginning? For years, scholars have repeatedly argued against the impossibility of communist self-reform. China certainly provides an important counter example to this long-cherished conviction. The key is that institutional equilibrium is not a static point but shifting states. Given an initial situation, actors always take action to maximize their interest, the interactions of these actors give rise to institutional equilibrium, and changes in these actions will also change the equilibrium. Due to “unanticipated consequence” as discussed, choices made in one moment may cause far-reaching changes that cumulate into fundamental restructuring the initial institutional settings. But under this new “initial” institutional environment, same changes may happen again. Therefore, the end state and initial state can be significantly different from each other. In this regard, the concept of path dependency does not mean institution always move along the same track; it also allows institutional reforms that lead to radical change of the initial state.

So we do not need to look for esoteric or mysterious explanations for the self reform process of in Chinese socialism. The story told in this study is largely understandable in the tradition of rational analysis. As we saw, legitimizing the HRS was a serious challenge and remarkable

ideological undertaking. The same can be said about the introduction of the stock market, the legalization of private business corporation (not just individual ventures), and the overall legitimization of the market economy. During 20 years in post-Mao China, most people—from political leaders, intellectual, cadres and the masses—all experienced a fundamental reorientation of ideas, beliefs, habits and even styles. Throughout these changes multiple economic and institutional forces were at play driving the process forward. At what now, can be seen as a crucial moment, participants in the policy making community compromised on a temporary policy. Under the influence of this policy configuration, actors began to modify their strategies, searched for new information, and expressed new theories. These efforts brought about new economic, institutional, and theoretical results. This resulted in a change in the balance of power in the policy making community. Out of the new balance of power arose a new policy equilibrium (i. e. compromise). As reforms proceeded the reformers as well as the conservatives came to be reformed. This is a open-ending process of evolution. In this way, self reform in one of the world's most ideology-laden political Parties became possible.

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THE EVOLUTION OF ECONOMIC REFORMS IN CHINA

Hiromi Yamamoto

Kyoto University

I . INTRODUCTION

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A. Agricultural Reforms

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IX . CONCLUDING REMARKS

Intergovernmental Competition And Evolution of Rules Governing The Fiscal Relations In China¹

By Xingyuan FENG

Associate Professor of the Chinese Academy of Social Sciences

email: cassfeng@1010.com

Submitted to the International Conference on
“Evolutionary Perspectives on Transition Economies”,
27-29.March, 2002, in Kyoto, Japan

(DRAFT)

¹ This contribution is based on the findings from the project “Territorial Competition, Financing of Local Public Goods and Role of State in China” in collaboration between the Chinese Academy of Social Sciences (Prof. Dr. Li Yang) and the University of Witten (Prof. Dr. C. Herrmann-Pillath), in which the author participated as team member and project coordinator.

1 Introduction: quasi-compound and competitive governments in China

Breton (1996) referred “compound governments” to those governments under the federalism or in a confederation, which consist of center of powers with autonomy or quasi-autonomy. In China, governments are quasi-compound governments, although it is a unitary state. The centers of power, including the Party, the central, regional and local governments, departments of the governments, the Executive, Legislative and Judiciary, associations etc., have some, although limited level of autonomy since the reform. With the gradual reforms these centers of power followed their self-interests and gained some level of autonomy.

Governments in China are competitive². Take an example of the Tongxiang City in Zhejiang Province. It is a county-level city. In the administrative structure in China, Tongxiang is subordinated to Jiaxing City, a prefecture-level city in Zhejiang. The relevant five levels of governments, including the central government, Government of Zhejiang Province, Government of Jiaxing City, Government of Tongxiang and its township-level governments are competitive governments. Formally, there is cooperation between different layers of governments (vertical intergovernmental competition), between different departments or different centers of power in the same governmental system (intra-governmental competition) and between the governments in different territories (horizontal intergovernmental competition). In reality, there is competition between them, respectively.

The observation of the setting and evolution of the rules governing the fiscal relations in China should be the best way of “unpacking the state” in China and identifying the logical linkages between the fiscal system, the political system and the economic system whereas the fiscal system plays a most important role.

In the following, the author will focus on the analysis of the development of the central-local fiscal relations in China and attempt to find out how rules governing the fiscal relations were set and evolving. In the analysis, answers will naturally be given to the question why governments in China are quasi-compound and competitive governments. In the conclusion part, the author will discuss on the possibility of setting up a framework of rules regulating the intergovernmental competition and the central-local fiscal relations.

² The first paper applying the paradigm of “competitive government” for the China case should be C. Herrmann-Pillath, Die fiskalische und regionale Dimension des systemischen Wandels großer Länder: Regierungswettbewerb in China und Rußland, Wittener Diskussionspapiere, Heft Nr. 42, 1999.

2 Development of on- and off budget revenues and expenditures in China

The budgetary revenues in China increased from 17.4 billion Yuan in 1952 to 113.2 and 1144.4 billion Yuan in 1978 and 1999 respectively. The GDP in China increased from 67.9 billion Yuan in 1952 to 362.4 billion Yuan in 1978 and 8191.1 billion Yuan in 1999 respectively (see Chart 1). With the reform and opening policy since 1978, the budgetary revenues in 1999 was 3 times that in 1978, while the GDP in 1999 was 6.73 times that in 1978, if calculated in constant price of 1978.

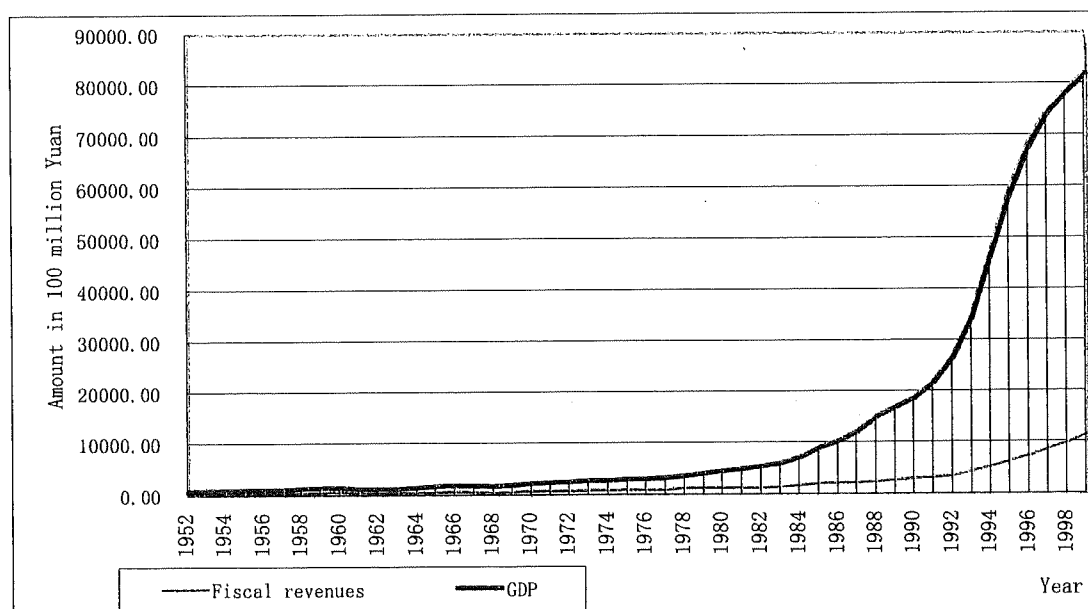
The percentage of budgetary revenues to the GDP in China ranged from 21.0% (1968) to 39.3% (1960) in the period of planning economy (1952-1978). It fell from 31.2% in 1978 steadily to 10.7% in 1995, and with the fiscal reform of 1994, it increased again since 1995 to 14.0% in 1999 (see Chart 2). It rose even to 15.8% in 2000 (CCTV, 25. February 2002).

In the period of 1979-1995, the growth rate of budgetary revenues fell behind the GDP growth rate, while it has been higher than that since 1996. See Chart 3.

But the general budgetary revenues are only one part of the total revenues. The amount of extra-budgetary revenues was not included in Chart 3. It was not significant in the planning economy before 1978. But it has made up an important part of the total revenues since the 1978 reform.

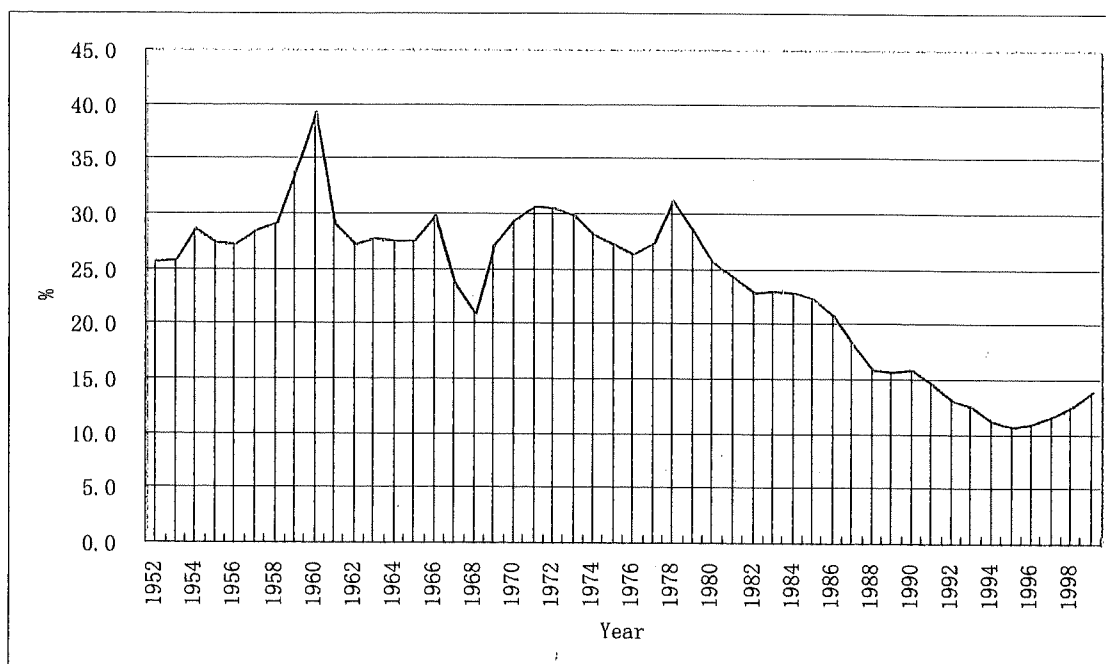
The total amount of reported extra-budgetary revenues increased from 1.4 billion Yuan in 1952 to 34.7 and 308.2 billion Yuan in 1978 and 1998 respectively. The amount of reported extra-budgetary revenues made up 31.2% of the budgetary revenues in 1998 in China, see Chart 4.

Chart 1 Development of amount of budgetary revenues and GDP in China (1952-1999)



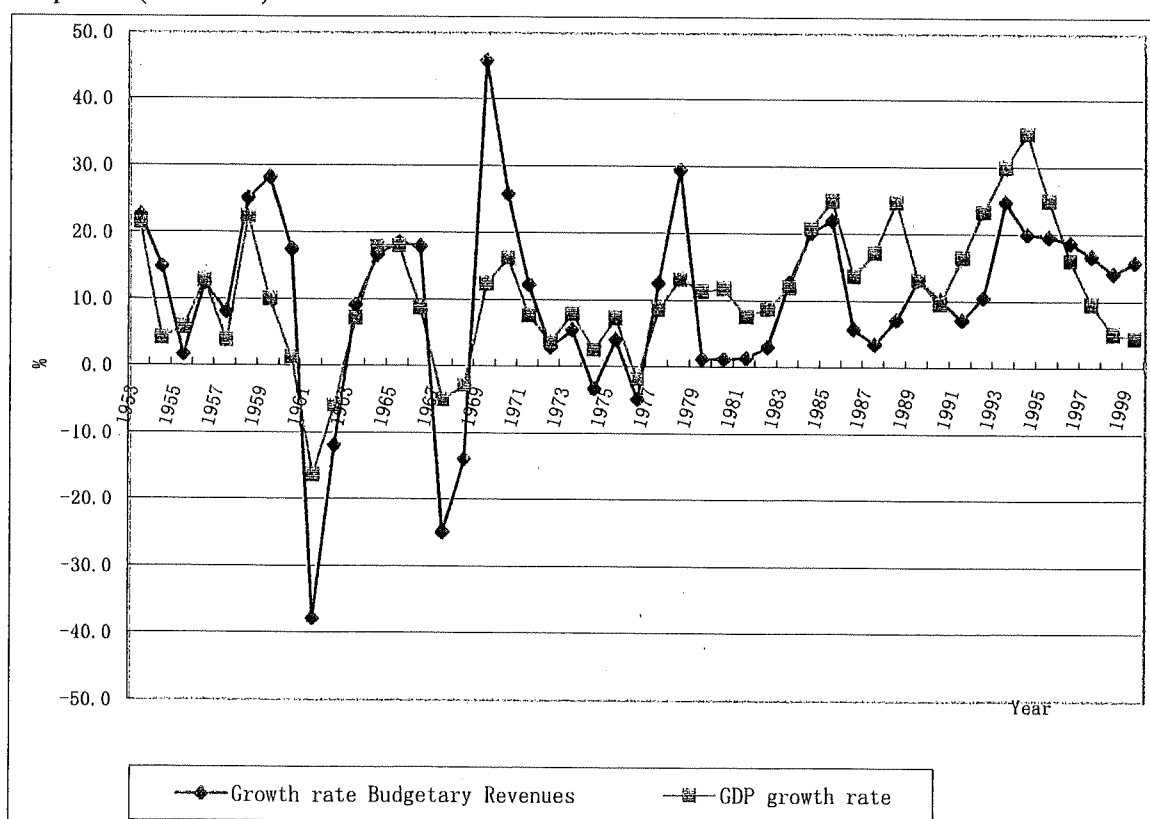
Source: China Finance and Economy Network.

Chart 2 Development of budgetary revenues as a percentage to the GDP in China (1952-1999)



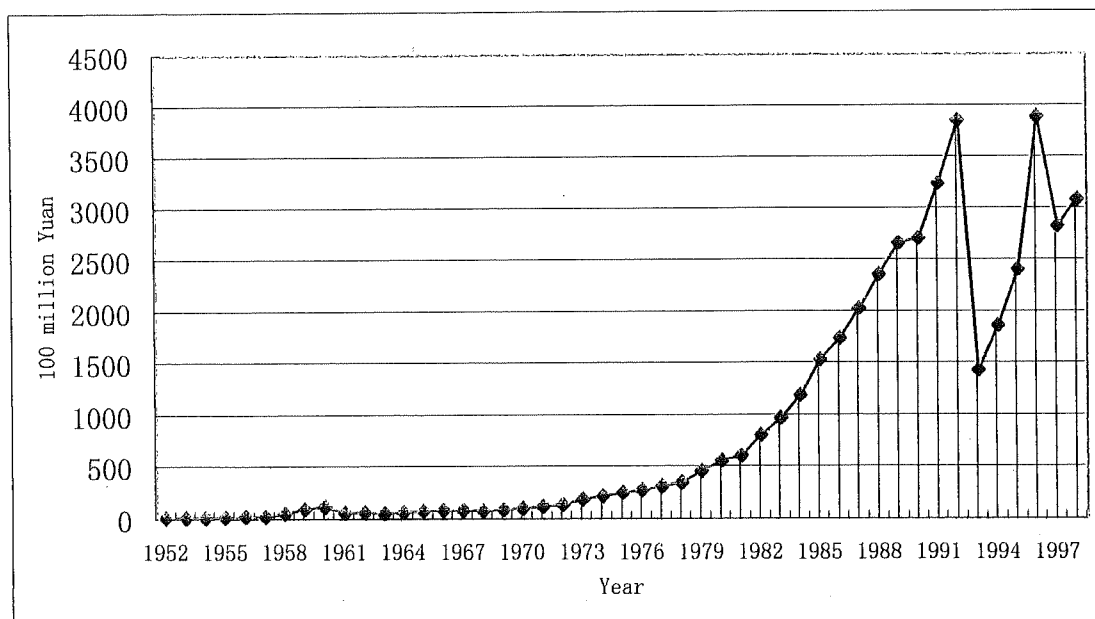
Source: China Finance and Economy Network.

Chart 3 The growth rate of the budgetary revenues and the GDP growth rate in China in Comparison (1952-1999)



Source: China Finance and Economy Network.

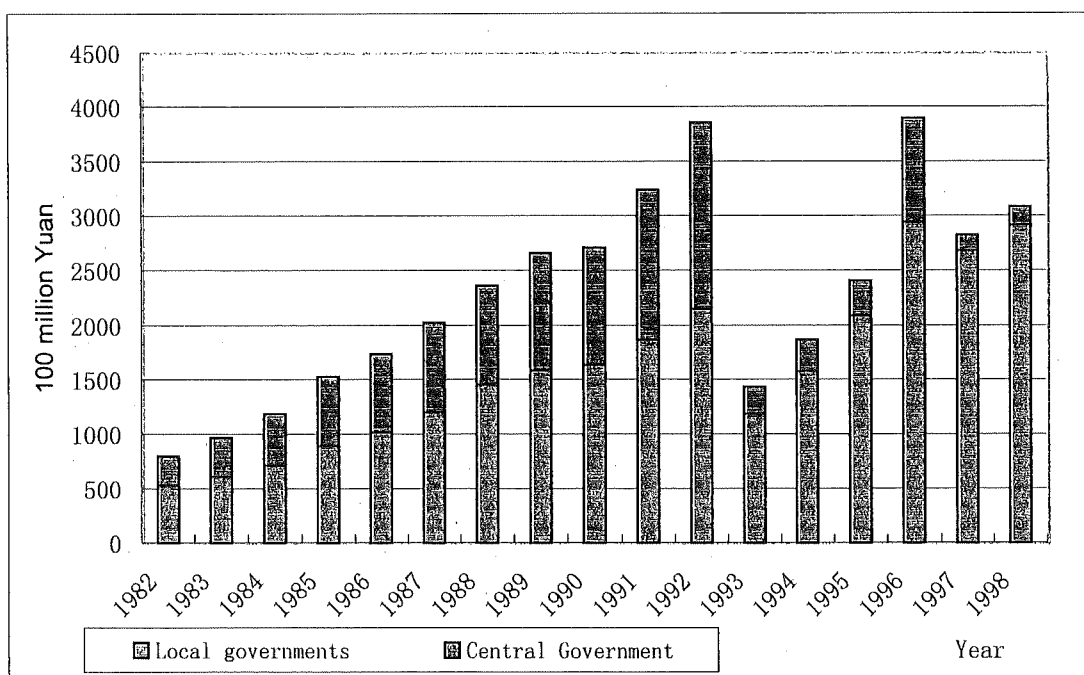
Chart 4 Total (reported) extra-budgetary revenues of the central government and local governments



Source: China Public Finance Yearbook 2000, 435.

Looking into the period of 1982-1998, the extra-budgetary revenues of the central government has been lower than those of local governments (see Chart 5). From 1982 to 1992, both the amounts of

Chart 5 Extra-budgetary revenues of the central government and local governments (1982-1998)



Source: China Public Finance Yearbook 2000, 436.

the reported extra-budgetary revenues of the central government and the local governments rose rapidly. The percentage of reported extra-budgetary revenues of the central government to the total

amount rose from 33.7% in 1982 to 44.3% in 1992.

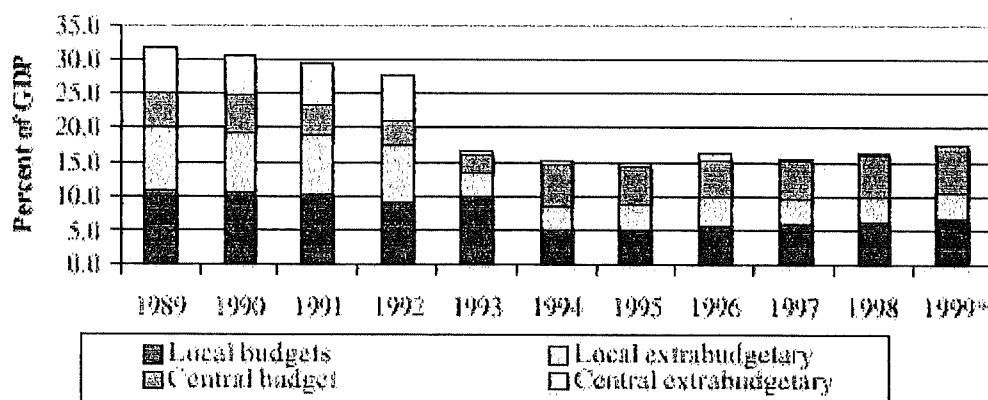
In 1993-1997, there were abrupt changes of the amount and structure of the extra-budgetary revenues. One reason is that the revenues from the state-owned enterprises were not more included in the definition of extra-budgetary revenues since 1993. The scope of the extra-budgetary revenues changed again in 1996. Some governmental funds are no more included since 1997. Since 1993, the amount and portion of the central government have been small and insignificant except that in 1996, while the amount and portion of the extra-budgetary revenues of local governments have been significant. The amount of the extra-budgetary revenues of local governments reached almost the level of 1992 in 1996 and rose further then after.

Put all the budgetary revenues and extra-budgetary revenues of the central government and local governments together, we can get a “whole picture” of the fiscal capacity of governments in China, see Chart 6. The ratio of “tax burden” at macro-level was estimated as around 17% of the GDP in 1999.

Chart 6 Revenues sharing on and off budget in China

Source: Ehtisham Ahmad, Li Keping and Thomas Richardson 2000, 4.

The extra-budgetary revenues are nontransparent. There are no precise statistic data on them.



* Extrabudgetary fund data estimated for 1999.

The data that the Ministry of Finance got are only a part of the total extra-budgetary revenues. They are called the “Second Budget” of the governments. Indeed there are many “second budgets” because the extra-budgetary revenues are kept on various open or hidden accounts of administrative units and other public service units and a large part of them escaped from the control of fiscal bureaus.

Besides the budgetary revenues and extra-budgetary revenues, there are also system external revenues (zhi du wai shou ru) in China. According to Christine P. Wong, the off-budget revenues (extra-budgetary and system external revenues) will be around 16-22.5% of the GDP, the total governmental revenues on and off budget made up therefore 28%-35% of the GDP in mid-nineties (Christine Wong 2001, 386-387). According to him, the off-budget activities included:

- (1) Non-tax revenues collected by governmental departments to provide with services: 8-10% of GDP;
- (2) Expenditures of the governmental departments, which were not reflected on the accounts for budgetary or extra-budgetary revenues and expenditures (tax expenditures, amounts in arrears, quasi-fiscal expenditures made by enterprises (providing with goods and services provided below the cost prices): 2-3% of the GDP or more.
- (3) Quasi-fiscal expenditures of governments: loans for state-owned enterprises to steer the direction of capital inputs: 6-8% of the GDP during 1985-1995.
- (4) The commercial revenues or losses of governmental institutions (funds raised by themselves, i.e. zi chou zi jin), revenues from the sale of capital assets: 1-2% of GDP now (much more in mid-nineties);
- (5) Social securities, regarded from 1996 as extra-budgetary revenues: 2-2.5% of GDP.

The percentages of extra-budgetary revenues to the budgetary revenues in the 31 Chinese provinces (cities and autonomous regions) were quite different in 1998, ranging from 30.66% (Guangdong) to 101.46% (Zhejiang), see Table 1. All the coastal provinces and cities except Tianjin (because of its smaller size of population and economy) had relatively large amount of budgetary revenues and expenditures, and extra-budgetary revenues and expenditures.

The budgetary revenues per head in various provinces varied from 145.60 Yuan (Tibet) to 2606.64 Yuan (Shanghai) in 1998, and the total revenues per head (including budgetary and extra-budgetary revenues) from 208.00 Yuan (Tibet) to 3481.61 Yuan (Shanghai) in the same year. The budgetary expenditures per head in various provinces varied from 348.78 Yuan (Henan) to 3128.42 Yuan (Shanghai) in 1998, and the total expenditures per head (including budgetary and extra-budgetary expenditures) from 459.23 Yuan (Guizhou) to 3954.17 Yuan (Shanghai) in the same year. This reflects great diversity in the distribution of revenues and expenditures in 1998 in various provinces of China. Especially because the figures of expenditures included already the transfers from the Central Government, it is a severe problem for the central government to equalize somewhat the fiscal capacity per head in all the provinces, measured by budgetary expenditures per head or total expenditures per head.

Table 1 Budgetary and extra-budgetary revenues and expenditures in 1998 in Chinese provinces
(in 100 million Yuan)

Provinces	Budgetary revenues	Budgetary expenditures	Extra-budgetary revenues	Extra-budgetary expenditures	% of extra-budgetary revenues to budgetary revenues	Budgetary revenues per head (Yuan)	Budgetary expenditures per head (Yuan)	Total revenues per head (Yuan)	Total expenditures per head (Yuan)
Provinces in total	4983.95	7854.58	2912.99	2774.73	58.45				
Beijing	229.45	280.68	121.09	111.17	52.77	1845.94	2258.09	2820.12	3152.46
Tianjin	101.40	137.93	35.84	34.44	35.35	1061.78	1444.29	1437.07	1804.92
Hebei	206.76	301.55	104.65	97.67	50.61	315.81	460.59	475.65	609.77
Shanxi	104.19	164.41	84.97	74.04	81.55	330.08	520.86	599.27	755.42
Inner Mongolia	77.67	170.31	28.80	26.95	37.08	332.56	729.22	455.87	844.61
Liaoning	264.62	390.29	118.50	106.07	44.78	638.02	941.02	923.73	1196.76
Jilin	93.64	190.10	49.97	47.31	53.36	355.24	721.17	544.81	900.65
Heilongjiang	157.27	259.42	72.43	72.92	46.05	418.05	689.58	610.58	883.41
Shanghai	380.70	470.05	127.79	124.07	33.57	2606.64	3128.42	3481.61	3954.17
Jiangsu	296.58	424.90	272.09	262.51	91.74	413.93	593.02	793.68	959.40
Zhejiang	198.10	286.81	201.00	200.29	101.46	445.62	645.17	897.76	1095.72
Anhui	159.19	424.07	95.46	94.86	59.97	258.61	393.26	413.69	481.23
Fujian	187.92	254.87	148.66	136.40	79.11	571.10	774.56	1022.89	1189.08
Jiangxi	97.16	175.26	75.20	71.05	77.40	232.97	420.24	413.28	590.60
Shandong	352.39	487.82	222.52	223.87	63.15	399.92	553.62	652.45	807.69
Henan	208.20	323.63	152.99	140.83	73.48	224.38	348.78	389.26	500.55

Hubei	168.95	280.12	93.49	90.91	55.34	286.84	475.59	445.57	629.94
Hunan	156.77	273.64	151.79	148.46	96.82	241.80	422.06	475.92	651.04
Guangdong	640.75	825.61	196.48	180.24	30.66	902.85	1163.32	1179.70	1417.29
Guangxi	119.67	198.36	98.29	92.73	82.13	257.13	426.21	468.32	625.46
Hainan	33.67	54.91	16.52	16.19	49.06	450.13	734.09	670.98	950.53
Chongqing	71.13	125.76	54.22	51.47	76.23	233.14	412.19	410.85	580.89
Sichuan	197.29	320.93	159.10	151.92	80.64	233.16	379.28	421.19	558.82
Guizhou	65.34	133.09	34.86	33.70	53.35	179.90	366.44	275.88	459.23
Yunnan	168.23	328.00	65.68	60.68	39.04	408.42	796.31	567.87	943.63
Tibet	3.64	45.32	1.56	0.98	42.86	145.60	1812.80	208.00	1852.00
Shaanxi	93.33	166.20	45.18	42.53	48.41	260.48	463.86	386.58	582.56
Gansu	54.03	125.34	27.18	27.41	50.31	215.56	500.06	324.00	609.42
Qinghai	12.77	44.09	4.80	4.30	37.59	255.66	882.68	351.76	968.77
Ningxia	17.75	45.12	8.44	7.38	47.55	332.40	844.94	490.45	983.14
Xinjiang	65.39	145.99	43.44	41.38	66.43	377.43	842.66	628.16	1081.51

Note: 1. The budgetary revenues are from the local level governments themselves. 2. The budgetary expenditures are local level expenditures.

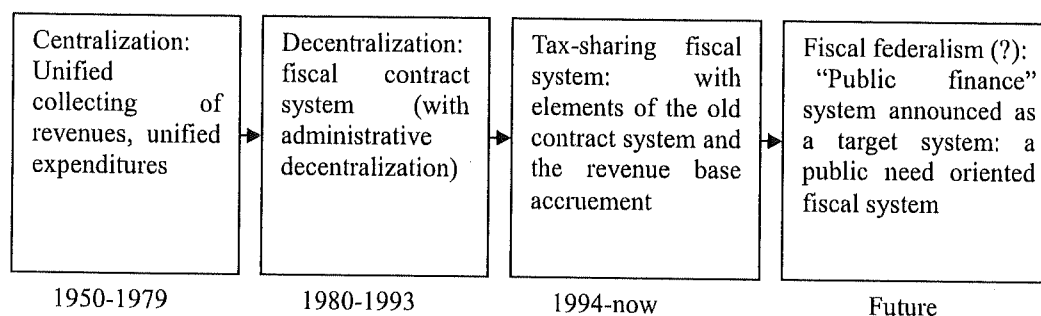
Source: China Finance and Economy Network; New China Fifty Years' Government Finance Statistics.

3 Evolution of the fiscal systems in China

3.1 Overview

Three periods can be divided to characterize the fiscal systems in China (see Chart 7). In the period of 1950-1979, the fiscal system in China was quite centralized. There was little autonomy of local governments in deciding on on- and off-budget revenues and expenditures. To give local governments incentives to develop the economy, the central government had to adjust the fiscal system frequently. More or less elements of contract systems were introduced since 1958. But the duties and responsibilities were not assigned to various administrative levels. In the economy, some regions practiced various kinds of contract systems in agricultural production, which were announced as illegal practices before 1976. After 1978, the family responsibility system in agricultural production spread rapidly in most parts of China.

Chart 7 Evolution of fiscal systems in China



The elements of contract systems in fiscal systems and the practices with contract systems in agricultural production were further adopted and imitated by the governments in China in the process of building up new fiscal systems in the eighties. The fiscal systems between 1980 and 1993 were branded as "contract systems". With devolution of powers for administering one part of state-owned enterprises to local governments (fang quan), giving state-owned enterprises rights to retain a higher portion of profits (rang li) and introduction of fiscal contract systems, the central government's share in budgetary revenues dropped down, while local governments gained a high level of de facto autonomy in fiscal affairs. Local governments gained also de facto rights of deciding on tax bases and tax rates. Budgetary revenues were channeled partially to accounts for extra-budgetary revenues of local governments. New enterprises were opened and run directly by departments of local governments or other local public service units. Loss-making local state-owned enterprises were privatized, although the central government disallowed privatization in fear of ideological resistance among the public. The phenomenon of local protectionism flourished. The rapid drop-down of the central government's share in the total budgetary revenues led to its adjusting frequently the fiscal systems in the framework of contract systems and requested even contributions from local governments in richer regions. Under a contract system, the revenues turned over to the central government last year would be the new base for turn-over of revenues to the central government in the contract of this year. The contributions were even to added to this new base. This led the local governments to disbelieving in the central government's behavior and losing stable expectation on it, so that the local governments did more "misbehaviors". Such a vicious circle lasted till 1994 and has still effect on the intergovernmental competition after 1994.

In 1994, a tax-sharing fiscal system (fen shui zhi cai zheng ti zhi) was introduced in China. Under this system, two largest parts of the cake of budgetary revenues were taken by the central government: 75% of all Value-added tax revenues and excise. Duties and responsibilities were

assigned to the central government and local governments. Categories of expenditures were also assigned. The taxation bureaus were split into state taxation bureaus and local taxation bureaus respectively. But there were some elements of the old system (contract system, revenue base for revenue turn-over and tax sharing by categories of taxes and jurisdiction of the enterprises) remaining within this new system. The vested interests of the richer regions were preserved by the central government's returning of a part of tax revenues to local governments, which based on the net revenues turned over to it in 1993 to local governments and on further growth of the 75% of the VAT and the excise. With introducing this system, the share of the central government in the total budgetary revenues rose again. At moment it reaches around 50% of the total budgetary revenues. This system based still on bargaining between the central government and local governments on revenue sharing bases, some informal requests by the central government for contributions, formal obedience but de-facto resistance of local governments by channeling budgetary revenues to accounts for extra-budgetary revenues and collecting other extra-budgetary and system external revenues.

The evolution of the fiscal system in China reflects a path dependency. Up to now there are still components of old systems left, such as revenue base accrualment, contract systems for the excess revenues, protection of the vested interests of various regions. The rules governing intergovernmental competition were to large extent endogenous in the context of this competition and of the change of the whole political, economic and social system.

The 1994 reform can be regarded as a step toward a fiscal federalism. But this was not the intention of the central government. Its main concern is to increase two ratios: ratio of the budgetary revenues to the GDP and ratio of the central government's revenues to the total budgetary revenues.

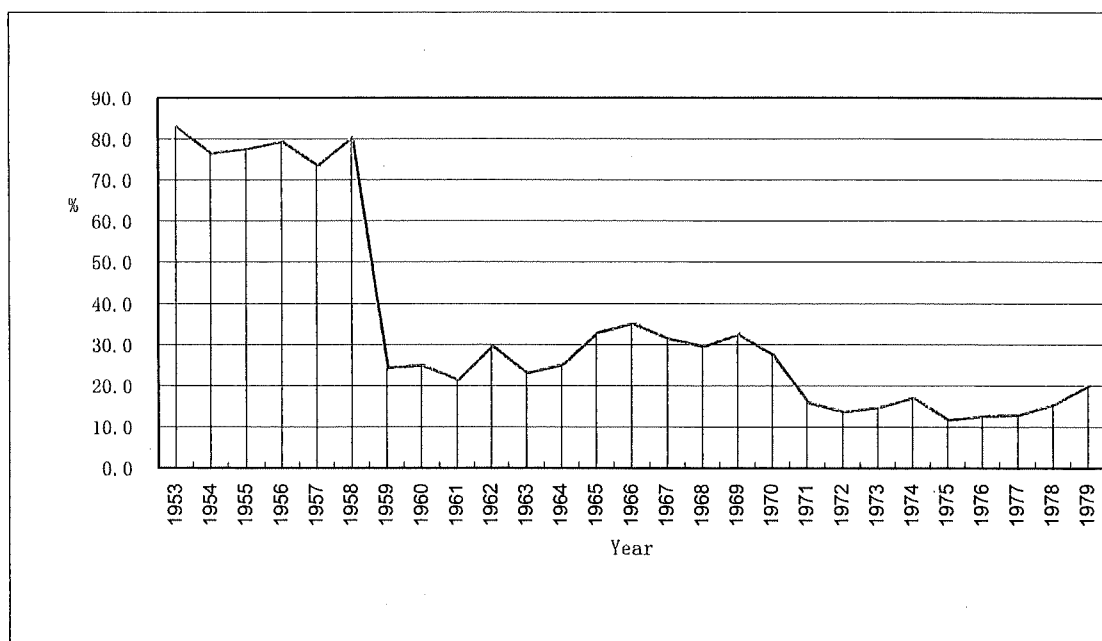
In December 2001, the annual Central Chinese Conference on Fiscal Work was held in Beijing. It stressed formerly the establishment of a "public finance" system, which means a public demand oriented fiscal system. The question would be: if the system will be public demand oriented, will it be different from a fiscal federalism?

3.2 Centralization of the fiscal system during 1950-1979: little local fiscal autonomy in China

The vertical intergovernmental competition already existed before 1980. There existed for a long time a "circle of eliminating the disorder" (zhi luan xun huan). The reason rests with the dilemma with which the central government faced up in the trade-off of centralizing and decentralizing the administrative and fiscal powers: Ministries and departments are set up according to sectors and products. Each enterprise is subordinated to a department of a local government or a ministry of the central government. The administrative units at the local level are divided mainly into two parts: One part was solely administered by the local government; the other part was jointly administered by local governments and the central government. As soon as the central government centralized the administrative and fiscal powers, more and more administrative units were established according to sectors and products, and local governments had no initiative of stimulating the economy and therefore generating more fiscal revenues. This brought pressure in the central government to devolve the administrative and fiscal powers to local governments. As soon as the central government decentralized the administrative and fiscal powers, local governments had incentive to stimulate the economy and therefore generate more fiscal revenues. But a byproduct would be the "disorder" that the central government perceived, so that it decided again to centralize the administrative powers. The passive obedience of local governments in the periods of more centralization and the "disorder" caused by more local autonomy in the periods of more decentralization were clear evidences of vertical intergovernmental competition. Horizontal competitions between local governments were also evident in so far that the local governments were competing for location of the projects (infrastructure and factories) financed by the central government. A common way of competition was for local governments to run to the ministries for getting the projects approved and have funds appropriated to these enterprises (pao bu qian jin). Before 1980, the fiscal system was mainly dominated by a system of unified administration of fiscal revenues and expenditures. The local governments had no autonomous budgets. Their

budgets were worked out by the Ministry of Finance together with that of the central government. The central government re-defined almost every year the individual items of the budgets of local governments. During the budgeting there were lots of bargains between the central government and local governments (Hu Shudong 2001, 39).

Chart 8 Shares of the central government in the budgetary revenues in China (1953-1979)



Note: The revenues are own revenues of the different levels of governments.

Source: China Public Finance 2000, p. 421-422.

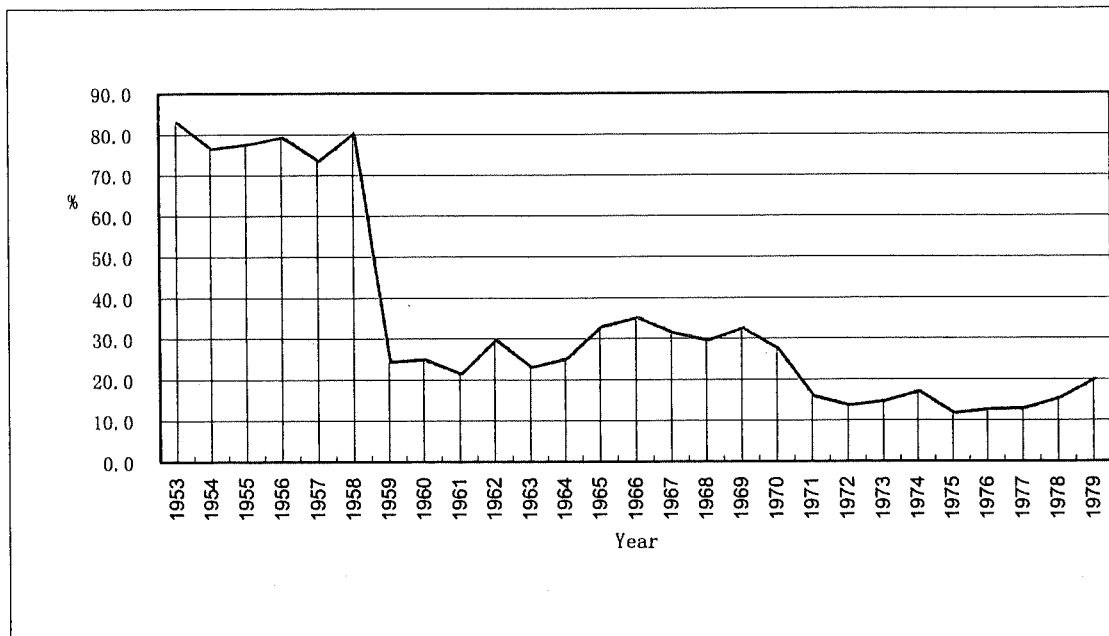
In general, there was little fiscal autonomy of the local governments during all the periods from 1950 to 1980 since the decentralization was also limited under a planning system.

Chart 8 described the percentages of the central government to the budgetary revenues in China (1953-1979). The share between 1953 and 1958 was quite high, ranging from 73.5% (1957) to 83.0% (1953). During that period, most of the tax revenues and profits of state-owned enterprises were turned over to the central government. The central government appropriated budgetary funds to the provinces according to their budgetary plans approved by the central government, to support the necessary local-level expenditures. The share between 1959 and 1979 was quite low, ranging from 11.8% (1975) to 35.2% (1966). Various kinds of fiscal decentralization were implemented, which were always short-lived. Although the local share was quite high, but the local budget plans were still to be approved by the central government. Large amounts of local revenues were turned over to the treasury of the central government, so that the central government's share of expenditure remained much higher than its share of revenues, see Chart 9.

Most of the economists in China might argue that the differentiation between the shares of the central government and those of the local governments in revenues and expenditures were not essential because the fiscal systems in the period of 1950-1979 was dominated by the characteristics of unified collecting of revenue and unified expenditures. It was true on one hand, but such a generalization was indeed misleading on the other hand. As shown above, it is necessary to "unpack" the Chinese state for that period of planning economy. Otherwise nobody will believe that there were intergovernmental competitions in that period.

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Chart 8 Shares of the central government in the budgetary revenues in China (1953-1979)



Note: The revenues are own revenues of the different levels of governments.

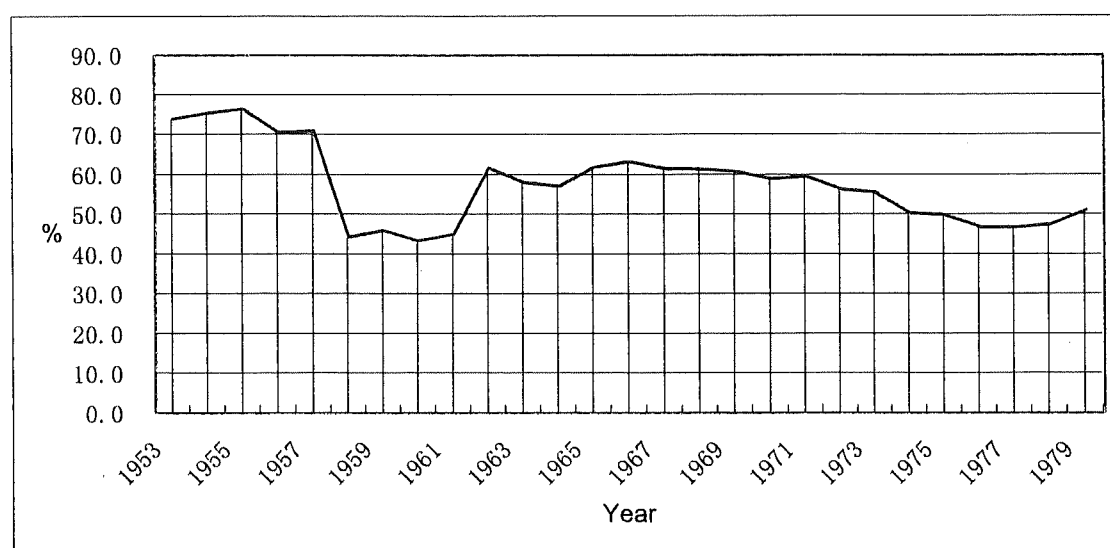
Source: China Public Finance 2000, p. 421-422.

In general, there was little fiscal autonomy of the local governments during all the periods from 1950 to 1980 since the decentralization was also limited under a planning system.

Chart 8 described the percentages of the central government to the budgetary revenues in China (1953-1979). The share between 1953 and 1958 was quite high, ranging from 73.5% (1957) to 83.0% (1953). During that period, most of the tax revenues and profits of state-owned enterprises were turned over to the central government. The central government appropriated budgetary funds to the provinces according to their budgetary plans approved by the central government, to support the necessary local-level expenditures. The share between 1959 and 1979 was quite low, ranging from 11.8% (1975) to 35.2% (1966). Various kinds of fiscal decentralization were implemented, which were always short-lived. Although the local share was quite high, but the local budget plans were still to be approved by the central government. Large amounts of local revenues were turned over to the treasury of the central government, so that the central government's share of expenditure remained much higher than its share of revenues, see Chart 9.

Most of the economists in China might argue that the differentiation between the shares of the central government and those of the local governments in revenues and expenditures were not essential because the fiscal systems in the period of 1950-1979 was dominated by the characteristics of unified collecting of revenue and unified expenditures. It was true on one hand, but such a generalization was indeed misleading on the other hand. As shown above, it is necessary to "unpack" the Chinese state for that period of planning economy. Otherwise nobody will believe that there were intergovernmental competitions in that period.

Chart 9 Shares of the central government in the budgetary expenditures in China (1953-1979)



Notes: The expenditures are own expenditures of the different levels of governments.

Source: China Public Finance Yearbook 2000, p. 423-424.

It might be the characteristics of a unitary state that the central government has more power and ability to change deliberately the rules governing the central-local fiscal relations. The various forms of fiscal decentralization were demanded and welcomed by local governments. The central government was pressed to change the situation of "passive obedience" of the local governments and launch some fiscal reforms, which were also results from the bargaining between the central government and the local governments, but the central government was able to change deliberately the rules after recognizing the risks of "disorder" that such forms of decentralization caused.

Table 2 indicates the change of evolution of the fiscal system in China in the period of 1950-1979. As shown in the table, there was almost no local fiscal autonomy in 1950, after then there was quite little local fiscal autonomy.

Table 2 Change and evolution of the fiscal system in China (1950-1979)

Period	Fiscal system planned and implemented	Results from implementation	Degree of local fiscal autonomy
1950	Highly centralization of fiscal revenues and expenditures, unified collection of revenues and unified expenditures (gao du ji zhong, tong shou tong zhi)	Implemented only one year, good for stabilize the political and economic situation (price stabilization, inflation control, balance of fiscal revenues and expenditures)	No
1951-1957	Dividing central-local revenues and expenditures, revenues and expenditures are managed by different layers of governments (hua fen shou zhi, fen ji guan li)	The central government began to consider how to extend the local fiscal rights.	Little
1958	Proportional dividing of revenues by differentiating the categories of revenues, ensuring the normal need of expenditures, the spending of surplus can be decided by the local governments themselves. 5 years of implementation were planned. (yi	Ceased after one year of implementation because of the leftist movement such as "Great Leap Forward"	Little

	shou ding zhi, wu nian bu bian)		
1959-1970	Proportional division of the total revenues, the proportion to be changed each year (zong e fen cheng, yi nian yi bian)	Some fiscal administration rights were withdrawn by the central government in 1961 because of the large-scale adjustment of the national economy; Re-introduction of the 1950 system for a while in 1968	Little
1971-1973	Contract system for fiscal revenues and expenditures, contract to be changed each year	Some minor adjustments to the fiscal arrangement in 1972.	Little
1974-1975	Proportional division of the fiscal revenues, Contract system for the expenditures	Change into this system in 1974 because the national economy was largely damaged and the 1971-1973 system could last	Little
1976-1979	Re-habilitation of the proportional division of total fiscal revenues, the system to be changed each year (zong e fen cheng, yi nian yi bian)	Stable period of implementation	Little

Source: based on Xiang Huaicheng (ed.), 1999, p.296-299.

3.3 Decentralization of the fiscal system in China during 1980-1993: increasing local fiscal autonomy

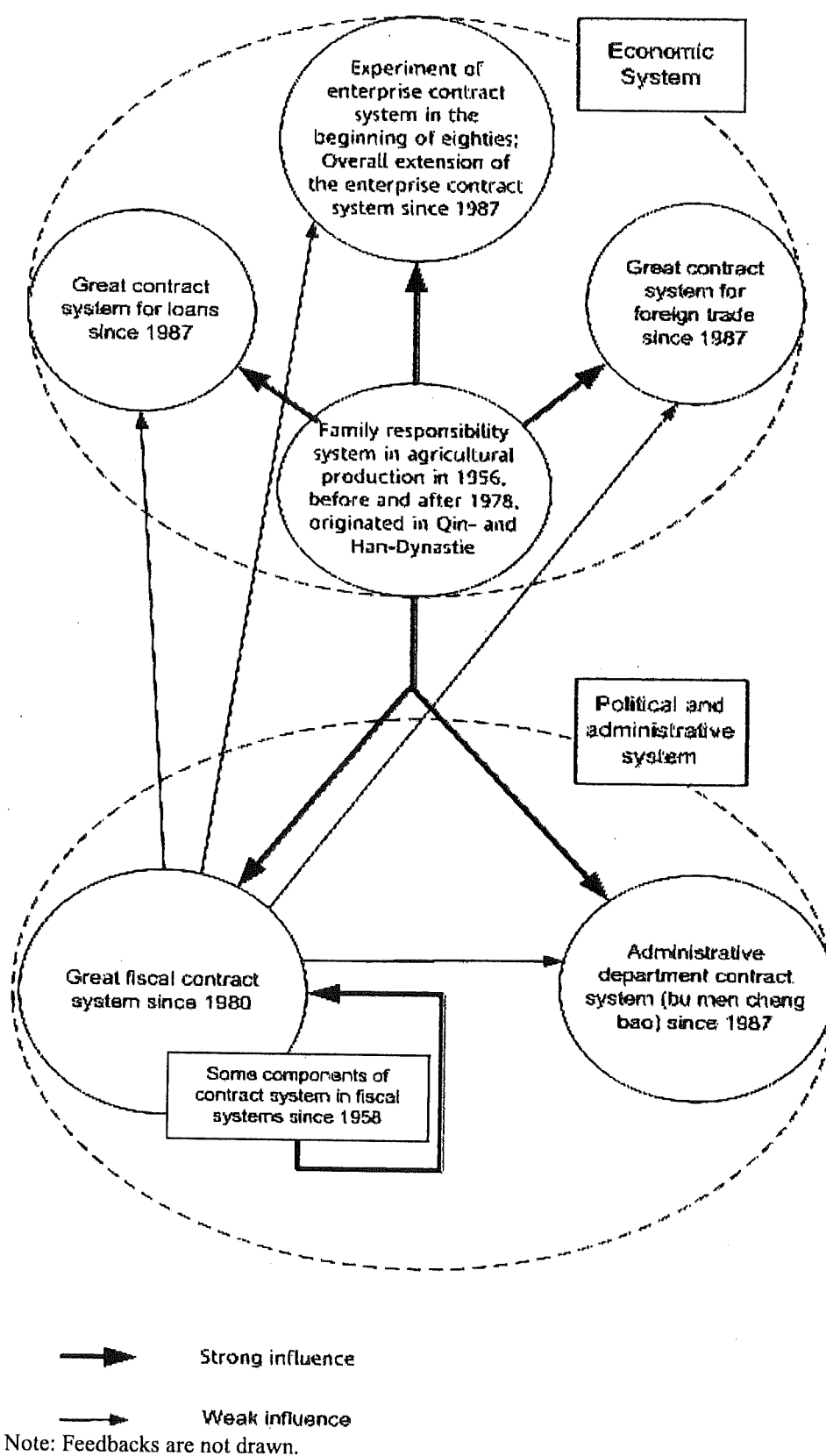
During 1980-1993, China practiced various fiscal contract systems. Before 1978 there were several short periods of time in which some local governments made some practices of rural household responsibility systems to boost the agricultural production, sometimes encouraged by some leaders of the upper-levels of governments, sometimes pressed by the miserable situation of food supply. Also fiscal systems since 1958 embedded more or less factors of contract systems. The rural household responsibility system was successfully practiced in most parts of rural China in 1979. This led to the belief in the merits of the contract system.

It was evident that the central government and local governments imitated the successful models of rural household responsibility system (before and after 1978) and practiced, also based on the former practices of fiscal contract systems, new contract systems in fiscal administration. The outcomes from the economic system was therefore perceived by the politicians and administrators and led to imitation and adoption of such a contract system in the fiscal system, see Chart 10.

The fiscal systems between 1980 and 1993 were all fiscal contract systems. The fiscal contract system in the first period (1980-1984) was known as "eating from separate kitchens" (fen zao chi fan) or "great fiscal contract system" (cai zheng da bao gan). Fiscal revenues were divided into fixed revenues of the central government, those of the local governments and revenues for flexible spending (to cover the gaps between the revenues and expenditures of local governments in some regions). The responsibilities for local expenditures were defined for the first time. The part of local revenues exceeding the local expenditures was to be turned over proportionally to the central government. With this system, within the scope of the local expenditures, the line ministries didn't dictate for the first time the tasks of local expenditures. The local governments were able to arrange the local expenditures according the local conditions and state policies.

There were further reforms of fiscal contract systems in 1985 and 1988. Large part of profits of state-owned enterprises was changed into taxes in 1995. State-owned enterprises didn't have to turn over this part of profits to the central government and local governments. This was a quite new situation regarding the relation between the central government, local Governments and the state-owned enterprises. In the fiscal reform of 1985, revenues were divided according to the categories of taxes into fixed revenues of the central government, fixed revenues of the local

Chart 10 Contract systems: institutional learning and interactions between the economic system and political and administrative system



governments and shared revenues of the central government and local governments. The responsibilities for expenditures were still split according to the administrative jurisdiction of the central and local governments. In the fiscal reform of 1988, six kinds of fiscal contract systems were practiced. In general, the contract systems were not strictly complied by. Some contract systems were changed frequently. In the end of 1991, the central government attempted to negotiate with local governments on a new system, but failed to reach satisfactory results. Therefore the fiscal system of 1988 lasted till end of 1993 (Ma Jun 1998, 121).

The 1988 reform introduced a new system, under which provincial governments each negotiated a fixed tax quota with the central government, with collections above that level being retained at the local level. This new system created a strong incentive for local governments to conceal information about local revenue from the central government, otherwise they would face a "ratchet effect", i.e., the information would be used by the central government to renegotiate and increase such a fixed tax quota (Ahmad, Li and Richardson 2000, 4).

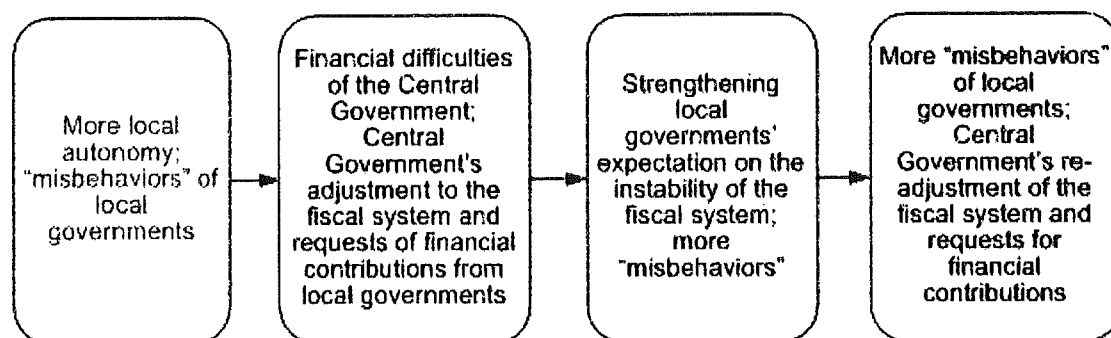
With these three fiscal reforms between 1980 and 1993, local governments were highly motivated to generate their own budgetary, extra-budgetary and "extra-system" revenues by:

- establishing their state-owned or collective enterprises;
- creating interregional trade-barriers (local protectionism);
- channeling budgetary revenues to the extra-budgetary accounts of the local governments;
- generating other extra-budgetary revenues by collecting fees and fund raising.

In that period, local governments also often illegally allowed various kinds of tax exemptions and granted various subsidies to the investors coming from outside or abroad (including Taiwan, Hong Kong and Macao). Many of the newly established enterprises were run by local governments, governmental departments or other public service sectors. There was an incentive for the local governments to hide the profits of these enterprises so that they don't have to pay too much tax.

In the whole period of 1980-1993, it was a vicious circle in the games between the central government and local governments: with the larger local autonomy, the local governments did some "misbehaviors" from the view point of the central government, which led to the financial difficulties of the central government, so that the central government adjusted the fiscal system and requested financial contributions from local governments in various ways. This strengthened the expectation of the local governments on the instability of the fiscal system, so that they did more "misbehaviors" and the interest of the central government was impaired, which led to its frequently re-adjusting of the fiscal system and requests in several occasions for "borrowing" some revenues from local government and for financial contributions (see Chart 11, compare Xiang Zhongxin 2001,111). The central government never returned the "borrowed" revenues to local governments and added the sum to the new fixed quota being turned over to the center in the next round of negotiation.

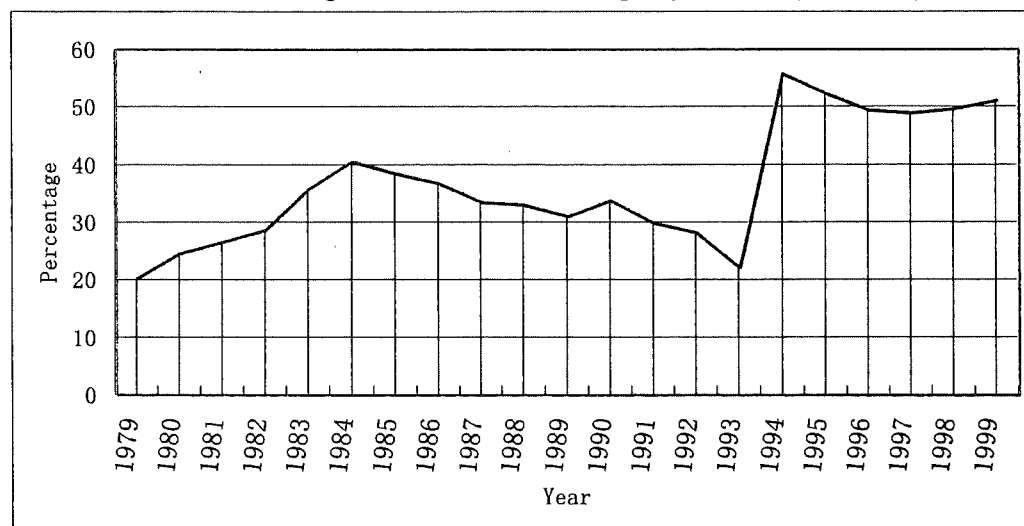
Chart 11 The vicious circle in the games between the central government and local governments (1980-1993)



The effects of the practices with fiscal contract systems between 1980 and 1993 were overwhelming. The local governments gained de facto ability of controlling the main tax bases and tax rates (Ma Jun 1998, 120). This control was realized mainly in three ways (compare Ma Jun 1998, 120): (1) Allowing legal or illegal tax exemptions; (2) Attempting to channel the budgetary revenues to the extra-budgetary accounts; (3) Collecting fees and raising funds.

In this regard, the central government adopted various non-standardized instruments to adjust the fiscal relations between the central government and local governments. This led again to the local governments' further motivation and practicing of "keeping the wealth among the people and enterprises" (cang fu yu min, cang fu yu qi ye) by retaining more revenues and turning over fewer revenues to the center, and to further bargaining between local governments and it (Ma Jun 1998, 120).

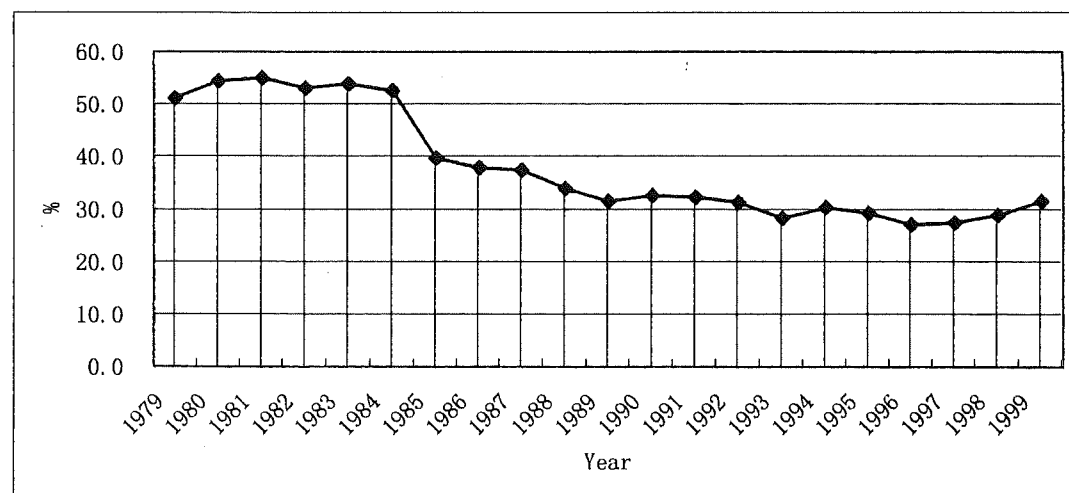
Chart 12 Shares of the central government in the total budgetary revenues (1979-1999)



Note: The revenues are own revenues of the different levels of governments.

Source: China Public Finance Yearbook 2000, p. 421-422

Chart 13 Shares of the central government in the total budgetary expenditures (1979-1999)



Notes: The expenditures are own expenditures of the different levels of governments.

Source: China Public Finance Yearbook 2000, p. 423-424

Chart 12 indicates shares of the central government in the total budgetary revenues during the period between 1979 and 1999. Looking into the period of 1979-1993, the central government's share in budgetary revenues rose from 20.2% in 1979 to 40.5% in 1984, fell then after to 30.9% in 1989, rose to 33.8% in 1990, but fell down again to 22.0% in 1993.

From 1979 to 1984 the share of the central government's expenditure was higher than 50% and dropped down since 1984 to below 30% in 1993. It has remained stable around 30% since then, see Chart 13. The development in the period of 1980-1993 had something to do with the

devolution of the power of administration of one part of state-owned enterprises to local governments, changing the method of appropriation of funds to state-owned enterprises to extending credits to them, and shifting off responsibilities for expenditures to the local governments etc.

3.4 Introducing a tax-sharing fiscal system in 1994 in China: an attempt to re-centralization or a step toward a fiscal federalism?

The introduction of the tax sharing system in 1994 was a new attempt to raise the share of the fiscal revenues of the central government, which was quite successful, as indicated in Chart 12. The share of the central government in budgetary revenues rose from 22.0% in 1993 to 55.7% in 1994 and remained around 50% of the total revenues since then.

During the 1994 fiscal reform, the expenditures were assigned according to the duties and responsibilities of the central government and local governments. The assignments matched in general the standards of most of the western countries. But there is no formal legislation for the assignments of duties and responsibilities of the governments in China. This gives the central government a leeway to shift off their responsibilities if necessary. The expenditures were signed as following (Zhong Xiaomin 2001, 94-95):

- (1) The central government is mainly responsible for expenditures for defense and state security, foreign affairs and the administration of the central regime, for adjustment of the structure of the national economy, coordinating the development of various regions, for macro-control or undertakings under jurisdiction of the central government. The expenditures of the central government include: central-level investment in capital construction projects, expenditures for technical renewal and development of the state-owned enterprises directly under the central government, geological prospecting, the central-level supports in agricultural development, defense, armed police, foreign affairs, foreign aid, administration fees of the central government, and debt service to be borne by the central government, expenditures for police, procuratorate and courts to be borne by the central government, expenditures for undertakings in culture, education, health, sciences etc. to be borne by the central government.
- (2) The local governments are mainly responsible for necessary expenditures for operation of the local regime, development of local economy and undertakings. The expenditures include: expenditures for investment in capital construction projects by using the raised funds, for technical renewal and development and designing of new products of the local level enterprises, for supports in agricultural development, city maintenance and construction, local level expenditures for administration and undertakings in culture, education, health, sciences etc. , local-level expenditures for police, procuratorate and courts, part of expenditures for armed police, expenditures for people's militia and for price subsidies, and other expenditures.

The 1994 fiscal reform assigned categories for taxes for the central and local governments according to the principle of combination of the assignments of revenues with the responsibilities. There are three groups of taxes: (1) central taxes, (2) local taxes; (3) shared taxes. See Table 3.

Table 3 Revenue sharing arrangements (1998)

Level	Tax	Central share
Central taxes	Domestic excises	100%
	Customs duties	100%
	VAT and excises on imports	100%

Local taxes	Personal income tax	0%
	City and township land use tax	0%
	Farmland occupation tax	0%
	Fixed assets investment orientation tax	0%
	Land appreciation tax	0%
	House property tax	0%
	Urban real estate tax	0%
	Vehicle and vessel use tax	0%
	Vehicle and vessel license plate tax	0%
	Deed tax	0%
	Slaughter tax	0%
	Banquet tax	0%
	Agricultural and animal husbandry taxes	0%
Shared taxes	Domestic VAT	75%
	Business tax - if paid by railroads, headquarters of banks or insurance companies, and 3% resource tax	100%
	Business income tax – otherwise	0%
	Enterprise income tax - if paid by railroads, post offices, headquarters of financial institutions and insurance companies belonging to the central government, offshore oil companies	100%
	Enterprise income tax – otherwise	0%
	Income tax on foreign and foreign funded banks	100%
	Income tax on foreign and foreign funded nonbanks	0%
	Resource tax - if paid by offshore oil companies	100%
	Resource tax - otherwise	0%
	City maintenance and construction tax - if paid by railroads, headquarters of banks or insurance companies	100%
	City maintenance and construction tax - otherwise	0%
	Securities tax - if collected on stock transactions	88%
	Securities tax-otherwise	0%

Source: SAT, Tax System of the People's Republic of China. (1998), p. 60; Quoted from Ahmad, Li and Richardson 2000, p. 26.

The central government's return of tax revenues reflects of preservation of the vested interests of the richer coastal regions. The amount of the tax return was calculated based on the net amount of

the revenues turned over by the local governments to the central government in 1993 and on the growth of VAT and excise in the following years. This net amount (excise plus 75% of VAT, minus transfers to the local governments) will be fully returned to local governments and is used as the base for the return of taxes in following years. With the growth of VAT and excise, the tax return can grow. The growth rate will be 30% of growth rate of the sum of excise and 75% of the VAT in comparison with last year. If the sum of the excise and 75% of VAT is less than the base for tax return of 1993, the local governments should turn over the difference to the centre (Xiang Huaicheng (ed.) 1994, 35).

The 1994 reform didn't change the arrangements of subsidies of the central government for local governments (yuan ti zhi zhong yang bu zhu), amount being turned over to central government (yuan ti zhi shang jie), subsidies for settlement of accounts (nian zhong jie suan bu zhu) and special grants (zhuan xiang bo kuan) under the preceding fiscal system. But the subsidies of the central government for local governments and the amount being turned over to the central government under the preceding fiscal system were calculated with the base number method. The preservation of the old system lead to more benefits for some regions and unfair redistribution to some disadvantaged regions (Zhong Xiaomin (ed.) 2001, 97-98).

On one hand, the fiscal autonomy of local governments was restricted and lowered by this reform, on other hand, it was ensured. The fiscal autonomy was restricted and lowered because:

(1) Taxation bureaus, formerly controlled mainly by the local governments and solely responsible for collecting all kinds of taxes, were split into state tax bureaus and local taxation bureaus.

The local governments have no direct instruments to hold back the VAT revenues and the excises because both tax revenues are now directly collected by the state taxation bureaus.

(2) Only 25% of VAT was returned to the local governments.

Further more, according to some further regulations, the National People's Congress (NPC) has the sole right of taxation legislation, including deciding on the categories of taxes, tax bases and tax rates. Only the central government can decide on collecting governmental funds (ji jin). Only the central government and provincial governments and governments of some designated "larger cities" can decide on collecting fees whereas the central government has right to control the decisions by provincial governments and abolish them if necessary. Other cities, prefectures, counties, towns and townships have no right to make any legislation, also no right for legislation for taxation, fund raising and fee collecting.

But on other hand, the fiscal autonomy of local governments was somewhat ensured. The 1994 reform was a qualitative progress in the direction toward establishing a modern fiscal system. The responsibilities for expenditures of the central government and local governments were assigned. The separation of state and local taxation bureaus was an attempt to institutionalize and permanentize the tax-sharing system, although it was also an obvious attempt to protect the central government's share of revenues from being eroded and the costs of tax collecting should be necessarily higher than before.

The raised share of the central government's revenues (around 50%) and its stable low share of own expenditures have been an instrument to control the local governments' behaviors through various subsidies (see Chart 12 and 13).

The 1994 system is only one for a transit period. Deeper reforms are still needed. The assignments of the responsibilities for expenditures of the governments are comparable with those in Europe and in USA. But they are not fixed in laws, only described in the central government's method of establishing this tax-sharing fiscal system. The duties and responsibilities of governments are also not explicitly prescribed in the decision and any law. Legislation by the National People's Congress is needed. Furthermore, the rest elements of the old systems are still to be wiped out.

After the introduction of the tax-sharing fiscal system, the central government introduced also a fiscal transfer system for the transit period. This system is equalization oriented. It is based on a set of standard equations for calculating the standard revenues and standard needs in expenditures. The sum for this purpose was little, but it was growing from 2.07 billion Yuan in 1995 to 8.55 billion Yuan in 2000, 312.8% of the amount in 1995, see Table 4. To some extent, this transfer system will remain a core element of the future fiscal federalism in China.

Table 4 Fiscal transfers in 1995-2000 in the framework of method of fiscal transfers for the transit period

(In 100 million Yuan)

Year	Number of benefiting provinces (cities and autonomous regions)	Total Amount of fiscal transfers	Change (%)
1995	18	20.7	-
1996	20	34.64	67.34
1997	21	50.21	44.95
1998	22	60.57	20.63
1999	22	75.29	24.30
2000	22	85.45	13.49

Source: China Public Finance Yearbook 1999; Ministry of Finance.

4 Developments since 1994: Path dependency in intergovernmental competition

The intergovernmental competition still happens under changing rules since 1994. The vicious circle of 1980-1993 still exists. There have been some attempts of the central government to improve the budgeting procedures, the budget management, the management of extra-budgetary revenues and expenditures etc. It shows a clear path dependency: The central government still attempted frequently to raise its own revenues; local governments mistrust the central government's behavior; most of the central government's attempts are perceived by the local governments as attempts to turn over more revenues from them.

4.1 Raising the central government's share by re-assigning revenues

The central government still managed to raise its share in the revenues from some shared taxes. Its share in the securities tax - if collected on stock transactions – was much lower than local

Table 5 Securities tax collected on stock transactions

Date/Year	Tax rate (‰, imposed on both sellers and buyers respectively)	Amount (billion Yuan)	The central government's share (%)
Before 1994	0.6‰ imposed upon sellers since 28. June 1990, 0.6‰ imposed upon sellers and buyers respectively since 23. Nov. 1990	0.0275 in 1991; 0.335 in 1992; 2.1 in 1993	Much lower than 50%
1994	0.3‰	4.524	50%
-	0.3‰	2.572 in 1995; 12.166 in 1996	80%
-	0.5‰ since May 1997	23.727 in 1997	88%
1998	0.4‰ since 12. June 1998	20.5	88%
1999	0.3‰ for B-share since 1. June 1999; still 0.4‰ for A-share	24.5	88%

2000		47.8	88% till end September 2000; 91% from 1. October to end December 2000
2001	2‰ since 16. Nov. 2001	-	94%
2002	2‰	-	97%

Source: China Public Finance Development Report 2001, 281-282; Data of State Administration of Taxation.

governments' share before 1994. It increased to 50% in 1994 and then to 80% and 88% later. In September 2000, the State Council announced that the central government's share of the securities tax would be readjusted in 3 steps since the beginning of October 2000 and would reach 97% in 2002 (see Table 4).

Another step was the re-assignment of the revenues from various income taxes since 1. January 2002. Enterprise income tax - if paid by railroads, post offices, headquarters of financial institutions and insurance companies belonging to the central government -, income tax on foreign and foreign funded banks, income tax on offshore oil companies, still belong to the central government. Except these enterprise income taxes, enterprise income taxes otherwise were sole revenues of the local governments. They were changed to taxes shared by the central government and local governments in 2002. The share of the central government is 50% in 2002, will rise to 60% in 2003. The share will be re-calculated in 2004 according to the fiscal situation of both sides. In the years from 2002 on, if the local governments will get more than the amount of base year 2001, they should turn over the excess amount to the central government, if they will get less than the amount of the base year 2001, the central government will give subsidies to close the gap. The revenues collected by the central government herewith will be fully used as general fiscal transfer to western and middle regions in China (China Securities Network, 2002).

These two examples clearly show that the central government is still using its power to change the fiscal system deliberately. It can be understood as a strategic action of the central government against the local governments' behaviors of non-obedience and collecting more extra-budgetary revenues.

4.2 Shifting off the responsibilities for expenditures by the central government

Table 6 described some compulsory expenditures required by the laws, regulations and governmental documents in China.

Although the central government announced in its reform plan of 1994 to assign tax categories under the precondition of assigning the responsibilities for expenditures, there was no progress in assigning the responsibilities for expenditures. The central government didn't like to give up its leeway to change the assignment of responsibilities for expenditures. Otherwise it would be difficult for the central government to balance its revenues and expenditures. But without a stable assignment of the expenditures, the assignment of tax categories itself was not enough to ensure the stability of the fiscal situation of the local governments. The central government shifted off frequently its responsibility for expenditures to the richer provinces. This could only solve the fiscal problems of the central government for short run, but could affect the motivation of these provinces to collect more revenues and forced them to channel the budgetary revenues to the accounts for extra-budgetary revenues. This was also one of the important reasons why the percentage of the fiscal revenues to the GDP fell down (Ma Jun 1998, 129).

Table 6 Some compulsory expenditures required by the laws, regulations and governmental documents in China

Scope of Duties	Laws, regulations, documents or other source of reference	Target of expenditure
Education	Central Government's Decision on the Reform of the Education System, 27. May, 1985 Compulsory Education Law, passed on 12 April, 1986, put in force on 1. July, 1986 General Guidelines for the Reform and Development of Education, 13. December 1993. Teachers Law, passed on the 31. October, 1993, put in force on 1. January, 1994 Education Law, passed on 18. March, 1995 and put in force on 1. September, 1995	Expenditure must reach 4% of the GDP by 2000.
Agriculture	Agriculture Law, 2. July, 1993 Law of Extension of Agricultural Technologies, 2. July, 1993	The growth rate of agricultural expenditure must be higher than that of the total fiscal revenues
Propaganda and culture	Central Government's Decision on Several Important Questions on the Construction of Socialist Spiritual Civilization, 10. October, 1996	The growth rate of the expenditure must not be lower than that of the total fiscal revenues.
Science and technology	Law of the Development of Science and Technology, 2. July, 1993 State Council's Decision on Acceleration of the Development of Science and Technology, 6. May, 1995	Expenditure must reach 1.5% of the GDP by 2000.
Environmental protection	State Council's Decision, 3. August, 1996	Expenditure must reach 1.5% of the GDP by 2000.
Health	State Council's Decision, 15. January 1997. Wang Bin 1998, p. 569	The growth rate of the expenditure must not be lower than that of the total fiscal revenues; The expenditure per head must increase from 2.60 Yuan to 4 Yuan. The expenditure for health should make 8% of the total fiscal expenditures.
Salary for administrators	Administrative Affairs Law, passed on 24. April, 1993, put in force on 1. October 1993	Salaries for administrators must be similar with those in state-owned enterprises.
Social Security	Ministry of Civil Affairs' Regulation on Minimal Living Security for the Urban Residents, promulgated on 28. September, 1999 Method of Minimal Living Security in Zhejiang Province, promulgated on 1. October 2001	Funds for minimal living securities should be granted to all the urban residents, costs should be borne by the city and county governments themselves. Funds for minimal living securities should be granted to all the residents,

		including the peasants, costs should be borne by the city and county governments themselves
Family planning	Wang Bin 1998, p.569	Standard per-capita-expenditure for family planning should be 2.00 Yuan.
Sport	Wang Bin 1998, p.569	Standard per-capita-expenditure for sport should be 0.30 Yuan.

Source: World Bank 1998, Chapter 4; Wang Bin 1998, 569. Some parts are added by the author of this paper.

4.3 The central government's attempts to strengthen local governments' budget management

The budgeting process is dominated by bargaining between governmental departments and interest groups on one hand and the department of finance on other hand. Finally, the budget is decided by the head of a government deliberately. It reflects then a balance of the interests of various parties. In such a process, there is no consideration of any mechanism of optimizing the expenditures. Some projects proposed by local governmental departments or local government are "fishing projects" (diao yu gong cheng), the costs of which are intentionally overestimated in order to strive for the central governments appropriation of more funds for them. This led to the central government's prioritization of the expenditures by the level of pressures it perceived in the appropriation of funds (Li Yong 1998, 25).

An efficient implementation of the budget plans of the central government and local governments is impossible because the budget plans submitted to the NPC and local people's congresses themselves are very rough and thin. Only amounts for different categories of expenditures (by functions) are listed. The people's congresses are not able to check the implementation of expenditures because the budget plans themselves are not transparent enough.

Upon the request of the NPC, the central government in China should make and submit the budget plan according to functions and departments (bumen yusuan). But it is up to now only experimented in few ministries and not extended to other ministries and local governments. It seems that the central government itself prefers to low transparency of its budget plan.

The central government decided that all the governments should work out the budget plans according to the "zero-base budgeting method" (ling ji yu suan). But neither the central government itself nor local governments have implemented this decision thoroughly.

Because the budgeting and budget management are heavily affected by various interests of departments, regions, interest groups and individuals, the central government and the upper-level governments are often only able to re-assign the increased part (zeng liang) of revenues from the lower-level governments to it, in the precondition of the preservation of the vested interests. This should be the reason why the long-lasting, non-scientific "base-number budgeting method" (ji shu yu suan bian zhi fa) can not be substituted by "zero-base budgeting method" or "factor analyzing method" (yin su fen xi fa) etc (Li Yong 1998, 26).

The separation of regular budget and budget for construction (fu shi yu suan) was prescribed by the Budget Law, but it has been only tried out by the central government and provincial governments. Even in the try-out process, the budgeting is not detailed enough and doesn't meet the required standards.

According to the Budget Law, the central government and provincial governments should work out the complete budget plan which includes the budgets of the lower-level governments. According to law, local budget plans should be approved first by the people's congress at the same level and put on records in the people's congress at the next higher level. But the annual NPC meeting on budget plans is held normally in March, while the meeting of local people's congresses

is held normally even later. This mismatch of timing leads to the working-out of total budget plans by the higher-level governments (including "budgets" of lower-level governments) even before they get information about the real budget plans of local governments (Xu Zhi 2002).

In this regard, the governments' behaviors of "deliberately breaking the law" are obvious and serious. If we consider the learning processes, and the "imitation" and "innovation" of such kinds of behaviors, it is no doubt that there are so many phenomenon of "deliberately breaking the law". Without any sanction, China will be far lagging behind the goal of rule of law. This misbehaviors of one government and its departments and officials has infectious effects on the behaviors of other governments, their departments and officials in the intergovernmental competition. They have even the same effect on the behaviors of the actors in the economy, including those of entrepreneurs and inhabitants, for example behaviors such as tax evasion, default in paying back loans etc.

According to the Budget Law, the final results from the implementation of budget plans of one government should be approved by the people's congress at the same level and be put on records in the people's congress in the next higher level. In reality, the final results should also be approved by the fiscal bureaus at the next higher level. Because of the tax-sharing system, the share of fiscal revenues and expenditures of one government depends on the settlement of final accounts and all the turn-over or transfer amounts. This makes it necessary for the upper-level government to check the fiscal accounts of the lower-level government.

4.4 Efforts with reform of fees and funds

Extra-budgetary and system external revenues are now partially administered on a special fiscal account (cai zheng zhuan yong zhang hu), partially not administered like that. The latter part disperses among the various administrative units and other public service units. It escaped from the control by the people's congress and the upper-level governments. Indeed, the administrative units and units for public undertakings at all levels have extra-budgetary revenues. But with the 1994 reform and some other regulations, the central government's share of extra-budgetary revenues is no more significant, while the local governments' share and amount is growing. Besides the funds and fees approved by the central government and provincial governments, local governments collected various kinds of further fees and fines, raised further funds, raised standards of fees, often without the approval by the upper-level governments and even without notice to the local fiscal bureaus and other departments at the same level.

The reasons for the "booming" of extra-budgetary and system external revenues include:

- The budgetary revenues of local governments are still limited. It is difficult to meet the standard need for expenditures;
- Local governments (like the central government) emphasize on the collecting of more revenues but not on the control of the quality and effects of expenditures so that the per-unit-cost for a standard benefit is high. This leads to a need of more funds for fulfill a task;
- The central government shifted off responsibilities for expenditures to local governments;
- There is a necessity of maintaining and building up general, economic, educational and social infrastructures to improve the competitiveness of the regions and cities. The local leaders are "political performances" oriented. They are measured by the number of larger projects implemented, revenues they generated etc.

Lots of fees are "user fees"(shi yong fei). They are charged to users for providing some public services or infrastructure. Some of them are collected in every region. Other of them are special in some regions. It is possible and necessary for upper-level governments to approve each kind of the latter ones if the rates are reasonable. A better way is that the local people's congresses have powers of approving such kinds of fees and funds. The precondition is that local people's congresses are directly elected and can effectively control the local government's behavior in interest of the voters, and the voters can control effectively the members of the people's congress. So what we need is the public finance in a democratic process. Some of "user fees" are business-oriented fees (jing ying xing shou fei). The solution can be marketization of such units of undertakings or marketization of the undertakings.

Some fees are collected to finance some pure public goods. But pure public goods should be better financed by taxes. Such fees can therefore be changed to taxes or integrated into existing taxes. Some fees are administrative fees for specific administrative service (gui fei) and can still be charged to a specific person or enterprise.

According to the central government, some kinds of fees should be changed to taxes, for example the road-maintenance fees and lots of other road- and fuel-related fees should be changed into fuel tax. The central government's proposal for establishing a fuel tax was rejected by the National People's Congress in October 1999, a change of various fees charged upon the vehicles, totaled 100 billion Yuan for repairing and building ways and highways. The reason was that the local governments perceived this reform as a new move to turning over of the revenues to the central level.

The extra-budgetary and system external revenues and expenditures are the hotbed for corruption of local cadres because of the non-transparency of these revenues. The best way of protecting the local cadres from being corrupt is a transparent, rule based fiscal system.

According to a regulation of the central government, all the extra-budgetary revenues should be kept on a special account of the local government for fiscal revenues. But there is still a part of the reported extra-budgetary revenues which was not kept on this account, and there should be another part which was not officially reported and therefore unknown to the upper-level governments and even other departments of the same-level government. Table 7 indicates the extra-budgetary revenues and expenditures of Zhejiang Province in 2000. Some parts of the extra-budgetary revenues are turned over to the special account of the local government, some part can be left in the hand of some departments of the local government upon its approval, and the other part is not turned over to the special account for various reasons.

According to the local governments, they could not turn over all the extra-budgetary revenues to the special account for fiscal revenues for technical reasons. If we also consider other revenues which are not reported and thus not included here, a better explanation would be that the special account can be a trap for local governments because the central government can easily raised the revenue base for calculating revenues to be turned over to it. Before the assignments of revenues, expenditure and responsibilities of governments are written in a law, this can be regarded as a trap for local governments.

Table 7 Extra-budgetary revenues and expenditures of Zhejiang Province in 2000

(In 10 000 Yuan)

Items of extra-budgetary revenues	Extra-budgetary revenues				Items of extra-budgetary expenditures	Expenditures
	Total	Turned over to the special account	Left in hand upon approval	Not turned over to the special account		
Fees for administrative affairs and other public services	1464407	1149093	257046	58268	Expenditures for administrative affairs and other public services	1565112
Governmental funds (surcharges)	174962	170806		4156	Expenditure for basic infrastructures for different sectors	155353

Revenues collected by the administrative units in charge (zhu guan bu men ji zhong shou ru)	78299	59941	16161	2197	City maintenance expenditures	165760
Funds raised and collected by towns and townships	450538	218228	61088	171222	Expenditures from funds raised and collected by towns and township	371597
Other revenues	318426	218762	66192	33472	Other expenditures	210026
Total revenues within 2000	2486632	1816830	400487	269315	Total expenditures within 2000	2467848
					Funds channeled by the local government	67557
					Under which: channeled to budget account	11248
Rest amount of 1999	445716	358548	55963	31205	Rest amount of end 2000	396943
Total	2932348	358548	55963	31205	Total	2932348

Source: Fiscal Bureau of Zhejiang.

4.5 Fiscal credits, debt issuance and management in China

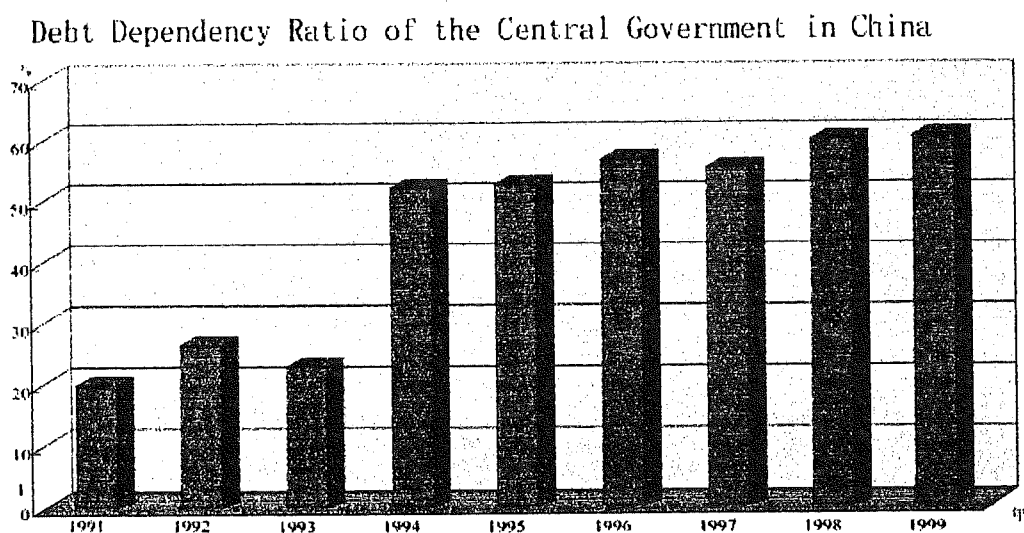
Local governmental departments and other local public service units often established some business companies. With the privatization in recent years, most of these companies have changed their legal status. They are now joint-stock companies, limited companies, shareholding cooperatives and so on. In these enterprises or the other unchanged enterprises, the state or collective shares still exist. Some administrative units such as bureau of city construction established some construction companies for building-up of infrastructures. Lots of them have a legal status as limited companies. For all these companies, the local governments often help them to get loans from banks, by giving them formal or informal guarantees.

There are also turn-over-funds which are funds of various departments of upper-level governments for special use. These funds are given to local governments as "fiscal loans" (Fiscal revenues are changed in this case to "loans"). "Interest rates" are to be charged. The size of turn-over-funds is several times as large as that of the annual local budgetary revenues in some cities.

In the fear of that the local governments have too much bad debts, the central government doesn't allow the local governments to issue debt securities directly. Deficit financing by the local governments is not allowed by the central government and the Budget Law. The local

governments must have a balanced budget each year. This principle is called “deciding on the expenditures according to the size of revenues” (liang ru wei chu, yi shou ding zhi). But in a modern country, the duties and responsibilities should first be assigned to various administrative levels. According to the duties and responsibilities, the size of expenditures can be derived. According to the size of expenditures, the size of revenues of the government can also be derived (“deciding on the revenues according to the size of expenditures”, yi zhi ding shou). But this principle applies only if the whole process is under control of a parliament which reflects the preferences and needs of the voters. One of the problems with “deciding on the expenditures according to the size of revenues” is that the governments emphasize highly on collecting more revenues, but they don’t take much care of the quality of expenditures.

Chart 14 Debt dependency ratio of the central government in China (1991-1999)



Note: Rate of debt dependency of central government = [Debt issued within one year / (Fiscal expenditures of central government within the same year + Repaid capital and interest)]*100%.

Source: China Finance and Economy Network.

The central government itself issued state treasury bills and invested the funds directly to large capital construction projects and infrastructure projects etc. It also issued state treasury bills and “lent” the raised funds as “loans” to local governments, because the central government distrust the local governments and fears that the local governments would borrow too much and have too high bad debts. But in realities, it is impossible to forbid local governments’ borrowings and hidden debts issuance (through its companies).

To further increase its own revenues, the central government issued large amount of debt. The debt dependency ratio of the central government was almost as high as 60% in 1999, see Chart 14.

The ratio of fiscal deficit of the central government to the GDP was around 2.2% in 1999 (see Chart 15). Both the debt dependency ratio and the ratio of fiscal deficit was approaching the “red light” of 60% and 3% if we use the convergence criteria of the EU as our reference criteria.

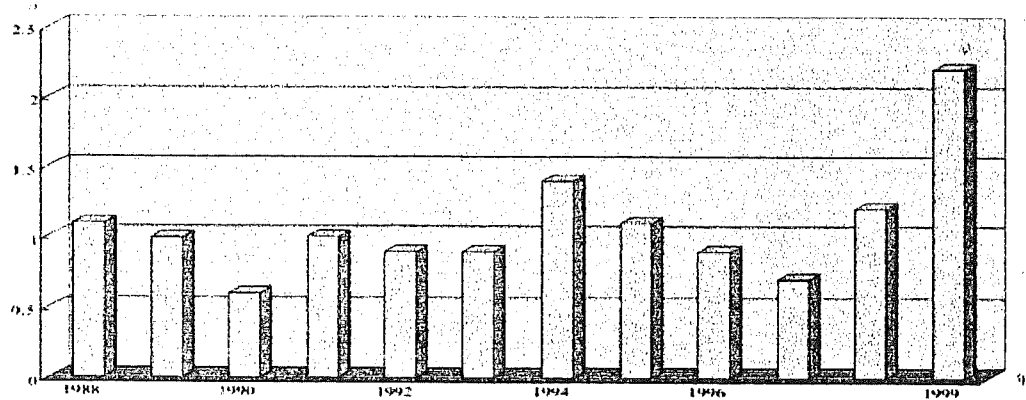
Local governments established several years ago investment and trust companies. They are windows of the local governments and bridges for them to get loans and raise fund in capital markets. Because of high bad debt ratio of local governments in some important cities (for example Guangzhou), the central government decided on liquidating and “sanifying” their assets and liabilities.

At moment, there is for example a fiscal credit company in Tongxiang City, Zhejiang Province, which is associated to the fiscal bureau and responsible for lending out the temporarily excessive funds for income (In this case, fiscal revenues are used again as “loans”). At the same time, there is also a state-assets investment center associated to the fiscal bureau. This center is responsible for the protection and increase the value of state assets in this city. Funds will be invested in companies, stocks etc. The business of both units is not transparent.

Although the central government requests that the local governments have balanced budget (also

according to the Budget Law), this doesn't mean that local governments have no debt. According to many research results, lots of county-level and township-level governments have heavy debt burdens. This is also a necessary result from shifting off the responsibilities from one high level to one lower level.

Chart 15 Fiscal deficit of the central government as a percentage of the GDP in China



Source: China Finance and Economy Network.

5 Solutions for fair rules governing the central-local fiscal relations and intergovernmental competition

In December 2001 there was a Central Chinese Conference on Fiscal Affairs. In the conference, the building up of a "public finance" system was officially stressed. The term of "public finance" has special meaning in the Chinese context: The governments should provide public goods and services, which meet the needs of the general public. This should mean a large change of the orientation of the fiscal system. To reach this goal, the reform of the political system should be indispensable. Only a political reform can lead to the establishment of a framework of fair rules governing the central-local fiscal relations. Without setting and enforcing the meta-rules based on consensus of all actors at the constitutional level, a rule-based fiscal system and intergovernmental competition is not possible, because both the central and local governments will still attempt to disobey and change the rules of second or third order. The meta-rules and institutions should include at least:

- An institution protecting the interests of local governments from being impaired;
- A democratic institutional setting revealing the preferences and needs of the general public;
- Laws on assignments of duties and responsibilities, expenditures and revenues of governments at various levels;
- Check and balance mechanisms.

Some institutions at central level are to be established to protect the interests of the local governments. Some examples in the EU, Germany, USA and Japan can be scrutinized in this regards.

In the EU, there is a Committee of Regions (CoR) representing the interests of the regional and local governments, and a European Parliament representing the member states of the EU and voters. In Germany, there is a Bundesrat (Upper house) representing the federal states. In the USA, there is a Senate representing the federal states. In Japan, there is a ministry taking care of local autonomy (zi zhi sheng) and an Upper House representing the local governments. The local governments express their concerns through this ministry and through their senators in the Upper House. This ministry is able to negotiate with other ministries of the central government. The

latter ones have naturally interests in shifting off the responsibilities for expenditures to local governments, even if the assignments of expenditures are prescribed by the law (Ma Jun 1998, 129).

In China, there are three alternatives to protect the legal interests of local governments: (1) The establishment of an institution like the Committee of Regions in the EU or the Ministry in charge of Local Autonomy in Japan; (2) The establishment of an Upper House representing the provinces; (3) Enhance the NPC which is now the parliament of China and is still weak to represent the highest power of the people. The membership of representatives reflects at this time still rather an honor for than the ability of them. In the transit period, the third alternative might be acceptable to the political decision-makers.

At the local level, the local people's congresses (except provincial people's congresses and those in some minor designated larger cities) have no power for legislation and there is no direct election, which means that the preferences of local residents can not be revealed as needed. This power should be granted by the constitution or another law. A direct election should be introduced step by step. At moment China practices direct election at village level and is experimenting this at the township level. The direct election at a higher level should be acceptable and will also be indispensable if China seeks to establish a real "public finance" system.

In this regard, it is necessary to build the central and local state in China (state-building). The NPC should be more autonomous than today. It should take more responsibilities for setting up meta-rules. The decision on the fiscal system in current China was made by the State Council. The NPC should take further actions in such a context to pass a law prescribing the assignments of duties and responsibilities, expenditures and revenues of the governments at various levels. These are prescribed in the constitution, a fiscal basic law or a basic law for taxation.

Budgeting procedures and requirements should be legislated by the NPC, not worked out and fixed by the Ministry of Finance because any governmental department itself is an interest group. The autonomy of the people's congresses at various levels can be improved if there is a law forbidding that the officials from the administration become members of the parliament at the same time.

Based on above-mentioned institutional improvements, mechanism of checks and balances can be developed.

A fiscal system based on all these institutional arrangements will be naturally a "fiscal federalism", under which not only the interests of the central government and local governments, but also those of the general public are protected.

The fiscal relations and intergovernmental competition are not a sole matter of governments. The governments' complying by rules and laws or breaking them in the political-administrative system have direct effects on the behaviors of all the actors in the economic system, because people can learn "good" as well as "bad" patterns of behaviors in the process of institutional learning from the political-administrative system.

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The Achilles Heel of China's Economy:
Understanding the Process of Institutional Evolution in a Large Transition Economy

Song Lei (SL@3f.soec.nagoya-u.ac.jp)

"Let the dice fly high...Even yet we may draw back; but once
across that little bridge, and the whole issue is with sword."

Julius Caesar, before crossing the Rubicon River

"Cross the river by feeling stones"

Deng xiaoping

"It was the best of times, it was the worst of times, it was the age
of wisdom, it was the age of foolishness, it was the epoch of
belief, it was the epoch of incredulity, it was the season of Light,
it was the spring of hope, it was the winter of despair, we had
everything before us, we had nothing before us, we were all going
direct to Heaven, we were all going direct the other way,....."

Charles Dickens, A Tale of Two Cities

"Every highway and byway leads to capitalism eventually, of
course, but precisely what kind do they lead to, how fast, at
the cost of how many sacrifices, and with whom as the winners
and whom as the losers? Each fork in the road poses a choice
problem. So although most people accept and endorse the
'main direction', there are innumerable dilemmas ahead".

Kornai, Highway and Byways

1 Introduction

If we do not take political reform into account, China's reform should be taken as the most successful one among the transition economies. However worrying signs began to appear at the end of 1996 and nowadays it is not in doubt that Mainland China is facing stagnation. In order to analyze both the high-growth and the stagnation under the same analytical framework, we introduced the *Regulation Approach* into the analysis of gradual reform as a competing analytical framework and proposed the hypothesis of gradual reform without long-term perspectives (Song, 2002).

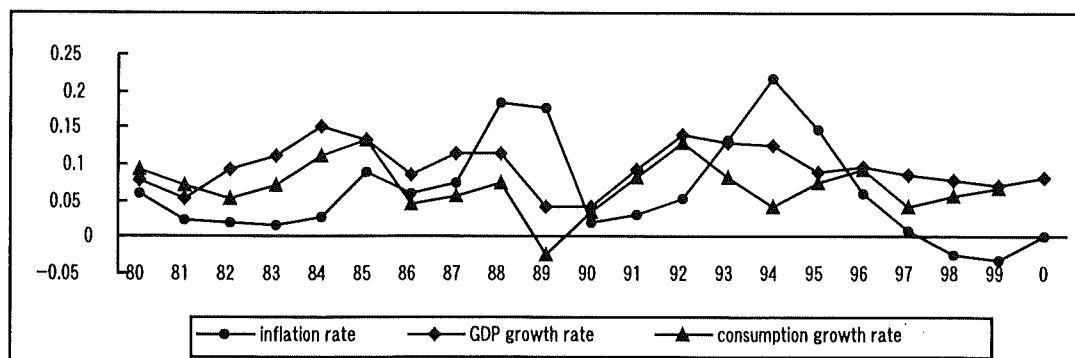
However, there are at least two unsolved problems in our previous research. The first one is to analyze the process of institutional evolution in details. The second one is to elaborate our analysis about the buffers that ease the tension accumulated in the process of reform. In this paper, we aim to solve the two problems and deepen our understanding of process of institutional evolution in a large transition economy.

□

2 What had happened in Chinese-style gradual reform?

Figure 1 shows us two facts. First, China had attained remarkable performance (in terms of GDP and domestic consumption) until 1996. Second, the GDP growth rate continued to decline after 1996, lower than the government's hoped-for growth. Furthermore, it is a fact that growth, employment¹ and the price index have never deteriorated at the same time in the past. Especially, according to independent experts, the real unemployment rate ranged from 15% to 20% in recent years (Wang, 2000: 12; Meng and Wang, 2000).

Figure 1 High growth and "stagnation"



Notes: In 2000 and 2001, besides housing and services, deflation continued in most goods.

Sources: *China Statistical Yearbook* 1999 and documents released by the National Bureau of Statistics

Back in the 1980s and early 1990s, Chinese studies used to be a popular topic and many hypotheses have been proposed. But the stagnation that began from 1996 raised an important question about the sustainability of Chinese-style gradual reform and causes us to check these previous studies once again: Can existing hypotheses explain both the development and recession (or crisis) in the same analytical framework?

3 How to analyze gradual reform?

When reforms in Eastern Europe and China were in their infancy, the task of reforming the Communist system was basically considered as analogous to that of implementing 'structural adjustment' programmes in developing countries². When the huge paradox that China had continuously brought out good results and the former USSR³ failed to recover as advocates of shock therapy had promised arose, the early optimism disappeared. Nearly everyone, including the designer of shock therapy, J. Sachs, began to rethink radical reform⁴. However when China failed to show that recession is just an adjustment after a soft-landing, the new round of debate began.

Although the sustainability of China's economic growth is not a novel topic at all, in recent years this topic became a main topic in Chinese studies. We will survey some of these previous researches about the sustainability of gradual reform by dividing them into two groups: the leap argument and the complementarity argument.

The leap argument can be viewed as a new version of shock therapy. According to the leap argument, the reform of state-owned enterprises (SOEs) has been a source of macroeconomic instability. Since SOEs are deemed to be inferior to private enterprises in making profits, the Chinese government has to decentralize property rights and support more rapid comprehensive reforms, including privatization (Fan and Woo, 1996; Zhang,

1999). In other words, they argue that after the lifting of the ban on privatization, the economy will set forth on a sustained, smooth growth path. Similarly, Nakakane (1999) pointed out the limitation of gradual reform and emphasized the importance of privatization from the viewpoint of establishing the 'institutionalized market (legal codes to guide economic transitions)'⁵.

Contrarily, the advocates of the complementarity argument show strong confidence in the direction of gradual reform as they did in the past decades (Lin, 1994, 1998a, 1998b; Lin et al, 1999). They argue that the establishment of fair competition conditions⁶ will be decisive to resolve the last and harshest problem left in the process of gradual reform: improving the efficiency of SOE (Lin, 1999). According to Steinfeld, the problem within Chinese SOE today is not that ownership is in the wrong hands but that ownership itself simply does not function. Ownership fails to function because the external market mechanisms (e.g. competition conditions and the reliability of account data) needed to make it function in large production organizations are deeply flawed in the Chinese context (Steinfeld, 1998).

Although these arguments show different perspectives concerning further reform, they share three characteristics in common.

Firstly, both of the arguments are affected deeply by the gradualism-shock therapy dichotomy⁷. Compared with advocates of the leap argument who take privatization as the solitary resolution, Lin tries to avoid introducing privatization or Big Bang into gradual reform. However, according to his analytical framework, it seems that he cannot propose anything more than the establishment of fair competition conditions, which do not ensure the success of SOE reform at all. Therefore, if the establishment of fair competition conditions, the final prescription that can be given by the complementarity argument, is not a panacea as expected, the last choice, large-scale privatization becomes inevitable. In this sense, the complementarity argument can be viewed as a hybrid of the leap argument. In short, there exist crucial defects in both the leap argument and the complementarity argument. Advocates of the leap argument have to

explain why China had achieved rapid growth under the gradual reform that is obviously contrary to their doctrines, while advocates of the complementarity argument are facing the dilemma of introducing the Big Bang into gradual reform, which is contradictory to their logic, too.

Secondly, advocates of both the leap argument and the complementarity argument attempt to get the reform fulfilled by designing some new additional policies. It is well known that additional policies have been the main topic in most of the previous studies on gradual reform. Therefore, it is not so surprising to find that advocates of the leap argument and the complementarity argument imply that the problems of SOEs can be solved by adding additional policies, in the very conventional sense, say privatization or the establishment of fair competition conditions. When we consider the fact that reform has entered its third decade, however, we should say that to analyze the reform process from medium or long-term perspective is much more important than just to choose an additional policy from the toolboxes of gradualism or shock therapy. In other words, if we cannot understand the nature of institutional arrangements and the nexus existing between them that developed in the process of reform and sustained the reform, we can not find any appropriate answers to complete the reform. Although the quality of institutions has been pointed out as the key to understand the sources of growth in the transition economy, there exist only a few studies emphasizing the role of the nexus between these institutions from the viewpoint of medium or long-term perspectives.

Thirdly, most of the previous studies are inclined to take into account only the supply-side of the Chinese economy. Consequently, demand-side factors were neglected.

Drawing conclusions from the above critical survey of the previous studies, we consider an alternative approach that is based on the interaction of supply and demand, and medium or long-term institutional analysis would be necessary. It is the very reason why we introduce the *Regulation Approach* into the studies of gradual reform.

4 Institutional Evolution in a Large Transition Economy: A *Regulationist*

4.1 Is *Regulation* Approach suitable for the analysis of Chinese-style gradual reform?

From the 1980s, the *Regulation* Approach has been introduced into the analysis of Eastern Europe and former USSR's reforms, and has shown that a transition economy is an appropriate subject for this approach (Chavance, 1990). By contrast, few studies on gradual reform were undertaken in line with this approach. Here, we have to answer the following questions. Firstly, is the *Regulation* Approach suitable for the analysis of Chinese-style gradual reform or not? Secondly, if the answer is basically positive, which aspects should we pay special attention to when we try to draw conclusions from the analysis based on this approach?

As far as ownership structures⁸ and resource allocations⁹ are concerned, it is obvious that the current Chinese economy is different from the pre-reform planned economy as well as the so-called Market Socialism. Actually, Mainland China is evolving into a special type of capitalism.

Economic reforms changed not only the ownership structures and resource allocation, but also the labor-wage nexus, which is one of the most important concepts of the *Regulation* Approach and also a key to understanding the planned economy and the transition economy. As for the labor-wage nexus in pre-reform socialism, some authors took it as a specific non-capitalistic nexus, while others took it as a hybrid of capitalistic labor-wage nexus (Chavance, 1990). It is noteworthy that after 20 years of reform, China's labor-wage nexus had been approaching the latter, and its non-capitalistic characteristics had withered away.

- (1) As the non-state enterprises had absorbed more and more of the workforce, the managers of SOEs were granted more autonomy in the hiring and using of workers. In other words, a capitalistic labor-wage nexus had become the dominant one in industry in the past two decades.

(2) The models of the *Regulation* Approach are usually based on some stylized facts of capitalist economies, in which the manufacturing sector has played an important role (Bertrand, 1983; Boyer, 1988). Here, then arises an unavoidable problem of how to analyze the agriculture sector, which still remains as an enormous sector even after reforms in China.

Firstly, through studying the changes taken place in the agriculture sector, we find some similarities between the agricultural laborer-government relationship and the labor-wage nexus in the manufacturing sector. Actually, because government owns the land in China, the agricultural laborer-government relationship could be viewed as a kind of specific labor-wage nexus, in which the household responsibility system and prices mechanism of farm products played important roles.

Secondly, as Boyer (1994) pointed out, informal job is as important as formal job in developing countries. In Mainland China, the development of TVEs (Town-Village Enterprises) supplies formal and informal jobs for rural residents and brings the labor-wage nexus into the rural society.

Because it is undeniable that development patterns differ between regions, especially between coastal and inland, we take China's economic development as a process motivated by competition between different regions under the rules set up by the central government¹⁰.

In sum, although the *Regulation* Approach is not a panacea, it is at least an antidote against the previous biased studies. In other words, the *Regulation* Approach can provide us with a decidedly effective and unique lens, which is different from those adopted by advocates of shock therapy and gradual reform. Furthermore, we will find the outcomes and causality become far clearer under this lens.

4.2 Understanding the process of institutional evolution in a large transition

economy

4.2.1 China's path: Institutional economists' interpretation

In the 1980s, the unique initial conditions were viewed as the factors of objective set of China's growth. However, even if these initial conditions are necessary conditions, they are not sufficient conditions of growth. In the 1990s, some institutional economists who feel dissatisfied with the above interpretations had tried to reinterpret the growth from the aspect of institutional evolution.

4.2.1.1 Path-dependence: institutional economists' interpretation about initial conditions

According to the institutional economists' analysis, gradualism and experimentalism, the major principles of China's reform originated from the initial conditions. Therefore, path dependence is the key to understand China's growth.

Different from the Soviet Union, the number of commodities subject to China's central government's plan is small (Byrd, 1991, 104), commune and brigade enterprises, the predecessors of the later TVEs had been established since the 1950s, the labor supply has been sufficient, rather than short. All these factors have been used to explain the difference between the two large transition economies' performance. However, institutional economists did not stop here, they chose the characteristics of the organization structures as the starting point of their analysis about path dependence.

According to Qian and Xu (1993), The dominant organization structures in Soviet Union and China are different (note 1999). In the Soviet Union the economies were organized in the U-form in which hierarchical information flow and control were organized into a unitary form by functional or specialization principle. Because of the strong interdependence between enterprises across different regions, comprehensive planning and administrative coordination between ministries at the top level of the government were crucial for the normal operation of the U-form economy. By contrast, the Chinese economy is organized into multi-layer-multi-regional form mainly according to territorial principle, in which each region at each layer can be regarded as an operating unit. In other words, regions are relatively self-contained and the hierarchical structure of each region at each level is a copy of that of the central

government. The emergence of the two organization structures were the results of the historical reasons, technological levels in the two countries. Qian and Xu (1993) take the institutional differences between the M-form organization in China and the U-form organization in the Soviet Union as the principal reason why China and the Soviet Union chose different ways to reform their planned economies.

Reforms have further decentralized the M-form economy among regional lines, which provided flexibility and opportunities for carrying out regional experiments, for the rise of non-state enterprises, and for the emergence of markets. Furthermore, Qian, Roland and Xu elaborated their analytical framework and applied it to explain the emergence of the Special Economic Zones and the experimental privatization of small-and medium-sized SOEs (Qian, Roland and Xu, 1999). Their analysis was based on the organization theory and did deepen our understanding about the path-dependence in a large transition economy. However, a path-dependency approach should focus on both the heritage and creation (Chavance and Magnin, 2000: 198).

In so far as new enterprises or interwoven ownership enterprises go, what is important is not only if new companies or interwoven ownership enterprises emerge or not, but also if these enterprises can evolve into real market participants or not.

4.2.1.2 Institutional complementarity : Will the process of institutional evolution be completed under gradual reform?

Although the dominant organization structure existed in the pre-reform era was one of the principal variables, its effects were doomed to step down while the reform made progress. When the reforms are intensively implemented, whether the initial institutional innovation can bring out subsequent institutional changes or not is crucial for the fate of the reform. Here, the institutional complementarity between the initial institutional innovation and the subsequent institutional changes is important. In fact, if this problem can not be solved, the hypothesis based on institutional difference in organization structures will never be completed. In this sense, Qian and Ronald (1996) and Lau, Qian and Roland (2000) are complementary to Qian and Xu (1993).

Lau, Qian and Roland (2000) examined how the dual-track approach worked in product and labor markets. Compared to their analyses which emphasis the importance of path-dependence, they indirectly raised an interesting problem that if the entry of

non-state enterprises brought out the institutional changes in product, labor and finance markets. Actually, one principal theoretical contributions of Qian and Ronald (1996) is that they examined how the change of labor market (from uncompetitive labor market to competitive labor market) affect the institutional arrangement in finance market and harden the budget constraint.

Although they did not associate their analysis of institutional complementarity to their previous studies on path-dependence clearly, there exists linkage between their studies on the two issues that can be summarized as the follows.

U-form organization structure made the entry of non-state enterprises possible. The competition between state-owned enterprises and the new comers raised the efficiency of state-owned enterprises and harden their budget constraints. In other words, the entry of non-state enterprises firstly changed the mode of competition in product market, and then the new mode of competition brought out the institutional changes in labor and finance markets. Evidently, path-dependence and institutional complementarity are the two keywords in their analytical framework.

The analysis based on the institutional difference in organization structures and institutional complementarity provides a very persuasive explanation about the China's reform till 1996, and the authors hint that the process of institutional evolution will be completed under the gradual reform (Qian, Roland and Xu, 1999: 1093-1094).

However, the development after 1996 did not support their reasoning. Since 1996, new policies that are heterogeneous to the preceding policies have been implemented.

Firstly, asset management bureaus were allowed to trade in SOEs' (especially small and medium scale SOEs') assets, and a new form of external discipline on managers was brought forward. With the slogan of "reducing employees and improving efficiency", some thirty million urban workers, a phenomenal number for a country even as vast as China, were expected to lose their jobs throughout the process.

Secondly, because the national banking system was mired in insolvency and non-performing loans had reached an astronomical level, central government had to swing into action to avoid the fate of its Asian neighbors. As a consequence, the banking system was to be wrenched from local control, and subsidized credit to state firms was to be summarily cut. In other words, bankruptcy-induced market exit and commercial provision of capital are the two key characteristics of present reform. Although the authors still attempt to describe the reforms after 1996 as piecemeal, additional ones,

their argument sounds not as well founded as their argument about reform till 1996 (Qian, Roland and Xu, 1999: 1094).

Therefore, the process of institutional evolution is not completed under the gradual reform, and as we discuss below, even if the process of institutional evolution complete when gradual reform is changed into a radical one, the efficiency of the process of institutional evolution as a whole is quite questionable.

4.2.2 Nature of the process of institutional evolution in a large transition economy

Besides emphasizing the importance of path-dependence, *Régulationist* proposed unique analytic framework about the process of institutional evolution in a transition economy. According to Chavance (2000: 249-251), at the most abstract level, capitalism and socialism can be defined as two species within the 'monetary-wage labor system (MWLS)'. Therefore, the transition from the latter to the former is composed of the changes happening in the latter's institutional forms, especially monetary regime and wage-labor relation. In this sense, any institutional analysis should not neglect the monetary regime, wage-labor relation and the relationship between them.

According to the *Régulationists'* understanding about institutional complementarity, when we make a comprehensive assessment of the process of institutional evolution in a large transition economy, we should take not only the sequence of institutional evolution, but also the macroeconomic effects of institutional evolution into account. Different from other institutional economists, *Regulationists* understand the term "institutional complementarity" from a more macro-dynamic and social perspective, so they prefer to use the concept of "structural compatibility" (Hollingsworth and Boyer, 1997; Uemura and Isogai, 2000). Many scholars take the additional institutional arrangements in China as "well-designed" or "well-intended", and other scholars take the "sequence" of institutional evolution as the key to understand the process of institutional evolution. Here, we should distinguish the process of the institutional evolution with its macroeconomic effect. In this sense, Qian and his group's studies concentrate on the sequence of the institutional evolution in a transition economy. It is true that "sequence" or institutional complementarity is the key to understand the process of institutional evolution. However, the process of institutional evolution is self-enhanced, it can lead the economy to stable growth, but it can lead the economy to

persistent crisis too. Therefore, the real problem is how to estimate the macroeconomic effect of the process of institutional evolution.

If we divide the institutional evolution in a large transition economy into the institutional evolutions in products markets, labor markets and finance markets, it is clear that China's institutional evolution in labor markets and finance markets are far from completed. It is the very reason why China has been faced a serious transformation since 1996. In this sense, we have to be skeptical to the dominant hypothesis that the institutional evolution in product markets will bring out the efficient institutional evolution in labor and finance markets and bring China's economy to a efficient market economy eventually.

5 The Achilles Heel of China's Economy

Having posited the basic thesis and methodology in Section 2, 3, 4, in this section I intend to present a hypothesis which regards structural compatibility between principal institutional forms as the institutional foundation of China's economic development. Because there are not many pioneer studies about the Chinese economy from the viewpoint of the *Regulation* Approach, reinterpreting the growth and the recession of Chinese-style gradual reform rather than drawing a comprehensive conclusion would be much more important at the present stage. The subject of presenting a comprehensive hypothesis will be undertaken in future research and therefore the hypothesis presented in this paper is merely a tentative one.

As is well known, labor and finance are key factors in the mode of *regulation*. Not so well known, labor and finance occupied very decisive positions in gradual reform and are thus crucial to a full understanding of both the impressive growth and the subsequent recession. Here, I intend to focus on the reasons of the growth and recession of Chinese-style gradual reform in the term of structural compatibility or incompatibility between the labor-wage nexus and the monetary regime.

5.1 A bird's-eye view of gradual reform

I will first look at the specific institutional arrangements, the micro foundations of the labor-wage nexus and the monetary regime, which were shaped in the process of reform. Because a historical review of the process of gradual reform is beyond the scope of this study, our review will only concentrate on the formation and changes of such institutional arrangements concerning labor /wage and finance /investment.

5.1.1 A critical appraisal of additional policies

In our view, the main characteristics of Chinese reform until 1996 can be summarized as the combination of two inter-related principles: political acceptability and economic gradualism. Although it seems very difficult to make economic reform Pareto-improving, and even more difficult for economic reform to be simultaneously Pareto-improving and efficient, acceptability or social stability was adopted as a basic doctrine along the whole process of reform owing to political reasons. As a result, gradualism¹¹, under which the dual-track price system was created, and SOEs and non-state enterprises coexisted, was chosen as an essential principle for designing any concrete policies in practice.

However, since 1996, new policies, which are heterogeneous to the above policies, have been implemented. Firstly, asset management bureaus were allowed to trade in SOEs' (especially small and medium scale SOEs) assets, and a new form of external discipline on managers was brought forward. With the slogan of 'reducing employees and improving efficiency', some thirty million urban workers, a phenomenal number for a country even as vast as China, were expected to lose their jobs throughout the process. Secondly, because the national banking system was mired in insolvency and non-performing loans had reached an astronomical level, central government had to swing into action to avoid the fate of its Asian neighbors. As a consequence, the banking system was to be wrenched from local control, and subsidized credit to state firms was to be summarily cut. In other words, bankruptcy-induced market exit and commercial provision

of capital are the two key characteristics of present reform. Although some advocates of gradualism still attempt to describe the policies after 1996 as piecemeal, additional ones, their argument sounds not as well founded as their argument about reform before 1996.

As we have noted, many scholars believe it is these 'well-intentioned' additional policies that made the record-setting growth possible and they have been attempting to find the next additional policy to maintain the growth. In the following parts of this section a decidedly skeptical view will be proposed towards their assumption. The first reason for this skepticism concerns the way we view high growth and recession, while the second source of skepticism involves our understanding of the nature of reforms in a transition economy and additional policies in China.

Firstly, taking the reliability of public statistical data into account, we discover that the recession is much more serious than advocates of gradual reform would like to believe. Under such circumstances, it would be presumptuous of any academic to suggest that he has an easy answer for the tough policy choices concerning China's future.

Secondly, the debate about the transition economy should be seen in the context of the competition between two different strands in economic theory: the neo-classical framework and the evolutionary perspective. However, the process of transition is ongoing and our knowledge about it is still limited.

- (1) The failure of the experiment of shock therapy in Russia does not mean that Chinese-style gradual reform will succeed. We should not forget that policy-makers did not have a blueprint in mind when they set out to reform the economic system (Perkins, 1988). Therefore, these additional policies should not be taken as 'well-intentioned'. Actually these additional policies were a series of second-best choices at most, and every policy had been chosen in circumstances that had been shaped by the previous policies. Therefore, even if every single policy was the 'first-best' choice at that time, it is the very sum of such 'appropriateness' accumulated in the process of reform that led to the recession. Chinese-style gradual reform reminds us to rethink the

meaning of the path-dependence and lock-in. The second-best, additional policies enforced themselves and 'evolutionary' reform does not lead us to an efficient market economy undoubtedly.

- (2) Many scholars use the 'Chinese way' as an argument in favor of gradualism and against shock therapy, and some scholars show optimism about China's future because they view China's story as an evolutionary one. However, it is obvious that past success does not ensure future growth, and the evolutionary approach itself does not ensure satisfactory end in either the natural world or society. We should not forget that Gorbachev tried gradualism and his reforms were ended by a revolution.
- (3) Growth can be attributed to the evolution of the Chinese planning system which is different from the standard Soviet model to some extent (Qian, 2000) and some reforms, especially reforms in agricultural sector, are evolutionary. However, most additional policies are designed to maximize the benefit in the short term. It is hard to describe the whole process of China's reform as an evolutionary one. The difference of effects of institutional arrangements in product markets, labor markets and capital markets is a good example to understand the limit of Chinese 'evolutionary' reform. The deregulation of product markets does have a positive effect on reforms in labor markets and capital markets. However, until the end of the 1990s, the safety net had not been established and major banks were in bankruptcy. Therefore, we cannot conclude that the reform in product markets, which is the central reform, has improved the reforms in labor markets and capital markets successfully. In this sense, even if we take China's reform as an evolutionary one, it is quite unbalanced and far from completed.

Thirdly, additional policies can be implemented by two ways: putting into practice the different policies one after another (e.g. the transformation from rural reform to industrial reform) or carrying out the different parts of one policy successively (e.g. the reform of incentive mechanisms had been divided into several stages). Additional

policies have played two crucial roles. First, these policies provided new impetus for development when the preceding policies came to their end. Second, these policies had been used as buffers to mitigate accumulating conflicts. In the process, a potential and dangerous problem came into being: because additional policies were used as motive power and buffer at the same time, the failure of additional policies simultaneously mean that the main buffer fails to play its role. In other words, as we argue below, in Mainland China, the institutional foundation of development is unstable, and buffers besides additional policies, say an efficient safety net, do not exist.

In order to analyze the relationship between productivity increases and the real income of rural residents, I divide the whole rural reform process into

- (1) From the early 1980s to 1990, there had been an obvious correlation between the rate of productivity increase and the increase of rural residents' real income. During the early 1980s, both the rate of productivity growth and rural residents' real income had risen steadily. In the late 1980s, following the decline in productivity, rural real income had dropped too.
- (2) During the early 1990's, the correlation between productivity and real income of rural residents has been weakened (1991-1993; 1995-1996). From the late 1990s, the rate of productivity growth, real income and the price index of agricultural goods had declined at the same time. It means that the rural areas have been deeply affected by the recession that began from 1996.

1981-89	1990-98
$\dot{RW}=0.00404+1.386\dot{Q}$ $R^2=0.846$	$\dot{RW}=0.048+0.398\dot{Q}$ $R^2=0.072$
(0.26) (6.21)	(0.842) (0.742)
This trend is confirmed when we use the average value of every three years:	
1982-89	1990-97
$\dot{RW}=-0.022+1.56\dot{Q}$ $R^2=0.675$	$\dot{RW}=-0.0557+0.201\dot{Q}$ $R^2=0.03$
(-0.83) (3.53)	(1.77) (0.43)
RW: growth of real income of rural residents; Q: growth of agricultural output	

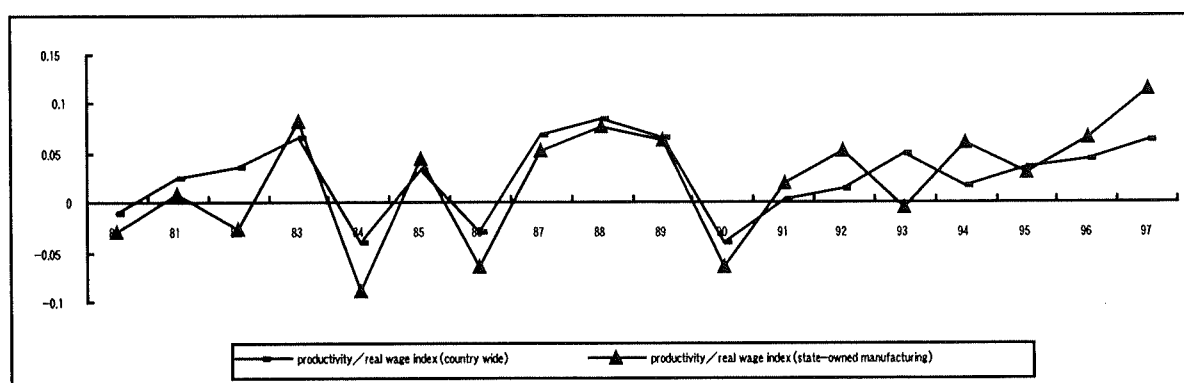
In short, the above facts hint that the household responsibility system, known as the principal institutional arrangement in rural areas, has gradually lost its effect on the development in rural areas since the early 1990s. Additionally, as we argue below, in recession periods, TVEs' ability to absorb rural labor has been limited.

5.1.2.2 "Virtuous circle" in the industrial sector

Except in rare instances (hyperinflation in 1985, 1987-1989), from the 1980s to the beginning of the 1990s, the increase rate of real wages in the industrial sector had exceeded the rate of productivity increase, or if not, the gap between them had been small. In this period, productivity growth had

been inflated (Wang, 2000: 11-12), bureaucrats tended to report the wage fund as lower, and the profit ratio had fallen. At the same time, non-wage income such as free housing and health care existed (Fang and Woo, 1996: 213), employment had been secured. We can conclude that the increase in the productivity had been distributed favorably to the laborers up to the beginning of the 1990s. However, even though the profit had been eroded by over-compensation of employees (job security and growth of real wages) until the mid-1990s, we could not accept the conclusion without reservations¹². Actually, the trend has been totally changed when many employees lost their jobs in the second half of the 1990s.

Figure 2 Productivity/real wage index (1980-1997)



Notes: Productivity/real wage index is used as the proxy variable of "real social wage cost (Aglietta, 2000: 90-100).

Source: *China Labor Statistical Yearbook 1998*.

Until the middle of the 1990s, laborer's right to claim the surplus had been strengthened in both the agricultural and industrial sectors.

From 1979 to 1984, several important experimental initiatives were emphasized to enlarge producer autonomy. It included the replacement of collective farming with the household responsibility system in rural areas¹³ and the introduction of profit retention and performance-related bonuses¹⁴ in urban areas. Although a bonus tax was introduced in 1984, its effect was quite limited. From 1987 to 1992, the contract responsibility system, which was designed to clarify the authority and responsibility of enterprise

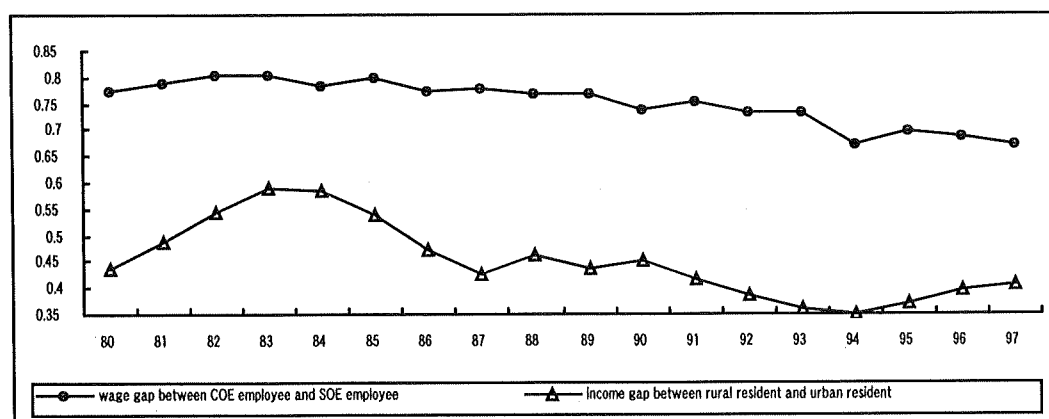
managers, was widely adopted. However, manager's appointment and promotion were affected by employees (Walder, 1989), and manager's income was linked to the employees' salary. As a result, the wage fund had risen persistently even under the contract responsibility system. Therefore, in this period, in so far as wage/employment goes, many enterprises, especially SOEs and COEs (collective-owned enterprises) can be viewed as 'insider/laborer managed enterprises'.

Actually, in this period, the positive correlation between increase in wage/bonus and the increased productivity was confirmed (Groves et al, 1994; Yao, 1997). It means the performance-based wage/bonus system contributed to the productivity increase.

The persistent wage growth gave rise to the enlargement of the market size, especially the enlargement of the consumer durable goods market.

Following the decrease of income/wage gap between regions/ownership (see Figure 3) and the increase of consumption expenditures, there had been qualitative shifts of the structure of consumption expenditures in the 1980s (see Figure 4). The first qualitative shift was the decrease in the gap of consumption expenditure between strata. The second qualitative shift was the increase of expenditure toward consumer durable goods. These shifts can be understood as the result of relatively equal income distribution. Thus, the increase in real income/wages accompanied by the decrease in income/wage gaps between strata ensured the development of the consumer goods sector from the demand side, and accelerated capital formation in the consumer goods sector.

Figure 3 Income/wage gap between regions and ownership

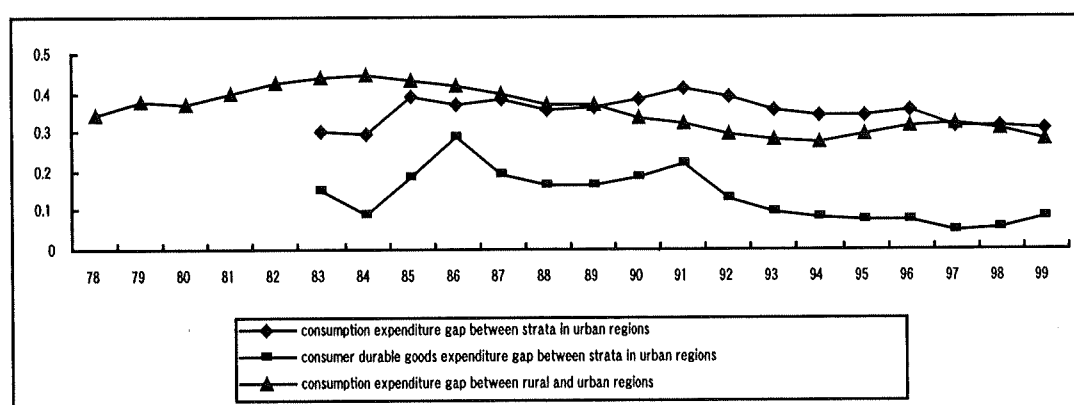


Notes: Wage gap between COE employees and SOE employees is used as the proxy variable of

wage gap originating in sizes of enterprises.

Sources: *China Labor Statistical Yearbook 1998*; *China Statistical Yearbook*, each year.

Figure 4 Changes of consumption pattern



Notes: Consumption expenditure gap between strata in urban regions: the ratio of the second poorest

stratum's consumption expenditure compared to the second richest stratum's consumption

expenditure. Consumer durable goods expenditure gap between strata in urban regions: the

ratio of the second poorest stratum's consumer durable goods expenditure compared to the

second richest stratum's consumer durable goods expenditure.

Sources: *China Statistical Yearbook*, each year.

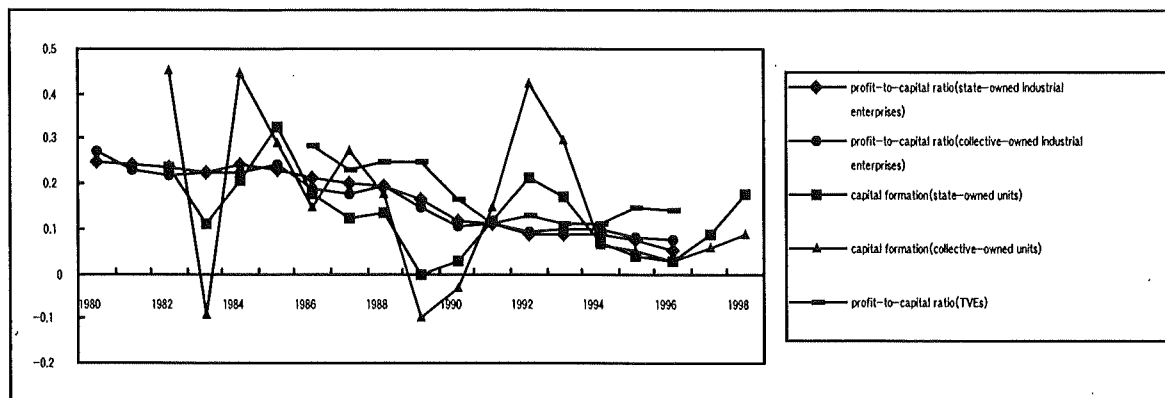
The facts that, until the middle of the 1990s the real unemployment rate had been very low, and the labor share changed counter-cyclically in 1986 and 1990 (Figure 2), show that the reserve army effect did not exist in this period. But we need more evidence to assert that the growth was lead by wages. Especially, because the data are quite limited, it is hard to judge in which sector the 'acceleration of mechanization (Bertrand, 1983)' happened. However, the increase of capital formation in light industry and the comparative decrease of capital formation in heavy industry hint that there existed a positive correlation between the rise in real wages, increase in consumption and capital formation in consumable goods sector in this period.

Although the increased productivity distributed favorably to the laborers contributed to prompt mass consumption (productivity—real wage—consumption), and induced the increase of investment (consumption—investment) consequently, we should not neglect the role of soft-budget constraints, another source of investment in that period.

Persistently increased capital formation set off the negative effects on profit ratios brought out by the increase in real wages. At the same time, it gave rise to accumulated bad debts. However, it's interesting to note that the profit ratio was not the major determining factor of investment decisions (see Figure 5).

At the initial stages of reform, the existence of shortage means that comparatively high profit ratios had been guaranteed, large-scale investment was chosen as the main tool to solve the problem of shortage (profit—investment). As a consequence of the large-scale investment, production and productivity had achieved further increase (investment—production—productivity). But when shortage was removed, which means the decline of the profit rate, it is the paternalistic governments that financed the investment through banking systems (institutional environment—investment).

Figure 5 Profit-to-capital ratios and capital formation

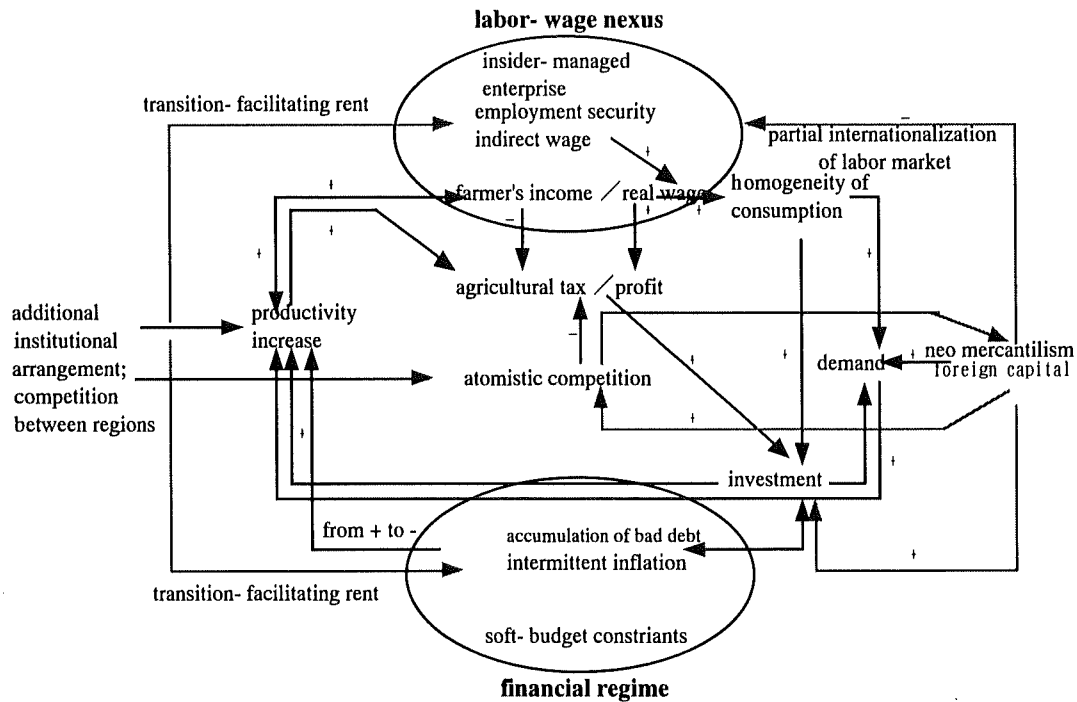


Sources: *China Statistical Yearbook*, each year. SOEs and COEs's profit-to-capital ratios: Lo (1999: 698).

5.2 Instability of institutional foundation

When principal institutional forms ensure stable macroeconomic circulation, we can conclude that there exists structural compatibility between these principal institutional forms, especially between the labor-wage nexus and the financial regime. In other words, we should comprehend the meaning of the term 'institutional complementarity' not only from the viewpoint of the microeconomics, but also from the viewpoint of the macroeconomics. However, when we take complementarity between incentive systems, duality between structural compatibility and buffers into account, we find the institutional foundation of Chinese-style gradual reform is not stable.

Figure 6 Causal links in the high-growth period (1978-1996)



Notes: Because most industries in China are composed mainly of small or middle-sized enterprises, competition in these industries is described as atomistic competition (Yin, 1996: 55).

Given the time and space, I will discuss the role of export in China's growth in another paper. As for the Regulationist's interpretation about export in Asian development, see Sum (1998). Transition-facilitating rent (Lau, 1996: 60-62) contributed to the homogeneity of consumption by maintaining the indirect wage (housing and health care). However, massive restructuring in the second half of the 1990s, accompanied by commercialization of housing and health care, affected the mode of consumption directly, and had been one remote cause of the following deflation.

6 Political economy of reform in a large transition economy: roles of buffers and their weakening

There were two buffers in the virtuous circle shown in Figure 6. The main buffer is the additional policy (institutional arrangement) that had brought about the persistent increase in capital formation. The subsidiary buffer is the development of TVEs. TVEs had eased the tension accumulating in the process of reform by absorbing rural labor into the manufacturing sector. They also improved the efficiency of the allocation of

resources through intensifying domestic competition. However, different from SOEs, the economic activity of TVEs is much more sensitive to market conditions. Thus, as a subsidiary buffer, TVEs' role tended to decline when the economy went into recession¹⁶.

Furthermore, there are prerequisites for the two buffers to play their roles respectively. The prerequisite for the main buffer is that the bad debts should be kept in reasonable size. The prerequisite for the subsidiary buffer is that there are still jobs for the TVE employees in agriculture, in other words, the unemployment cost of SOEs and TVEs employees should be acceptable. However, in the absence of safety net and enough jobs in agricultural sector, the unemployment costs are quite high in both urban and rural regions.

Since the middle of the 1990s, before a backdrop of persistent reduction in profit ratios and the accumulation of bad debts, the right to work has been placed under the manager's discretion. This change had a direct bearing on the shifts of consumers' expectations and consumption patterns¹⁷. At the same time, inefficient loans were cut. All these facts show that gradual reform without long-term perspectives had come to its end. China's reform has moved away from the principles (reform without losers; crossing river by feeling stones) established in the process of reform. At present, we do not know if the change is the introductory chapter of new growth or the prelude of real crisis. However, it is clear that the change is accompanied by massive social costs and is not based on the basic experience drawn from the reform until 1996, that the demand side had played an important role in the remarkable development until the middle of the 1990s.

Table 1 Institutional foundation of an unintended virtuous circle and its transformation

	unintended virtuous circle (1980s-middle of the 1990s) from seller's market to the coexistence of seller's and buyer's markets	transformation of the mode of growth or prelude of crisis? (after the middle of the 1990s) buyer's market
labor-wage nexus vs. financial regime	job security and increase of real wages in 'insider-managed enterprises' under the principle of 'reform without losers'	'manager-managed enterprises'
cost	intermittent inflation; accumulation of bad debts	persistent deflation; crisis of reform's legitimacy

7 Conclusion Remarks

- (1) China's market-oriented economic reform can be characterized as a gradual reform without long-term perspectives. The relationship between the labor-wage nexus and the financial regime, which was the institutional foundation of China's reform had never been stable, and it is impossible for China to complete its transition by choosing any new additional policies from the toolbox of gradualism. Although each single additional institutional arrangement is 'well-designed', the very aggregation of such 'well-designed' institutional arrangements has in the long run given rise to the recession. In this sense, the recession began from 1996 is an inevitable consequence of the gradual reform without long-term perspectives, rather than a result of Olson shock, say the Asian financial crisis.
- (2) The dilemma that Chinese-style gradual reform is facing does not provide enough proof for us to conclude that shock therapy is the only approach to be adopted in a transition economy. There exists 'the third way' to reform the planned economy. The significance of achieving Kaldor-improvement in Mainland China should be comprehended not only from the viewpoint of humanitarianism, but also from the fact that the demand side had played a crucial role until 1996.
- (3) We should distinguish the institutional evolution in specific market with the process of institutional evolution as a whole. "Sequence" or institutional complementarity is the key to understand the process of institutional evolution. However, the process of institutional evolution is self-enhanced, it can lead the economy to stable growth as well as persistent crisis. Furthermore, institutional evolutions in product market, labor market and financial market evolve according to different logic in a large transition economy.

China stands at the most critical juncture in its journey from plan to market after rapid growth in the past two decades. I do not hint China will meet a dark future. On the contrary, China's economic awakening will undoubtedly go down as one of the great events of the 21st century. As it has been pointed out, because its population is so huge, it will become a major economic power if it achieves even a fraction of Western productivity levels. However, considering its history and tradition, the widening

disparity between regions and classes, the real question is what kind of capitalism China will arrive at: will China rerun the path opened up by Japan, Korea and Taiwan before it, or degenerate into crony capitalism?

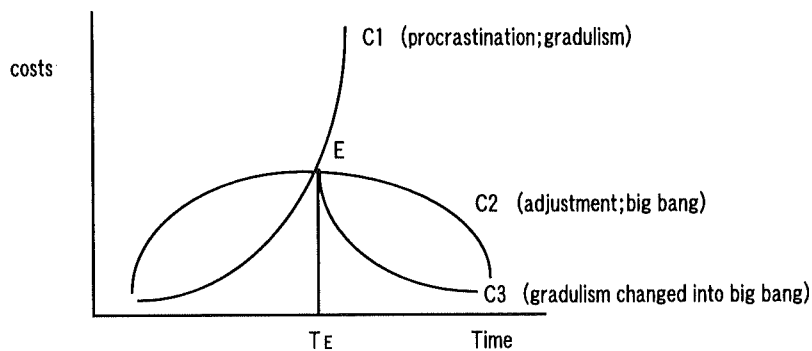
¹ In the China Statistical Yearbook, the unemployment rate refers to the registered urban unemployment rate, which is the ratio of the number of registered unemployed persons to the sum of the number of the employed and registered unemployed persons.

² Actually, gradual reform had not been taken seriously until the early 1990s. Transformation of labor from rural to urban had been thought as the main source of the growth of productivity (Sachs and Woo, 1994). Even in 1996, the World Bank insisted that the gap in performance between China and Russia could be explained by their unique initial conditions, and that further mobilization and privatization were necessary (World Bank, 1996).

³ Regarding the scale of national economy, it is appropriate to compare China with Russia, rather than other reforming countries in Eastern Europe.

⁴ Sachs (1999) recently admitted that the privatization in Russia is a total failure. "When privatization was rushed through via mass voucher schemes, the results are corrupt asset grabs, and paralysis of firms". And he began to emphasize the importance of civil society, institutions and history, although he had never mentioned these factors in his plans.

⁵ Nakagane's analysis can be reinterpreted by a simple model developed by Luiz and Jario (1997). According to Luiz and Jario, although the cost of gradual reform is smaller than that of Big Bang at the initial stages, it becomes bigger than the latter in the long run, so the designers of reform can change the trend by introducing Big Bang into gradual reform. Nakakane (1999), Luiz and Jario (1997) pointed out the demerits of gradual reform, but what they suggested seems to be nothing more than Big Ban



Source: Luiz and Jario (1997)

⁶ It is well-known that SOEs bear much more society duty, such as pension for retired employees and so on. In this sense, SOEs face unfair competition conditions, compared with collective or private enterprises.

⁷ Actually, Sapir(1993) hinted that the gradualism-shock therapy dichotomy is not a good starting point to analyze the transition economy when he pointed out the collapse of planned economy gave us an opportunity to replace the plan as a common policy instrument, rather than as an accessory of ideology. However I criticize gradualism-shock therapy by emphasizing that

China's reform is just a specific case of gradual reform. Under the principle of gradualism, there exists other choices to reform the planned economy, which is different from China's experience.

⁸ Economic reform has changed the overall ownership structure of China's industrial sector. By 1994, the non-state sector accounted for 66% of total industrial output and 68% of the total industrial workforce, and industrial output and the employment share of the state sector had declined continuously in the 1990s. However it would be a tremendous error to think that SOEs have been pushed to the periphery, for employment growth in the state sector has not slowed to match the sector's declining share of national output (Stenfeld, 1998).

⁹ One of the most important characteristics in China's transition to a market economy is the existence of a dual-track price system. However, in the early 1990s, the transactions based on market prices had become dominant transaction pattern (World Bank, 1994).

¹⁰ I learnt a lot from discussions with Prof. Wang, J-H. and Prof. Alan, Smart about the role of state.

¹¹ With the pre-existing rents protected by plan track or SOEs, government had compensated (potential) losers.

¹² We should point out four facts here. Firstly, there has been a gap between the average profit ratios of the banking system and industrial sectors. Therefore, perhaps it was the profit of the banking system, not wages that had eroded the profit of the industrial sector (Lo and Zheng, 2000). Secondly, the pension for retired employees had been one part of the wage fund. Thirdly, there was no statistic evidence to support the argument that profit had been continuously eroded by wages in the 1990s. Fourthly, the increased productivity had been distributed favorably to the laborers by two ways: job security and the growth of real wages.

¹³ By Lin's (1992) estimation, decollectivization (the household responsibility system) is found to improve total factor productivity and to account for about half of the output growth during 1978-1984.

¹⁴ Because the basic wage was under the control of central government, bonus and subsidy were used as the major tools to adjust the level of employees' income. In 1978, the bonus and subsidy were negligible. However, in 1993, bonus and subsidies accounted for 48.4% of income (Xing and Perkins, 1999).

¹⁶ In the recession periods (1988-89; 1996-1999), compared to SOEs, TVEs's investment slowed down noticeably (*China Investment Statistic Yearbook 2000*: 168).

¹⁷ In 1990, the average propensity to consume and marginal propensity to consume were 0.85 and 0.59. However, in 1998, these data declined to 0.77 and 0.35 (Macroeconomic Task Team CASS, 2000).

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Relation of Central and Local Governments in the Industrial Policy in China's Transition Period to Market Economy

Feng Rui

(Graduate Student in Economics, Osaka City University)

Introduction

1. Purpose of Research

Along with the economic reform and the open policy in 20 years or more, Chinese economy has accomplished remarkable development. In industrial structure, a big change appeared with increase of GDP. The change is considered as a result of a governmental (central government and local government) policy. The policy which plays an important role in the policy which the government made/practiced -- industrial policy it is. On the other hand, about effect of industrial policy,¹ there are scholars who claim functioning effectively, and there are also scholars who claim no functioning effectively (Jiang(1996), Jiang(1999), Marukawa ed.(2000)etc.).

Central government makes the principle of industrial policy, and Local government submits and practices the concrete policy based on it. This is the general flow of making/practicing of the China industrial policy. It is an important problem whether the action of local government is in agreement with the principle of central government in the process. That is, it is very interesting for transaction which is involving the process of making/practicing than the external effect of industrial policy. Where is the true motive or reason which makes and practices industrial policy for China in transition economy. Of course, since the contents in connection with this problem are huge, any number of books may be unable to be explained completely. So, this paper takes up and analyzes the relation between central government and local government in the process of making/practicing of industrial policy at first.

The analysis about industrial policy in China is mainly analyzing the industrial

¹ The industrial policy in China's economic transition is the policy which is going to bring about the competitive motivation in industries for the perfection of market order (feng, 1999).

policy according to industry categories. The analysis which governmental relation takes up is not so much. Imai (2000) showed the concept of "decentralization type industrial policy" based on an argument called local state corporatism (Oi, 1992).² However, he considers that industrial policy in China consists of both the industrial policy of central government and the industrial policy of local government. Although local government added local peculiarity based on the industrial policy of central government to make the local government's in many cases in China, fundamentally speaking, the industrial policy of local government will be embodiment of not an independent policy but the central government's. It is the point which I want to emphasize in this paper.

2. Compositions

This paper, first, deals with the relation between central government and local government in making / practicing process of industrial policy. Then, in the second section of this paper, I want to analyze the action of local government and central government in making / practicing process of industrial policy. Finally, the third section is concluding part of this paper and the research subjects of future.

I . The relation between central government and local government

In China, during to a huge area and natural resources and the distinct productive capacity level of each district, the relational problem of central government and local government is always the major problem in political economy relations, and whether it deals with the problem well influences economic development and social stability. In China, local government has two features. As for one, local government represents the double profits of center and district. As for another, local government stands the role of a bridge (information exchange) between central government and enterprises (Sun, 2001). So, while local government manages the economy of the district as agent of central government, it negotiates with central government to realize the maximization of profit in the district.

The relation between central government and local government is still an important composition element of economic system in China's economic transition. Especially, the relation expressed some change with economic transition. The local revenue increased considerably by the reform of financial system. A function of local government as an economic organization in which has the objective of economic independence interest is stronger, and its dependability to central government as administrative organization is weaker. On the other hand, by the reform of administration system, i.e. "fangquan" (according to the importance of decisive rights, central government transferred a part

² According to Mr. Imai's research, the industrial policy of local government played the role which complemented the function of lower market mechanism, especially capital market.

of decisive rights to local government), local government negotiated with central government and acquired the means to realize maximization of district interest. When the policy of central government is not in agreement with the interest objective of local government, local government can request central government for adjustment of the policy.

Therefore, in this paper, I think of making central government and local government as two action groups in China's economic transition (Feng, 1999). That is, to make/practice industrial policy, central government and local government which have each interest objective act cooperatively to pursue minimization of transaction in making/practicing process. I want to emphasize the side which central government and local government are regarded as economic unit here.³

According to the financial situation, the view of local government is different on the industrial policy of central government. It is stressed here.

Fig. 1: Economic growth and autonomy

Suppose that local preference object are only two, economic growth and autonomy now. If it is the purpose to have growth more or have autonomy more, transaction costs have to pay to attain the purpose. In this way, the social possible curve f of growth and autonomy which can be attained changes greatly with districts. For example, as shown in Fig. 1, two curve $f(N)$ and $f(Y)$ can be considered. Here, Y represents developed local and N represents developing district respectively. Moreover, owing to growth or improvement of life standard and preferential treatment of autonomy, preference (W) naturally changes with districts. It is naturally different in which the preference of developed district is A , the preference of developing district is B .

³ To analysis briefly, I think that the interest objective of related enterprises and local government are coincidence. The interest objective of related section is also coincidence with the interest objective of local government similarly.

II. The action of local government and central government on the industrial policy of making/practicing

1. Industrial policy as institution

Industrial policy assumes one formal rule (North, 1990). Since central government grasps the right of making of industrial policy, two results are brought about. As for one, because the shortage of information or the distortion of information exist during making process, the policy which was made is always rough, and it is necessary to make it concretely in practicing process. As for another, owing to the effective control cost of practicing process is high to the industrial policy as a formal rule, central government as maker cannot restrain the action range of local government as practitioner.

The one related in the rule as industrial policy is an interest group (or local government), and another is an administration bureaucrat (or central government). I think that such a rule has the two characteristics as follows. First, it is rare that the rule is established between two sides. One side includes two or more related parts at least. Secondly, the contents of the rule have many ambiguous ones.

Industrial policy is a kind of rule of supply initiative type substantially. That is, on the basis of constitution order and morality action, central government has the capability and volition which supplies a new rule. It is a decisive element for rule making. The capability and volition of central government are decided by the power structure of each social acquired interest group. The features of the rule of supply initiative type are following many points. First, central government is leading power which supplies the rule. Secondly, through the governmental administration system, the new rule is made is carried out by the command and law of central government, and the new rule is forced downward from a top. Finally, the interest objective of central government and local government is different. Therefore, it is difficult to avoid the rule supply of central government and the imbalance of rule demand of local government (Feng, 1999).

2. The flow of making/practicing of industrial policy

In China, there are the following stages in the flow of making/practicing of industrial policy generally.

First, the typical enterprises of local/department related is assembled by the department responsible for industrial of central government, and the meeting which examines the problem about development of the industrial is held. Generally speaking, the department responsible for industrial of central government submits the draft of industrial policy before the meeting.

Secondly, the draft of industrial policy is corrected to reference for the opinion by which the department responsible for industry of central government is collected at the meeting.

Thirdly, the department responsible for the industry of central government distributes the draft of correction to the enterprises of the main local and departments

(the time all), and hears the opinion of the enterprises.

If there is necessity, the second and the third phase will be repeated repeatedly.

Fourthly, the department responsible for the industry of central government promulgates the draft of the industrial policy corrected again as formal industrial policy.

Fifthly, industrial policy is practiced being dependent on the enterprises of each local and department. According to the situation of the practicing, the department responsible for the industry of central government may coordinate industrial policy. Only the department responsible for the industry of central government has rights, such as an interpretation, explanation, etc. about industrial policy.

Finally, the department responsible for the industry of central government reports the result of industrial policy in annual work summary report. Generally, there is no specific summary report to the practicing of industrial policy (Feng, 2001).

There are some interesting points from the flow of making/practicing of industrial policy. First, the department responsible for the industry of central government has a tremendous influence, and the preference/interest of the department is easily expressed by industrial policy. Making action of industrial policy is leading action of the department responsible for the industry of central government, and the right of interpretation / explanation about the industrial policy of the department is always the source of game. Secondly, owing to the examination organization of industrial policy does not exist, a question may arise about the objectivity of industrial policy. Thirdly, since the enforcement result of industrial policy seldom affects governmental achievements, central government or local government seldom get interested in the result of industrial policy. Industrial policy tends to become a matter of form.

Table 1 is the questionnaire which is the attitude of local bureaucrat for the industrial policy of central government.

	Local government bureaucrat		
	Agreement	No agreement	Whichever is sufficient
Even if there is the admission of policy, you should negotiate with the central government for local benefit	62.5	31.0	6.5

In order to ease the pressure which is brought by macro economy reform, you should take effective measures according to your situation.	80.7	14.4	4.9
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Unit: %

Table 1: The attitude of local bureaucrat to the policy of central government

Source: Correction by the projection group (1996) table 7

Here, the point which should be stressed is negotiation about the thing besides policy admission. For local bureaucrat, as for such negotiation, the risk exists considerably. However, according to Table 1, about 2/3 local bureaucrats choose the attitude which should negotiate in this situation. For this reason, central government has to pay great attention to the opinion from local government in making/practicing of the policy.

By financial system reform, the autonomy of local government has greatly expanded, especially local government has had the considerable right in the distribution of local resource since the beginning of the economic reform. Simultaneously, the influence of central government is becoming weak about the distribution of financing and resource. In the economic activity, owing to the utterance right of local government is becoming large, to attain better result of the policy, the cooperation of central government and local government is required. So, the achievement of central government is considerably dependent on the cooperation of local government. On the other hand, local government gives its influence to the policy, protecting local benefit through negotiation with central government.

The actions of local government are mainly the following four types to the industrial policy of central government (Yang, 1998). 1) Secret doing. Local government causes the practicing deviation of industrial policy through a new interpretation and so on about the policy. Or local government makes the enforcement regulations of the district through connections. 2) Asking for the addition after doing. With the enforcement regulations of the policy in which the district was made, local government asks central government for recognition of the enforcement regulations after enlarging local economic strength. 3) The approval of central government. Local government tries hard to be able to obtain the tacit permission from central government through various routes. 4) From darkness to open. Local government pays a certain amount of costs, such as a fine, gets the consent of central government, and the enforcement regulations of the district will be become formal policy.

The following analyzes simply about the action game of central government and local government.

Central government has three kinds of choices or three attitudes on the action of local government: contrary, tacit permission, approval. Because the attitude of central government is not known when local government acts, the action probability of central

government is guessed based on the past experience ($P1+P2+P3=1$). Table 2 is each benefit of central government and local government. In it, R_l is interest which the action (enforcement regulations) of local government brings about, and R_c is interest which central government brings about by the action (enforcement regulations) of local government ($R_c > 0$ or $R_c < 0$ or $R_c = 0$). C_1 is the transaction cost in connection with its action in local government, and C_2 is the transaction cost for local government having the action recognized from central government, when central government opposes the action of local government. Central government has the transaction cost in connection with the action, when approving the action of local government.

Seeing from Table 2, the attitude of central government affects the action of local government, and this is conversely concerned with the expectation interest of central government again. When $P1(R_l \cdot C_1 - C_2) + P2(R_l \cdot C_1) + P3R_l > 0$, or $R > P1(C_1 + C_2) + P2C_1$, local government chooses action. Therefore, as the expectation interest of action of local government are high, and the transaction cost of action is low, and the attitude of central government approves, the possibility of action of local government becomes high and its practicing possibility of action is also larger. The developed district (i.e. coastal areas) not only has the experience in foreign trade, but has improved the system relevant to the market economy considerably compared with an inland district. For this reason, the expectation interest R_l of action of local government is relatively higher, the transaction cost is a bit lower, and the central government has put reliance on the action of local government, and usually approve of the action.

			The selection of local government	
			Action	Un-action
The selection of central government	P1	Opposite	$(R_c + C_2, R_l \cdot C_1 - C_2)$	$(0, 0)$
	P2	Tacit permission	$(R_c, R_l \cdot C_1)$	$(0, 0)$
	P3	Approval	$(R_c - C_1, R_l)$	$(0, 0)$

3. The influence elements on making/practicing of industrial policy

The making/practicing process of industrial policy is as a result of an equilibrium outcome of a political process (Dixit, 1999). The transaction cost of the negotiation (action) and practice about industrial policy, especially asymmetrical information, or information of the imperfection (Williamson, 1989) and the check cost of a situation becomes the influences element of industrial policy. In addition, the influence also exists from history, culture, the existing bureaucracy, and so on.

1) Asymmetrical information

The world is complicated and the knowledge and the information that central government and local government are obtained about it are imperfect. In making/practicing of industrial policy, the information of central government and local government is different. Although central government has its information gathering system, it is provided by local government about most information. On the other hand, local government is nearer from practicing situation (the sources of information) and has much information than central government. So, it is appropriate that central government is regarded as the principle and local government is regarded as the agent in the negotiation (action) about making/practicing of industrial policy.

Since asymmetrical information exists, the tendency of opportunism appears in being concerned with making and practicing of the policy (Stiglitz, 2001). That is, what should have responsibility don't takes over results (interest or loss) brought about from each action. After all, it pulls up making/practicing transaction cost of the policy, and the effect of the policy becomes small. In making/practicing process of industrial policy as China, information exchange between central government and local government is very important. When information exchange is inadequate, local government sets forth the measure to that to practicing of industrial policy becoming impossible, without cease. In order that central government raised the standard of living of the people in the 80s, the preferential treatment policy was taken out about the refrigerator manufacturing industry. However, the development speed which central government predicted was farther slow than the actual development speed of market. Although local government asked central government for which increased the production authorization-by-law factory or the quantity of production at first, central government did not accept the requirement. While local government held the chance and accepted the demand after all, the local refrigerator manufacturing industry has been developed. The same situation existed also about the development of auto industry.⁴

The problem of inconsistent of interest objective between central government and central government has become large with increase of economic strength of the district since the beginning of the economic reform. Therefore, owing to local government hidden the true information to central government in the process of making/practicing of industrial policy, industrial policy which was made leaves greatly the original policy objective. That is, the problem of adverse selection arises. In China, since making of industrial policy is dependent on information which is offered by the enterprise of local government, local government has the leadership about negotiation with central government. For local government, it is natural for negotiating with central government and making the policy advantageous to its direction for district interest. It is one cause in which the objective of much industrial policy separate from the expectation objective of central government, and the policy become an equalitarianism thing.

Seeing from the making situation of industrial policy, there is almost no attaining the original objective. The big cause is the moral hazard problem of local government. That is, depending on cooperation of local government, local government offers only

⁴ Refer to Jiang(1999).

information constantly advantageous to the district also for practicing of industrial policy. Central government doesn't instantly obtain the change of making situation and making condition of the policy, the adjustment of the policy is quite later than the change. The policy may become a matter of form after all.

2) The check cost of a situation

In the process of making/practicing of industrial policy, local government acts as an agent. However, since local government is the agent which has two or more principles, the interest brought about by making/practicing of the policy is low, and it has great influence on the incentive of local government. The reason has three. (1) There is not alike on resources and the natural situation in every district, and the economic development level and the maintenance situation of market system is different in every district, too. That is, each local government is not necessarily sharing the same information. 2) Because the situation in every place is various, for local government, it is difficult to agree the interest obtained from cooperation of two or more principles on the whole distribution, and making/practicing of the policy do not become its achievements. 3) In many cases, local government has two or more duties about making/practicing of industrial policy. In these duties, it is few that the priorities of central government and of local government are consistent. Because of each position of central government and local government is different.

In the case of China, central government is leading power which has the capability and volition which supply the new policy and supplies the policy. For central government, since it is the work to which industrial policy got used, when the problem arises to industry, industrial policy is set forth at first. However, the deliberation mechanism about industrial policy does not exist, since there is not much effect in the achievements of central government, the expectation of central government for industrial policy is low, and the incentive of making/practicing industrial policy decreases.

3) On path dependence

(1) Dependence to the history path

It has big influence on making/practicing of industrial policy as informal rule, such as culture and ideology. The influence appears by maker/ practitioner of the policy action.

In China which carried out planned economy for dozens of years, the influence is left behind considerably. For example, the means of industry policy depend on the direct or the administration means as usual. Although each industry department which has imitated the Soviet Union and made was cut down sharply by about ten years of administrative reform, the bureau of industrial policy still exists in State Economic and Trade Commission. On the other hand, owing to private sector organizations, such as the industrial association, are not prepared, usually the information exchange between central government, and local government/enterprise is not carrying out very much. Therefore, the practicing cost of industrial policy made in such a situation is high, and practicing cost makes it an excuse to set forth the original measure with local government.

(2) For central government and local government, the difference in each amount of

sunken investment⁵ affects the action of owner, and that the quality of management and efforts are unobservable also affects the efficiency of other goods. The quality and efforts of management determine the good how much are efficiently combined. That is, the governmental organization and governmental governance structure have serious influence to government activity. Making/practicing of industrial policy is especially easy to constitute each interest organization of center and district. The interest which is brought about by the policy is considered to be the specific investment of the interest organization. The department responsible for industry as a part of central government which carries out given investment may scheme for fixation of the policy in conspiracy with local government which has given property for interest.

3. Conclusion

The effect of industrial policy is considerably concerned with many making/practicing elements of policy deeply. If the mutual influence mechanism of many elements is fully understood, the possibility which industrial policy play the original role should be existed.

This paper is not touching on the opposite influence brought to central government and local government by making/practicing of industrial policy, although the influence situation of central government and local government in making/practicing process of industrial policy has been analyzed. I think that it will be the future contents of research.

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⁵ Once sunken investment makes an investment, it will point out investment of the type which cannot regain expense related the investment.

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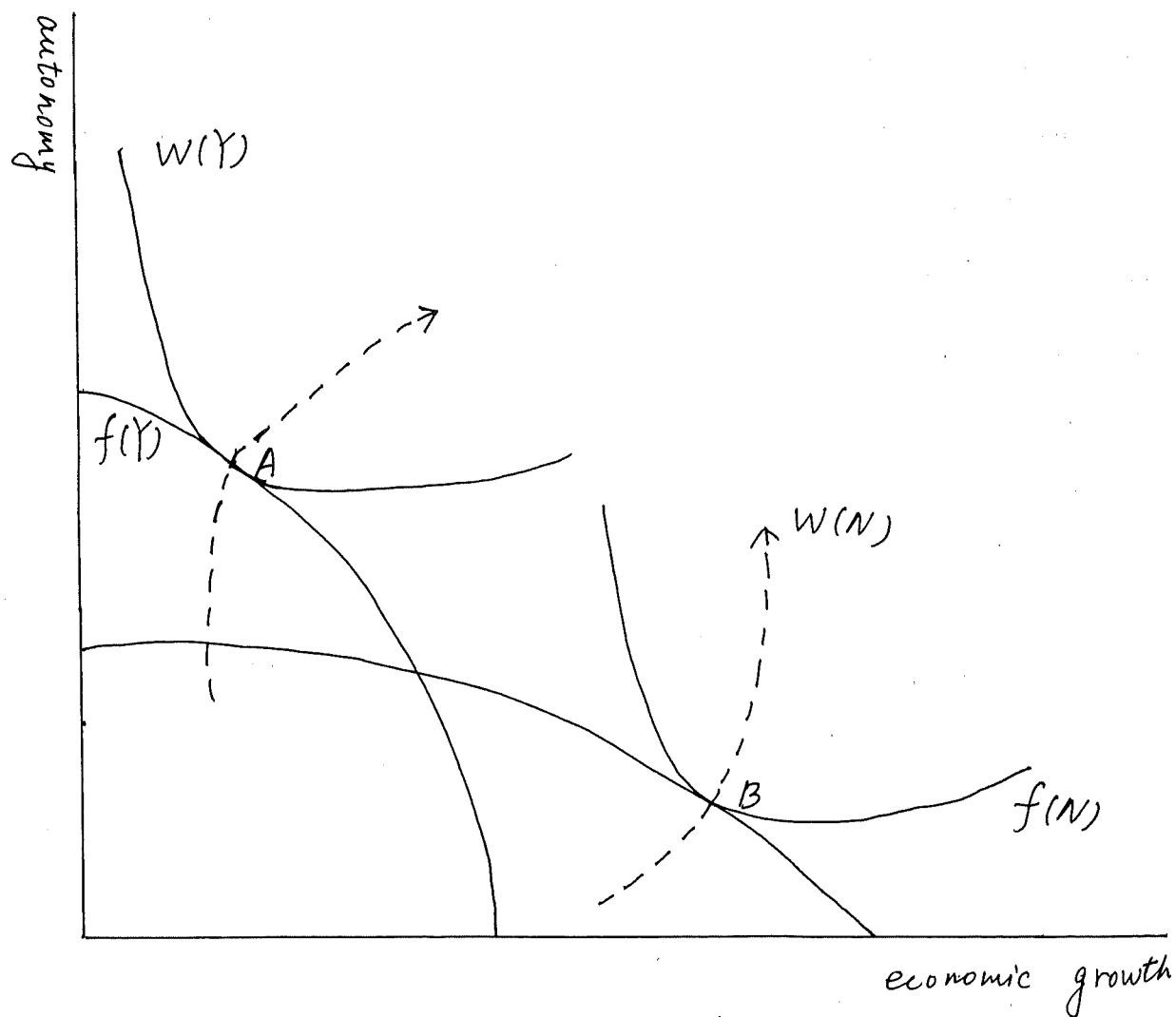


Fig. 1: Economic growth and Autonomy

EVOLUTIONARY ECONOMICS AND SOME PROBLEMS OF MODERN RUSSIAN ECONOMY

Introduction

As the substitution of a market self-regulation pattern plus private property (including cooperative property) for the planned management pattern and, correspondingly, public property makes a feature of a transitional economy, it is quite natural that the main subjects of most studies on transitional economy, including those of evolutionary kind, are privatization, competition, market infrastructure, and formation of market institutions. However, one can't help paying attention to the fact that in these studies problems of macroeconomic policy are frequently considered as secondary. Some economists in general prefer to bypass macroeconomic problems. They seem to believe that the recommendations of the IMF aimed at the minimization of budget deficit, the limitation of inflation, and the making of an open economy of liberal kind are quite sufficient for macroregulation of transitional economies.

We can't agree with such an attitude to macroeconomic problems. First, the macroeconomic policy makes the general background for any economy. This background may either favor the development or not. This background is particularly important for transitional economies. For example, if privatization is taking place when there is a lack of legal sources of private wealth (and it is a macrolevel factor), a planned economy is very likely to transform into a criminal-market one. On the other hand, if a macroeconomic policy doesn't favor the growth of demand or doesn't create a favorable investment climate, and such a situation persists for a long time, then a transitional economy may revert to its initial state, namely to a planned pattern.

Second, the IMF macroeconomic recommendations, so obvious on the face, in practice proved to be inefficient as applied to the industrially developed Russian economy, as well as to a number of other former Soviet republics. The deep recession of GDP, investments and real incomes of the population, which occurred in Russia in nineties (especially in 1992-1993), was induced not just by the process of destruction of the planned framework, but also by a drastic shift in the macroeconomic policy, in particular, by significant reduction of state financing of the country's military-industrial complex.

Third, and this is particularly important, a profound cause of inefficiency of IMF macroeconomic recommendations is the heavy reliance of these recommendations on anti-evolutionary patterns of financial stabilization, as elaborated in the framework of Washington consensus. The anti-evolutionary nature of those patterns is called forth by the fact that they are based on conceptions of the theory of general equilibrium, while the latter treats the development as conservative, since it is supposed that the cast of economic actors and the set of available technologies and produced goods remain invariable. In other words, the theory of general equilibrium considers the set of choice as given and known, whereas "in evolutionary theory, choice sets are not given and the consequences of any choice are unknown" (Nelson and Winter, 1982, p. 276). This feature of evolutionary theory emerges from the essence of economic evolution. One may define the latter, as follows.

Definition: The economic evolution is a process of growing diversity, complexity, and productivity of an economy due to recurring changes of technologies, products, organizations, and institutions.

Any economy (first and foremost, a transitional economy) is able to develop in an evolutionary regime. That is why the issue of macroeconomic theory and appropriate policy is so relevant for transitional economies.

Note that the evolutionary macroeconomics makes just first steps on the path of own formation. There is enormous time-consuming hard work in store, requiring participation of many scientists.

Nevertheless, we believe that it is possible to make an attempt of evolutionary macroeconomic analysis of the modern Russian economy just now. Three problems will be considered which are interconnected both logically and historically.

First. What had been main macroeconomic causes (from the point of view of evolutionary economics) for the low efficiency of the planned pattern of economy in the USSR that ultimately made for the revolutionary shift from plan to market in Russia? The question may be put in another way. Whether the planned economy of the USSR could be more viable, should the Communist government conduct an evolutionary macroeconomic policy?

Second. How to explain, using evolutionary theory, the degradation of Russian economy in 1992-1998?

Third. How to restore economic evolution in Russia?

Before considering the above problems, let us formulate a number of theoretical theses, which conform to *The Theory of Economic Development* by J.A.Schumpeter (Schumpeter, 1961) and may be helpful for the forthcoming analysis.

1. Some theses of evolutionary economics of Schumpeterian trend.

Thesis 1. In every evolving economy the set of simultaneously acting economic agents may be relatively divided into two interacting groups:

- a group of innovators, who design and inculcate new technologies, commodities,

and services, establish new firms and reconstruct old firms, influence the formation of new institutions and disappearance of old institutions (behavior rules, routines);

- a group of conservatives, who exploit available technologies, produce traditional commodities and services, act in the framework of long-standing firms, tend to retain institutions immutable.

Such division is relative, because in practice individual economic agents may act as both innovators and conservatives simultaneously. For example, when a process of modernization starts in the framework of a long-standing firm, a conservative gradually becomes an innovator.

Considering the economic evolution as a general feature of human civilization, one may say that not only a capitalist is able to act as an innovator (entrepreneur), but also, as Schumpeter noted, authorities in a Socialist state, as well as a landlord or the chief of a primitive tribe. In every epoch the evolution occurred (and is occurring now, and will occur in future) due to the fact that innovators conquered a fraction of economic space occupied by conservatives, i.e. the former took away some share of inputs, customers, etc., from the latter. In the course of time other, "new" innovators come to replace "old" innovators and the process of seizure of a fraction of economic space is repeated. Exactly these recurrent acts cause the increasing diversity, complexity and productivity of economy.

The dichotomy "innovator - conservative" is substantial for us, because it makes a point of departure for distinguishing between evolutionary and non-evolutionary approaches to economic analysis. Indeed, within the framework of non-evolutionary theories the division of economic agents into innovators and conservatives is being ignored: all agents are treated as equivalent participants in economic relations. In particular, as applied to market economies, it is suggested that all agents seek to maximize their profit and have

opportunities for successful development. In reality, it is not so. Only innovators are maximum-oriented. As for conservatives, they seek to preserve their vital space, so for them criteria of survival are more relevant, for example, the striving to keep the achieved profitability by means of economizing on production cost.

Note also that although non-evolutionary theories do take into account the factor of uncertainty, they still ignore the different meaning of this phenomenon for innovators and conservatives. For innovators the uncertainty factor expresses itself as lack of advance knowledge, whether they will manage to capture a fraction of economic space, now possessed by conservatives. And for conservatives the meaning of this factor is quite opposite: usually they are not sure, whether they will hold their positions while struggling with innovators.

The list of differences between evolutionary and non-evolutionary theories may be readily continued. However, such an enumeration is hardly expedient in this paper. Our purpose doesn't involve a contraposition of different theories; it is to estimate the macroeconomic policy of the Russian leadership from evolutionary perspective.

Thesis 2. The mechanisms innovators use to capture economic space (including material and labor resources) owned by conservatives, depend on the type of social and economic relations which dominate in the country in question. In non-market economies, these may be mechanisms of violence or planned redistribution of resources. In market economies, similar functions are carried out by price mechanism, banks, stock exchange, the positive influence of these market mechanisms on evolution manifesting itself in forms seemingly (at the first look) destructive and contradicting to the orthodox conception of financial stabilization.

In particular, monetary emission and inflation it causes act as important factors of evolutionary redistribution of resources in favor of innovators. To illustrate the effect of these factors we give the following example.

Let a group of innovators come to the electric power market in order to obtain the energy, necessary for production of new kinds of goods. However, the market is already occupied by conservative consumers. So the situation of demand exceeding supply arises. In a non-market economy, there would be a command to cut off certain conservatives from power supply, in order to support innovators. In a market economy the similar redistribution occurs in a different way: the tariff for electric power increases, as well as production costs in every sector of the economy. Some conservatives can't raise prices for their output in order to compensate the heightened costs, because of the limited demand for goods they produce. If these conservatives don't have financial resources at their disposal to acquire power saving technologies, then they can't avoid the decline of profitability and subsequently the output reduction. As a result, a certain amount of electric power is released, and the innovators buy it for the high tariff. That is exactly what Schumpeter meant when he wrote that "one who wishes to carry out new combinations (i.e. innovator - *V.M.*) outbids the producers in the circular flow (i.e. conservatives - *V.M.*) in the market for the required means of production" (Schumpeter, 1961, p. 71) and thus deprives them of a certain fraction of those means of production.

Since innovators act similarly also in other markets, prices increase everywhere. So inflation starts, but it is inflation of evolutionary kind. Due to this inflation, innovators are able to oust some conservatives from the economic space and thus to renew technologies and to change the range of produced commodities and services. To struggle against such inflation means to counteract evolution and economic advance. However, in practice inflation is

double-faced. There is evolutionary inflation, as well as inflation that has nothing in common with evolution. For example, when inflation is an outcome of the growth of budget deficit and the latter is due to the increased expenditures on the salary of the army of bureaucrats, then it is non-evolutionary inflation, and it is necessary to struggle against such inflation by administrative, as well as economic measures.

As inflation is supported by a monetary-credit emission, the latter is also of dual nature. An emission enforcing evolutionary inflation is evolutionary itself. One should not treat such emission as a negative phenomenon, although this doesn't exclude strict monitoring and certain restrictions. It is necessary to counteract an emission of non-evolutionary variety that provokes non-evolutionary inflation.

Thesis 3. Another specific feature of economic evolution is that innovators don't take away resources from conservatives continuously, it is a discrete process occurring in time intervals of various duration; this process affects the path of economic development of the country, namely, it generates a cyclicity of the economic growth (Schumpeter, 1961, p. 223). To our opinion, the essence of such influence is that economic evolution proceeds as "creative destruction". Firstly, innovators destroy economic chains of conservatives (through taking resources away), which leads to a recession in production. And subsequently, after some time, those resources are switched to the innovatory production, and the economic upsurge starts. It is just this lag of "creative destruction" that makes simultaneously both the material basis of cyclicity and the sine qua non for the introduction of innovations into economy¹.

¹ To be sure, the explanation of the nature of economic cycles by means of lags of "creative destruction" is not complete. There is a considerable set of factors acting side by side with these lags, first of all monetary factors. However, we suggest that lags of "creative destruction" play the leading part in the process in question.

The truth of this thesis was corroborated by experimental computations on US economy, which we carried out using a model of evolutionary type (Mayevsky and Kazhdan, 1998). It has been revealed that every new group of American innovators (a macrogeneration) usually emerged during the periods of recessions of GNP production. Then, during the increasing of the output produced by this new group of innovators, as a rule, economic upsurge occurred. When the increasing of this output was becoming slower, the growth of the GNP ceased. Accordingly, from the moment of emerging of new group of innovators (a new macrogeneration) and till the appearance of the following group the trajectory of the GNP rate passes both the phase of recession and the phase of upsurge, that is a complete business cycle.

So, we have considered three theses of Schumpeterian evolutionary economics. Certainly, these theses are but a fraction of J.Schumpeter's theoretical developments in the domain of economic evolution. Nevertheless, we don't think it is expedient to expand the list of theses here, since these three theses are quite sufficient for the analysis of modern Russian economy.

2. Macroevolutionary characterization of the economy of the USSR before the beginning of the transitional period.

It is well-known that during seventies and eighties the development of planned economy of the USSR was slack. Particular difficulties arose concerning the introduction of scientific and technological achievements in most industries of the real sector (with the exception of military, aerospace, and nuclear power industries). Now it is usually said that the main causes of such a situation were the lack of fully fledged market relations, private

property, openness to the world market. We are not going to dispute such views, although note that in the USSR there was a competition of ideas and projects in the R&D sphere, and mechanisms determining efficiency of investment functioned, as the basis for selecting the best (according to Socialist criteria of efficiency) versions of reconstruction and expansion of enterprises, as well as of building new plants and factories. In other words, in the planned economy were available, albeit not in full measure, important prerequisites for successful evolution.

Nevertheless, one of most severe defects of the Soviet planned system was its neglecting the most important feature of evolution: In order to develop the production of new technologies and new goods it was necessary to bring to a stop the production of obsolete technologies and goods, to release labor, material, and energy resources. However, this didn't happen. Programs for developed were being elaborated with specially established system of plan indices, but there were no programs of retirement. The main stake was made on such factors, favorable for the introduction of new technologies and goods, as an increase in able-bodied population, the creating additional energy capacities, the exploitation of new deposits of minerals. While in many developed countries not less than 60 per cent of the introduced fixed capital was used for compensation of the retired capital and only not more than 40 per cent for the increment of capital, in the USSR the former made not more than 30 per cent. The rest was being directed to the increment. Such policy aggravated the resource deficit, was the cause of a well-known phenomenon of the dissipation of investment across many objects and, most important, impeded the diffusion of innovations in the economy of the USSR, and the latter had such an implication as the increasing technological lag from the "golden billion" countries. At the same time when the USA, Japan, Western Europe and South-East Asia started to master actively technologies of

post-industrial type, based on the advance in microelectronics, biotechnology and informatics, the economy of the USSR persisted in the exploitation of industrial and even pre-industrial technologies. The solution of such problems, as resource saving, the increasing of science intensity of production, the elimination of hard manual jobs, the creation of an efficient production infrastructure, proceeded extremely slowly. The weight of the structure of economy increased, with ever increasing share of the mining industry and the military-industrial complex. Thus ignoring the rules of evolution resulted in dramatic retardment in economic development, the defeat in economic competition with the capitalist system, and the political crisis of the whole planned management system.

The reason for such policy was of ideological vein: the Communist authorities of the country understood that owing to the lag of "creative destruction", a large-scale closing down the obsolete enterprises, even planned by the Gosplan of the USSR, would inevitably lead to recurrent recessions, unemployment, social tension, that is to phenomena, which the propaganda treated as vices of capitalism, whereas in reality they were (and will be) an integral feature of evolutionary development of economy.

The anti-evolutionary policy reached its acme during the rule of M.Gorbachev (1985 - 1991). Exactly in this period the principle of simultaneous acceleration both of quantitative and qualitative growth rates was declared. The country's leaders believed that it was possible to solve two problems at the same time: to raise the rate of economic growth and to modernize main industries, first and foremost mechanical engineering. They didn't take into account the obvious fact that modernization required bringing production to a stop, and temporal deceleration and even decline of GDP growth rates, rather than acceleration, should take place. The response of the economic practice to such a contradictory policy was quite

logical: instead of acceleration of growth rates certain deceleration occurred, and the modernization program was fulfilled but partially.

A question arises, whether the planned system could act in a different way, namely in accordance with evolutionary principles. The positive answer could be possible, had Soviet economists elaborated an evolutionary theory of economic development, and that theory would become the basis for planning of the Soviet economy. Probably, in this case the economic development in the USSR would assume a cyclical character and, at least in outward appearance, resemble the development of a market economy. However, as is generally known, Soviet economists didn't elaborate any evolutionary theory for planned economy. And what is more, Nicholas Kondratiev, who had discovered the phenomenon of long waves, was shot by the Stalin regime, and the theme of cyclic development of the Soviet economy became a forbidden topic. Therefore, the most precise answer to the raised question is the very fact of the transition in Russia from the planned system to a market system, where evolution is enforced by self-regulation of market mechanisms and (strange as it may seem) the evolutionary economics doesn't take part in the mainstream and doesn't influence real evolutionary processes.

3. An explanation of the degradation of Russian economics in 1992 - 1998 from the standpoint of evolutionary theory.

As is generally known, the great part in the degradation of the Russian economy played such processes as the disintegration of the USSR and, as a consequence, the breakdown of economic links; the pulling down of the command system of management, which wasn't compensated by formation of an efficient mechanism of market self-

performance and appropriate system of state regulation; the speeded up privatization program, which gave rise to speculative modes of capital accumulation, etc. Nevertheless, one may pay attention to the following fact:

When a group of innovators appears within a standard market economy, as it has been noted, evolutionary inflation emerges: the prices for resources increase, production cost raises, and a certain fraction of conservatives, who use the least efficient technologies and whose produced goods are in poor demand, is forced to cease its activities. Something in this kind occurred in Russia in 1992 - 1993. But it was the administration of Gaydar-Chernomyrdin that acted as innovators: using command methods, it raised relative prices for energy sources so rapidly that some enterprises completely or partially stopped their activities. As a result, labor, raw material, and energy resources released. According to the evolutionary logic, the initiator of resource release usually uses the released resources for development of new technologies and production of new kinds of goods. It means that the Government had to accomplish such action through managers it empowered. But this didn't happen. Adhering to the liberal position, the Government dramatically reduced budget support for the economy. Besides that, it took the course of a restrictory monetary-budget policy and thus as though imposed a ban on investing new productions by home innovators.

In this situation the place of home innovators was taken up by foreign ones. The modernization of a number of enterprises started with their financial support. Of course, it slowed the process of economic degradation in Russia. However, because of the fact that domestic mechanical engineering, with few exceptions, didn't take part in modernization of economy, the danger emerged of comprehensive technological dependence of Russia on the "golden billion" countries and self-liquidation of the machine-building complex in Russia.

So, the pattern of Government's policy shifted from that of the period of the seventies and eighties to a quite opposite one. While in the former period in the economy of the USSR mechanisms of retirement of conservatives hadn't worked and so the opportunities for innovators' entry to the economic space had been but limited, in 1992 - 1998 the Government stirred up the retirement of conservatives abruptly, but at the same time it didn't create necessary conditions (first of all, financial conditions) for innovators' entry into the real sector of economy. It turns out that neither Communist authorities of the USSR, nor the Liberalist Government of renewed Russia understood the elementary requirement of economic evolution: a normal realization of the latter is feasible if and only if both necessary conditions of innovators' entry to the economic space and those of conservatives' retirement are present.

The outcome of such lack of understanding became the suspension of the evolutionary process in 1992 - 1998, i.e. deindustrialization of the economy, the destruction of the R&D potential, social tensions, etc.

4. How to restore economic evolution in Russia?

The partial answer to this question one can find in the guidelines of long-run social and economic policy, elaborated under the guidance of Herman Gref for the Government of Russian Federation. There a system of measures is suggested to reduce administrative obstacles for the entry to market, to create equal competitive conditions for every economic

actor, to reduce risks that attend participation in the Russian economy and to diminish transaction costs.

Those measures are important, but not sufficient. As J.Schumpeter wrote, "talent in economic life 'rides to success on its debts'" (Schumpeter, 1961, p. 70). Only with the powerful credit support on behalf of institutional investors and commercial banks, a modern innovator is able to apply innovations in industry. That is one of most important conditions of economic evolution. However, at present there is a lack of necessary credit resources in Russia, and numerous proposals to carry out an emission for investment projects contradict modern non-evolutionary theories suggesting that investment ought to develop mainly on the basis of accumulated savings. What is to be done? Are we to rely on resources of foreign investors, to try to bring back the capital escaped abroad, to find some way to accumulate money now in the hands of the population, or to wait for a metamorphosis of the dwarfish monetary-credit system in Russia into a powerful giant able to credit innovators? In fact, there is a way out.

Experimental computations carried out by the author on the basis of the evolutionary model mentioned above showed that after the Second World War American innovators ensured the economic development with such a composition of their financial resources: approximately, 60 per cent of those resources were accumulated savings (only a part of these savings being owned by innovators, while the rest was borrowed in various ways at financial markets), and 40 per cent came by credit emission, that is by creation of new money (Mayevsky, 1999). However, the obtained result is quite understandable even without model calculations. Indeed, if we take into account that approximately 60 per cent of new fixed capital in the USA is being intended for reimbursement of retired fixed capital and usually

is financed at the expense of accumulated savings, then the rest 40 per cent ensuring the increment of fixed capital ought to be financed by a credit emission.

Thus, in the American economy, which development is of evolutionary type, new money comes first of all to innovators and defrays the costs of evolutionary inflation (the latter facilitates the withdrawal of a certain share of conservatives' resources by innovators), as well as investment expenditures, involved in the development of new activities. Innovators simply can't solve their problems without monetary emission. There is a paradox: America is living according to double standard. In the real economic life the country adheres to evolutionary laws, while in theory (especially in Neoclassical economics) these laws are rejected. They are not just rejected, but this rejection is being thrust through the IMF on other countries, including Russia.

So we may conclude that in order to restore the pattern of evolutionary development of the Russian economy, it is necessary not just using accumulated savings, but also promotion a mechanism of credit emission for investment projects. The size of annual emission must be constrained by the annual capacity of the investment sector in Russia, rather than by the total value of efficient investment projects: the solvent demand for products of the investment sector should not exceed the potentialities of this sphere. Accordingly, it is necessary to make an inventory of enterprises in the investment sector in order to estimate the degree of their viability and to determine expenditures needed for their modernization. Perhaps, the restoration of evolutionary pattern of the economic development should be initiated by modernization of enterprises in investment mechanical engineering. And it implies that credit lines should be opened for innovators in mechanical engineering and their cooperating enterprises, rather than for all innovators at once.

A constructive solution for the problem of crediting investment projects is the founding of the Russian Bank for Development. Such banks exist in many countries throughout the world. They support and stimulate such activities, as energy saving and nature conservation, finance new technologies and productions, help to create new working places, promote export, participate in the restoration of economy after a war or a natural cataclysm. The capital of such banks is formed either by state or through some combination of state and private resources. Refinancing proceeds by way of emission of own securities and their allocation in the capital market. Banks for development are attractive for innovators because of long-term credits (up to ten or twelve years) and fixed interest rates, usually below market rates. Credits are being given on the competitive basis after an appropriate expert examination of projects.

It should be said that nominally the Russian Bank for Development already exists, but due to bureaucratic procrastinations it is still idle, and, as a result, its branch network is disintegrating, as well as its skilled staff. The political will and responsibility of the country's leadership is needed in order to carry this business through.

The above theses are seditious from the standpoint of non-evolutionary theories, but they are in full accord with the evolutionary economics. The evolutionary theory doesn't deny that credit emission for investment activities of innovators entails considerable hazards. Maybe, some credited project will prove to be not efficient enough or the real demand for future output produced by an innovator will be inferior as compared to the expected output. An innovator may attempt fraud or be influenced by a criminal group, the latter compelling him to export capital illegally, and so on. However, such hazards do exist in any evolving economy. They should be minimized, but not by means of creating artificial barriers on the path of economic evolution.

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A Contribution to an Evolutionary and Institutionalist Approach of the Transition Process

Eric Magnin*

Introduction

The stabilization and transition programs implemented in most central and east European countries at the beginning of the nineties, with the technical and financial aid of western governments and international financial organizations, put the emphasis on macroeconomic adjustments while paying much less attention to the institutional legacy of former socialist economies and to structural reforms. It was supposed that quick liberalization and monetary austerity would rapidly restore macroeconomic balances while privatization and revived market mechanisms would give microeconomic agents the right incentives to restructure the economy. This policy directly derived from mainstream economics. The latter is currently the sole theoretical corpus in economics to be quasi-unified. This strong consistency, which in our opinion results from the underlying rigorous scientific method, i.e. the classical Cartesian analytical method and Newton's principles [Hodgson, 1993], explains it is generally considered as a paradigm. However if consistency is one side of the coin, reductionism is the other side. Indeed Cartesianism tends to cut reality in separate and isolated elements. This method clearly appears in the standard deterministic approach of the transition "to a market economy", granting strong reliance on rational individuals and markets in the process while underestimating the importance of the state and institutions. These weaknesses make room for an alternative evolutionary and institutionalist approach of the transition process. Actually, ten years after the beginning of the post-socialist transformation, economic debates have changed. The key role of institutions for the evolution and proper functioning of capitalism is one of the great lessons of the nineties. The EBRD [1999, p.5] for instance is now assessing that "institutional questions have been central to the *Transition Reports* from the beginning". However, the evolutionary approach is not unified and refers to a vast literature which can generally be related to schumpeterian, hayekian and veblenian traditions. Eclectism and confusion are generally the rules because, unlike mainstream economics, evolutionary works are not built on a unified methodological approach which could help to define common concepts. In other papers [Magnin, 1996b], we have suggested the *complexity* approach could bring these missing methodological foundations to evolutionary theories.¹ Therefore, we propose an institutionalist and evolutionary approach of the transition process which implicitly rests on the complexity method, although the presentation of the latter is beyond the ambition of this paper. These theoretical developments put the emphasis on the interactions between institutions, organizations and coordination modes so as to understand the evolution and transformation of economic systems. In the

* Associate professor, University Paris 7 (GERME), emagnin@ccr.jussieu.fr.

¹ The complexity approach here refers to a new developing paradigm which has been emerging in all sciences since the end of the 1970's. Generally speaking it can be considered as an extension and an enrichment of the systemic approach. The French sociologist Edgar Morin [1974, 1977-1991, 1985, 1992] is one among the rare specialists who has tried to define its methodological principles. Complexity in economics can be considered as a research program focused on a few common themes (order/disorder, self-organisation/chaos, path-dependence and non linear dynamics) in which economists from various theoretical schools are participating with their own conceptual framework.

first part of the paper we try to make clear for the reader the meanings we propose to give to the concepts of institution, organization and coordination mode. Then, these explanations allow us to introduce in the second part the concept of institutional field and to use these redefined concepts to analyse the post-socialist transformation process. The "transition" is then considered as a radical change of the institutional field of a national economy associated with a path-dependent self-reorganization process of production and exchange relations.

Institution, organization, market : back to the concepts

The concept of institution tends to be rather confusing in economics. It refers to various elements of social life such as property rights, market, enterprise, state, money, marriage, rules, norms, etc. Unfortunately it brings together in the same conceptual category very different realities. Everything can be described as an institution and the concept of institution eventually becomes blurred and hence less relevant. Consequently, a clear conceptual distinction between institution, organization and market barely appears in the economic literature, neither in the new institutionalist works - except those of D. North -, nor in the old institutionalist and their followers' writings. But this question of definition also raises the problem of their interactions.

Institutions

Beyond theoretical boundaries, most specialists retain the idea that institutions are the rules of social activities, ranging from customs and law to the constitution of a nation. Institutions can then be described as a set of more or less formal rules. North [1990, 1991, 1994] draws a useful distinction between formal institutions, i.e. social relationships which have been codified in the legal sense (law, regulation, constitution), and informal institutions, i.e. social relationships and patterned behaviour of people, whose regularity and duration have not been regulated by law so far (customs, traditions, sanctions, taboos, codes of conduct and myths). Formal and informal institutions should however be thought together in respect both of their distinction and combination. These two institutional forms are in fact interdependent. A lot of formal institutions appear to be ex post codifications by law of informal institutions, traditions or customs (private property, marriage for example). Respectively, formal institutions may be completed and modified by informal institutions.

However, the institutionalist literature often forgets to mention that, if institutions are necessarily rules by definition, all rules are not institutions. Some enacted rules are not implemented by the agents concerned. In that case, the rule can not be seriously considered as an institution. In the transformation of rule into institution, it seems that repetition is the key. Actually, the idea of repetition and of self-reinforcement – to use an evolutionary term – is an old one. At the beginning of the last century, Veblen already explained the emergence of institutions in terms of “habits²” and of “cumulative causation”. “Institutions are an outgrowth of habit. The growth of culture is a cumulative sequence of habituation, and the ways and means of it are the habitual response of human nature to exigencies that vary incontinently, cumulatively,

² The concept of habit, very important in the “old” institutionalist school, includes the idea of repetition and self-reinforcement. Habit is usually defined as “a more or less self-actuating disposition or tendency to engage in a previously adopted or acquired form of action” [Camici 1986, p. 1044].

but with something of a consistent sequence in the cumulative variations that so go forward" [Veblen 1919, p.241]. In a remarkable work, Hodgson [1993, p.131] brings to light the closeness between the emergence of institutions in Veblen's theory and the process of positive feedbacks and lock-in phenomena in Arthur's works on technological change. As North [1990, 1991] acknowledges the importance of the concepts developed by David [1985] and Arthur [1988] (self-reinforcement, path-dependence, lock-in) to understand institutional change too, the theoretical convergence between members of different institutionalist and evolutionary schools is here striking.³ In this perspective, the view taken here is that institutions emerge from a cumulative process which can be described as a self-reinforcing mechanism of social relationships and behaviour, which gain some permanence and social acceptance through time after being regularly repeated. Institutions are then reinforced by the same process and may engender lock-in phenomena.

Organization and economic systems

Intuitively, rules and firms seem not to belong to the same conceptual category. Actually, the firm is often called an organization (and not an institution) in the economic literature. However, a firm could not exist without internal or external rules. But what is an organization ?

In the specialized works on the theory of the firm and called "economics of organization", two distinct approaches can be observed : a "contractual" approach and an "organizational" approach. Surprisingly, the first approach, including transaction costs theory [Coase, 1937, 1960; Williamson, 1975, 1985; North, 1990], property rights theory [Alchian & Demsetz, 1972] and agency theory [Jensen & Meckling, 1976; Fama & Jensen, 1983] totally skips the proper concept of organization. Indeed it is often called "new institutional economics" or "neo-institutionalist" (but not "neo-organizational") approach. To put it briefly, the firm is considered as an alternative mode of coordination to impede market failures, a "bunch of contracts". The contractual approach is focused on exchange relations. In an extreme view the firm is a "legal fiction" or "a form of market". In short, the specificity of the firm as an organization, different from market and institutions, totally disappears.

On the contrary, the organizational approach of the firm, related to the founding works of Marshall [1920], Simon [1947], March and Simon [1958], Arrow [1974], refers to the roots of the concept of organization. The firm appears as a place for production, decision making, coordination and compromise among individuals displaying limited cognitive capabilities and diversified personal motivations. Firms are organizations because they organize production and the division of labour between different tasks and different people, generally in a hierarchic way. And then, organization increases rationality and reduces uncertainty.

The notion of organization is related to the concept of system, which can be defined as "a global unit made up of organizational interrelations between elements, actions or individuals" [Morin, 1977, p.102]. The firm fits to this definition since it is a global unit made of many agents whose interactions are organized (principally in a

³ It is interesting to note that this convergence mainly rests on the concepts of self-reinforcement (cumulative causation), path-dependence and lock-in, three phenomena related to the idea of complex causality, one of the basic methodological principle of the complexity approach. The latter explains that causality is not only linear, i.e. one effect comes from an antecedent cause, but can also be circular and retroactive.

hierarchic way). However, the firm-system here defined is not a homogeneous globality with well delimited boundaries but a social construct [Crozier et Friedberg, 1977]. This social construct displays systemic properties (consistence, stability) and imposes constraints upon actors and their strategies because it creates formal and informal rules. But it never completely succeeds. In the words of Michel Bonami et alii [1993], the firm is a “complex paradoxical unit”, combination of a system which tries to impose its logic upon actors and of a non-system which, as an expression of actors’ freedom, opposes the former, “inevitable combination of order and disorder”. This conception of the firm echoes theoretical works on the conflictual and convergent aspects of organizations because agents both follow the aims of the organization and their own objectives. We eventually agree with Simon and March’s [1993, p.300] definition of organizations as “systems of coordinated action among individuals and groups whose preferences, information, interests, or knowledge differ”.

The interpretation of the firm here conceived as a system (and as a non-system) may be generalized to other socio-economic organizations. Consequently organizations (systems) include all production (and decision) units which are hierarchically organized : industrial and financial firms, public agencies, social and political bodies (e.g., associations, trade unions, political parties).

Finally, in the *Principles of political economy*, Marshall [1920, book IV] gave three definitions of organization : the “social” organization of a whole national economy related to the social division of labour, the industrial organization referring to inter-firms organization and the organization of a single firm. For some specialists, this distinction may be rather confusing to understand what really is an organization [Ménard, 1990]. In the complexity approach, this distinction actually corresponds to the arborescence phenomenon, i.e. the hierarchic division of a system into sub-systems, etc., pointed out by Simon [Simon, 1962]. Then, in this Marshallian and Simonian perspective, it may be possible to interpret the Marshallian levels as three organizational levels related to three types of economic systems : the macro-level of the whole national economic system, the meso-level of the productive system⁴ and the micro-level of the firm-system (and of other socio-economic organizations).

Market, hierarchy, network : economic modes of coordination or organizational processes ?

What are the mechanisms enabling the firm in particular and socio-economic systems in general (whatever the organizational level concerned) not to be a simple sum of random individual interactions but organized units ? The answer is : market, hierarchy, network. The view taken here is that market, hierarchy, network are *organizational processes*. The latter seems more relevant than the concept of mode of coordination for at least three reasons. Firstly, it refers to a dynamic phenomenon. Market, hierarchy and network are organizing interactions among agents through the information they transmit. And production and exchange are the main (redistribution put aside) economic interactions among agents studied by economists. Secondly, markets, hierarchies, networks can be considered as both the *organized outcomes* of these interactions, i.e. a specific arrangement of agents relations (a hierarchical structure

⁴ At the intermediate mesoeconomic level, other systems can be defined besides the productive system : the banking and financial system, the so-called socioeconomic compromise (or the employment system [Magnin, 1996b ; Caire, 1994]) and the state. Indeed the organization of production and exchange relations among similar organizational units tends to form socio-economic wholes with systemic properties (industrial firms for the productive system, financial organizations for the banking and financial sector, etc.).

for example), and the *organizing processes* which, through the multiple actors' interactions, produce and constantly produce this outcome again. They are responsible for the permanent reorganization of socio-economic systems, i.e. "the ever repeated production of the process by itself" [Bonami and alii, 1993, p.63]. This idea refers to the very definition of the concept of organization since the latter includes both meanings : the action of organizing, i.e. to arrange relations between elements or individuals, and the outcome of this organization (the arrangement itself). The notion of coordination does not bear these two meanings. And thirdly, market, hierarchy and network are also organized processes. They are indeed organized by a set of institutions without which they could not exist. They are not the outcome of chance or of some natural selection but social constructs embedded in a set of institutions (we will call later "institutional fields"), of formal and informal rules, which give them a specific form and a particular dynamics.

Since the literature on market, hierarchy and network is quite vast and the space in this paper limited, the additional precisions given below are far from exhaustive but provide readers a brief survey of essential ideas.

Then, to put it shortly, *market* can be conceived as an organizing process of exchange relations among agents, in a decentralized and horizontally way, through the communication of information mainly via prices. This is not a new idea. It is close to Hayek's market theory in which the organizational dimension is important [Hayek, 1945, 1973, 1978].⁵ But market is also the (organizational) resulting form of this process, i.e. a specific arrangement of economic relations among agents, which is defined by institutions. And there are many forms of market associated with various institutional arrangements. Indeed markets are embedded in a set of institutions which are necessary for their organization, for example private ownership, contracts law, business law, competition law, business culture and know-how etc.

Hierarchy is a vertical mode of information diffusion and of organizing production and exchange relations. Hierarchy involves an order relation among participants and a subordination of the decision-making power. Hierarchy is associated with an authority relationship. It generally concerns the organization of internal relations within the boundaries of a firm or of a bureaucratic agency. But hierarchy can also organize economic relations among different units. The planned economy which was characterized by a macrohierarchy [Chavance 1995] is a case in point. Like market, hierarchy can not be separated from its founding institutions. Microhierarchy or corporate hierarchy is related to the wage relationship. The labour contract defines the hierarchical constraint by linking it with a wage scale. As far as the macrohierarchy is concerned, its organization results from the institution of central planning.

Networks are more difficult to analyze because of their informal nature. They can be considered as horizontal organizational processes of economic relations. Unlike market, which are legally enforceable contractual exchange relations, network relations

⁵ In Hayek's words [1973], market is a spontaneous order he compares to the concept of "self-organized system" used by physicists.

are not legally enforceable and transactions are conducted on the basis of specific informal institutions such as settled personal relationships, mutual obligations, trust and shared values or culture. At least two sets of factors explain the existence of networks. Market failures are one. For example, in case of a loose legal framework, high uncertainty and moral hazard, network may be more efficient than market, insofar as it may reduce uncertainty, increase agents' rationality by raising information quality and speeding up decision making, and make some transactions possible. But it may also be less efficient because of the constraints of belonging to a network (mutual obligations, reciprocity). The history of economic relations among agents, path-dependency, provides a second set of explanations. The repetition in time of these relations gives birth to trust and tends to give them a more personal character. These factors then contribute to perpetuate these relations until one of the party decides to challenge this trust and to exclude himself out of the network.

However, market, hierarchy, network, are generally conceived in the neo-institutionalist literature as opposites and mutually exclusive [Williamson 1975]. This conception tends to reduce their complex and creative relationship [Bradach and Eccles 1991; Hamilton and Feenstra 1995], which is here considered at the same time as complementary, antagonistic and competitive. It means that market, hierarchy and network are coexisting together in all socio-economic systems, whatever the organizational level concerned. However, their effectiveness and their dominance vary with the socio-economic system and the organizational level concerned. Let me quote two examples. In the firm, hierarchy is dominating. But as Simon [1993, p.301] points out, inside organizations, "organizational processes are, however, not consistently hierarchical. They also involve networks of other types." If the role of networks inside organizations, able to challenge and to complete the "official" hierarchical organization, is well-known since Simon's works [1947], studies on the place - quite limited indeed - of markets inside organizations are rare [Thomson and alii, 1991]. At a higher organizational level, the organization of production and exchange relations in the former socialist system showed an original combination of hierarchies, networks and markets. Central planning imposed a hierarchical organization of most production and exchange relations among agents. But these relations were both disturbed and completed by networks activities (all non planned transactions for example) and informal markets without which the system would not have been able to function properly and to ensure its continuous reorganization.

The effects of institutions on markets and organizations

Until now, we present a reinterpretation of the concepts of institution, organization and market (hierarchy, network), as well as a brief explanation of the relations between market, organization and system. However the link between institution, market (hierarchy, network) and organization must be clarified.

Most theorists consider that institutions impose form and social coherence upon human activity. They bring about order in economic interactions among agents. For North [1991], institutions "structure political, economic and social interactions". However, economists are not interesting in every institution. They mainly focus on institutions which exert an influence on economic interactions, i.e. on production and exchange relations. However we explained that the latter are organized by markets,

hierarchies and networks, which contribute to the emergence of economic systems. Institutions are not made of individual interactions (such as firms); they are not either dynamic organizing processes involving many agents and their interactions (such as markets, hierarchies and networks), but they influence the latter by defining the formal and informal rules which determine them. They provide the legal framework (and its loopholes) without which they could not exist and spread a principle of order, of behavioural homogeneity, of socialization among individuals. They contribute to the mediation between the parts and the whole, between the actor and the system. Normative rules, values are internalized and unconsciously affect individual behaviour and preferences. Monetary and non monetary incentives, legal or moral sanctions play a decisive role. Thus institutions and markets (hierarchies and networks) are distinct but inseparable. Since they impose constraints on interactions, reduce the range of possibles but create opportunities, institutions determine the form, density and dynamics of markets (hierarchies and networks). In that sense, they indirectly contribute to the organization of production and exchange relations among actors.

Elements of a transformation theory

The concepts we have previously presented allow us to propose a few elements of a post-socialist transformation theory focused on the interactions between institutional field and economic system, between institutions and organizational forms.

Institutional fields

We call an institutional field (IF)⁶ the set of formal and informal institutions which contribute to organize production and exchange relations among agents within an economic system. It is important to remember that institutions do not directly organize economic relations but influence the processes doing it (market, hierarchy and network) and the behaviour of actors involved. Each economic system is therefore indissociably linked to an institutional field whatever the organizational level.⁷ Each socio-economic organization, firm, public body or trade union, is linked to its own institutional field.

⁶ The expression institutional field is owed to Kurt Dopfer [Dopfer 1994] but the concept itself rests on the works on "morphogenetic fields" in biology. At the beginning of the twenties several biologists suggested that the morphogenesis of living organisms is organized by fields: H. Spemann in 1921, A. Gurwitsch in 1922 and P. Weiss in 1923. In the fifties, the biologist C.H. Waddington suggested a development of the idea of morphogenetic field including the time dimension of biological development. He called this concept a "chreod" [Hodgson, 1994b]. R. Thom [Thom 1975] developed Waddington ideas in mathematic models. In the words of Dopfer :

"An institution is effective within the confines of what may be called a synergetic closure. We call a domain in which a synergetic closure exerts behavioral command an institutional field" [Dopfer 1994, p.304].

⁷ Hayek established an interesting distinction between the formal and informal rules which lead to the formation of "spontaneous orders" and the rules essential for the formation of "organizations", which can be related yet in a restrictive sense to the idea of institutional field : "... the formation of spontaneous orders is the result of their elements following certain rules in their responses to their immediate environment... the rules which determine a spontaneous order differ in important respects from another kind of rules which are needed in regulating an organization... [...] while the rules on which a spontaneous order rests, may also be of spontaneous origin, this need not always be the case" [Hayek 1973, p. 43-45].

Unlike Hayek's theory, we argue that both types of rules belong to the same institutional field, the separation organization/self-organization as two extreme ideal-types being misleading. An economic system is always a combination of organization and self-organization, of intention and spontaneity.

For example, the institutional field of an industrial firm is itself part of a higher institutional field linked to the productive system to which the firm belongs, which is itself embedded in the institutional field of the whole national economic system, etc. We may therefore conceive a *hierarchically overlapping structure of institutional fields* parallel to the hierarchical structure of organizational levels. For instance, the organization of interactions among agents within a western firm is made easier by particular internal formal rules, by its own routines, its own corporate culture and know-how tradition, which constitute the specific institutional field of the firm. But the firm is also embedded in the field of the productive system including, for example, all the regulations of the industrial sector concerned. And the latter is also embedded in the "national field" including not only contracts law, business code, accounting rules, legislation on private property security, but also customs and settled habits concerning exchange relations.

The possibility to indissociably link institution, organization and organizational processes (market, hierarchy, network), three pillars of economic systems, and to distinguish clearly these three concepts, as well as to conceive their interactions, represents an essential interest of the concept of institutional field.

Moreover, the idea of a field seems more appropriate to conceptualize the reality of institutions and their effects. Institutions are indeed a complex reality, often difficult to define, with blurred boundaries. Institutions refer to an intangible reality, they are "real enough, but they are not "things out there" like cows or boats or bank buildings" [Neale 1994, p. 404]. They are partly visible, like formal institutions that materialize through a set of written rules, but often invisible when it refers to informal norms. By analogy with the magnetic field, the institutional field represents an intangible reality but of which effects are apparent, a domain of immaterial influence. The concept of a field refers to the idea of a diffuse and widespread influence exerted by institutions on individuals that contributes to organize their interactions. Institutions give an (organizational) form to these interactions. Besides, institution is a plural reality. It seems difficult to refer to one institution separately. Generally, a cluster of institutions, a set of rules, are related to the organization of a given economic activity.

Institutions have a cognitive and historical dimension. They "evolve incrementally, connecting the past with the present and the future" [North 1991, 97]. Firstly, institutions are, in our interpretation, related to the collective unconscious, the realm of archetypes, those primordial images at the roots of myths, which are perpetuating through time [Jung 1954]. Secondly, they often include old social norms which have incrementally evolved through time. They represent a kind of a collective memory of past knowledges, repeated behaviours and social relationships. As North puts it : "Time in this context entails not only current experiences and learning, but also the cumulative experience of past generations that is embodied in culture... It is culture that provides the key to path dependence - a term used to describe the powerful influence of the past on the present and the future" [North 1994, p.364]. In the words of Hayek, leaving aside his specific conception of natural selection, the thinking and acting of man "are governed by rules which have by a process of selection been evolved in the society in which he lives, and which are thus the product of the experience of generations" [Hayek 1973, 11].⁸ Institutions are all the more difficult to conceive in their integrity since their origins have been lost in time. It is not easy for example to check all the socioeconomic customs of a country. As Hayek points out, we are

⁸ Actually, we prefer to refer to an evolutionary self-reinforced process rather than a hayekian selection process.

“confined by rules whose purpose or origin we often do not know and of whose very existence we are often not aware” [Hayek 1973, 11]. But their organizing effects are still effective, such as black holes, invisible presences exerting their attraction forces on the material objects around.

To put it briefly, an institutional field “acts”, by analogy with chreodic development [Hodgson, 1994b], as if it would “attract” the economic system towards a specific organizational form it tends to stabilize, whether it is economically viable or not. The concept of institutional field includes therefore some determinism since institutions and culture partly determine man action and cognition [Hodgson 1993]. However individual freedom and creativity are not denied here.⁹ An institutional field does not represent a predetermined organizational form but the catalyst of a potential organizational form of individual interactions, a probable form among others, which gradually takes shape, which is being built by itself through experiences and learning, in short which is self-organizing. Then, the very functioning of organization, the dynamics of markets, hierarchies and networks, its “continuous reorganization” and development, have an effect on the founding institutional field back, tend to incrementally modify and/or to reinforce it, by creating directly or indirectly (via the state) new institutions, which will give a greater stability/instability to the related organizational form, and through learning and the formation of new habits. In turn, the institutional field contributes to organize economic interactions among agents. The institutional field and the associated economic system are thus continuing their mutual co-evolution, co-determination, underlying perverse or virtuous economic dynamics.

An institutional field always conveys contradictory influences related to the potential incompatibilities among institutions of a same IF, even if some are more effective and powerful than others. This incompatibilities may then lead to growing tensions, conflict and crises and hence to organizational instability and change. Eventually, the IF contributes to organize and to desorganize economic systems, to the emergence of a system and of a non-system.

The notion of coevolution refers to the idea, one can find in North's works, that, as far as institutions are concerned, change is generally incremental and rarely revolutionary. The East European post-socialist transition is a very rare case of an experience of revolutionary institutional change. But this revolution mainly affected formal institutions, informal institutions evolving more gradually. Self-reinforcement and path-dependency mark this coevolution. The latter does not necessarily mean (micro or macro) economic performances; on the contrary it may be locked in a less efficient trajectory which may reveal unsustainable in the long term [Arthur, 1990]. The former socialist system is a case in point.

A recombination of institutional fields

The view taken here is that the specificity of the post-socialist “transition” may be considered as a speed and radical change of formal institutions (the legal framework) whereas informal institutions, generally inherited from the former socialist system,

⁹ The concept of institutional field is not a negation of conflictual social relationships either, since it refers to institutions which are themselves codified social relationships expressing power relationships and the mediation of conflicts and dialogues. These are well institutionalized social relationships that are constituting institutional fields and organizing economic interactions.

evolve more gradually [North, 1994].¹⁰ If most “transitologists” pointed out the importance of the transformation of formal institutions, they often underestimated the role of informal institutions. Some writers however soon acknowledged the importance of distinguishing formal and informal institutions to analyse the transition process and the persistence of the latter [Mertlik, 1993 ; Nagy, 1993 ; North, 1994 ; Magnin, 1996ab; Chavance and Magnin, 1995] but they rarely insist on the combination of both types. The combination of these two types of institutions leads to the emergence of hybrid institutional form, typical of the early post-socialist period. To give an example, the 1990's Polish tax system could be considered as an hybrid institutional form since it was the outcome of a combination of new tax laws imitated from EU legislation and poor tax discipline inherited from the socialist system. Similarly, a quasi public "interwoven ownership" form emerged in Hungary in the first half of the nineties as a result of new property laws and persistent old alliances among actors [Chavance and Magnin, 1995]. The changed institutional field becomes then a new evolving combination of institutions (see table 1 below).

These hybrid forms are not necessarily simple recombinations but may be sheer new forms. Georgescu-Roegen [1971] insisted on the principle of "emergence of novelty by combination" in social sciences. They are not necessarily either intermediary forms between two systems with no incidences on the final model. Most of them will certainly disappear or be gradually modified but some others will be able to persist and even to create lock-ins determining the future evolution of the system and macroeconomic performances. For example, "interwoven ownership" has progressively disappeared in Hungary after 1995 with the speeding-up of privatization and banks' privatization, whereas the Czech Republic has met difficulties in disentangling its own quasi-private form of "interwoven ownership" [Magnin, 1999]. But a distinction is here to be made between post-socialist countries on the road to EU's accession and others (most CIS countries). While the former have to conform their institutions with EU standards, in the latter, informal rules tend to supersede the poorly enforced formal ones and hence hybrid forms tend to be more persistent.

To go further, the institutional field of a national economic system can be considered, to use metaphorically the mathematical theory of R. Thom [1975], as an *attractor* in an attraction basin. It "attracts" a socioeconomic system towards a potential organizational form which is gradually becoming effective as it is developing. Then, the post-socialist transition in Eastern Europe can be interpreted as a shift from one systemic attractor, representing the institutional field associated to the former socialist system, to another new one which is progressively taking shape. This idea can be related to Thom's description of morphogenesis and of all processes of creation or destruction of forms, as a disappearance of the attractors representing the initial forms and their replacement by capture by the attractors representing the final forms [Thom, 1975]. Thom calls this morphogenetic process a "catastrophe". The systemic attractor associated with the former system and the new born attractor differ among countries because of the diversity of institutional forms constituting national IFs and the diversity of transformation trajectories.

Actually, institutional fields of most central European socialist countries began to change throughout the eighties, dissatisfaction with the system being one of the main incentive. Thus national systemic attractors of the former socialist systems gradually weakened during this period. This weakening led to a progressive disorganization of

¹⁰ The informal institutions inherited from the former socialist system tend indeed to persist, even to strengthen, not only for their inertial essence but also because of the increase in uncertainty related to the systemic transformation process.

economic relations. Then the economic system entered an instability phase, a critical phase preceding a bifurcation, a change of the system state [Prigogine and Stengers, 1984], the crossing of a threshold, a system breakup. The instability phase can take more or less time. During this phase, it becomes very difficult to predict the evolution of trajectories different national economic systems will follow. Different paths are possible without being able to predict which one will be "chosen". Therefore an instability phase is also a creative phase. During this phase national trajectories are very sensitive to initial conditions. A small event may be decisive in the "selection" of the trajectory followed. The breakup of the socialist system was therefore not followed by a "systemic vacuum", as it was asserted at the beginning of the process [Bunce and Csanadi, 1992; Hausner and Nielsen, 1991], but was the result of an instability phase triggered by the attractor weakening. While many formal institutions rapidly disappeared, the invisible framework of informal institutions was still there.

2. A self-reorganization process of economic relations

The aforementioned recombination of institutional fields entails a reorganization of production and exchange relations among actors. Indeed macro-hierarchy has disappeared, sellers' markets have replaced buyers' markets and developed, micro-hierarchy within firms has been restructured and networks have been rebuilt. To be more precise, the transformation process can be considered as a self-reorganization process of economic relations, whatever the organizational level concerned (a firm, a mesoeconomic system or the national system), associated with the recombination of the corresponding IFs. The concept of "self-reorganization" links the idea of reorganization of existing economic relations to the spontaneous emergence of novelty, i.e. to innovation.¹¹ Then if the recombination of IFs leads to the creation of institutional innovations, the self-reorganization process it is associated with leads to the emergence of original hybrid organizational forms. For example, post-socialist ownership laws in Poland combined with employees' informal ownership rights gained in the eighties to give birth to specific "self-managed firms" [Table 1 below]. In Hungary, interwoven ownership was linked to specific holdings with "corporate satellites" [Stark, 1996]. Then the new institutional environments, the new institutional fields, of post-socialist economies, are progressively taking shape and lead national economic systems towards more or less stable organizational forms within a given period. Hence the specificities of post-socialist economies and their macroeconomic performances are partly determined by these new emergent institutional and organizational forms.

Table 1 here

Conclusion

In the evolutionary and institutionalist perspective taken here, the post-socialist transformation can be considered as a speeded-up coevolution and codetermination

¹¹ These processes can be separated : some existing organizations are simply reorganized (reorganization) by the authority concerned (state, manager) or new organizational forms are spontaneously created (self-organization) or created by the state (organization). Thus, the concept of self-reorganization enables us to think together breakup (destruction and emergence of novelty) and continuity (reorganization, hybridization with old elements) in the transition process.

process of institutional and organizational forms. The exceptional recombination of institutional fields leads to a quick reorganization of economic relations among actors. Hybrid institutional and organizational forms emerge during the process. Some disappear, others stabilize and even lock in. A new institutional environment, a new systemic attractor, is then progressively taking shape and guides the economic system towards a more or less stabilized form on a given period of time. Yet the outcome of the process remains undetermined and path-dependent.¹²

Finally, self-reorganization and lock-in phenomena do not mean a perfect road to an efficient market economy. Mutually inconsistent (respectively consistent) institutional forms may stabilize for a time, leading to a lasting systemic instability (respectively stability) and to poor (respectively strong) macroeconomic performances. Russia is a case in point. Conversely, a set of institutional forms may be mutually consistent (respectively inconsistent) but underlie an unsustainable (respectively sustainable) economic dynamics and/or poor (respectively strong) macroeconomic performances. It was the case of Hungary until 1995 and of the Czech Republic until 2000 (respectively Poland throughout the nineties). The task of the economist is then, after having identified institutional or organizational lock-ins and a perverse economic dynamics, to propose measures of a macro-institutional policy to modify institutional forms and to improve the macroeconomic dynamics they underlie.

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¹² The relevance of any theoretical framework being assessed according to the empirical results, it is important here to point out that this approach gives rise to empirical analyses of transformation trajectories in Hungary, Poland and the Czech Republic [see table 1; Magnin, 1996b; Chavance and Magnin, 2000].

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Table 1 : Systemic attractors and main organizational forms
(Hungary, Poland, Czech Republic in the first half of the nineties)

	Hungary	Poland	Czech Republic
Main institutional forms	<ul style="list-style-type: none"> • Quasi-public interwoven ownership • \pm soft budget constraint for large enterprises : • soft tax constraint • \pm soft credit constraint • Implicit social pact (interests coalition) • Failed proposal of a national explicit social pact • Collective bargaining with two relatively separated stages • Redistributive state paternalism • Weakening universal welfare regime • Poor consistent tax regime • Tightening socio-political constraint 	<ul style="list-style-type: none"> • Attenuated interwoven ownership • Half-soft budget constraint for large enterprises : • soft tax constraint • hard credit constraint • Unstable explicit social pact • Partially enforced proposal of a national explicit social pact • Collective bargaining with two stages but importance of trade unions and workers' councils inside the firm • Moderate state paternalism • Degenerated universal welfare regime • Poor consistent tax regime • Tight socio-political constraint 	<ul style="list-style-type: none"> • Quasi-private interwoven ownership • Half-hard budget constraint for large enterprises : • hard tax constraint • \pm hard credit constraint • Cooperative implicit social pact • High social consensus • Pseudo-tripartism at the central level • Market-type state paternalism • "Social-liberal" welfare regime • Efficient tax regime • Lax socio-political constraint
Main organizational forms	<ul style="list-style-type: none"> • Holdings/corporate satellites • Great number of hybrid micro-enterprises • Developed informal economy • Banking dualism : large state banks, efficient small and medium-sized banks with foreign capital • Embryonic financial market • Pluralism and trade union war 	<ul style="list-style-type: none"> • Quasi-private conglomerates • Public holdings • National investment funds • "Self managed" SME • Small number of hybrid micro-enterprises • Developed informal economy • Diversified banking structure : large specialized state banks grandes, state commercial banks, small private or state banks, cooperative • Embryonic well-regulated financial market • Bipolarity and trade union competition 	<ul style="list-style-type: none"> • Holdings ex-VHJ • Investment privatization funds • Great number of hybrid micro-enterprises • Still limited but growing informal economy • Banking dualism : large state banks, small private banks • Multiple and poorly regulated financial market • Domination of the former socialist trade union
Institutional compatibility and macroeconomic performances	High institutional compatibility but perverse economic dynamics	Low institutional compatibility but virtuous economic dynamics	High institutional compatibility and virtuous economic dynamics

Polish-German Trade and Polish Economic Growth

- An Explanation Based on Self-Organization Theory-

Kenji Tominomori

Introduction

Throughout the 1990s (except a couple of years in the beginning), Poland has experienced remarkably continuous growth, which has been apparently most outstanding amongst central European countries all known as relatively successful transitional economies (see Fig.1 & 2).

Main purpose of this paper is to analyse backgrounds of such unexpectedly successful procedure of Polish economy.

Since the phenomenon itself is very recent one, there has been little similar works done so far. As one of them, what deserves to be taken up here might be the work by Mark De Broeck and Vincent Koen¹ that appeared in the recent issue of *Comparative Economic Studies*.

Their works and mine could be clearly contrasted in both terms of its focus and methodology. As to the former, whereas they put main focus on such as industrial structure or equipment investment, I focused on such as international trade, mainly on Polish trade with Germany. On the other hand, our methodological difference is found in the contrast between their resorting to more or less supply-side-oriented method such as TFP approach and my resorting to self-organization theory in explaining an explosive increase of Polish-German trade in recent years.

It is doubtless that these twofold difference between us are interrelated. In other words, whereas it was necessary for them to use TFP approach to explain overall productivity increase causing continuous economic growth, it was unavoidable for me to seek for a new paradigm to be well explicable for such an explosive and abrupt upsurge of a particular trade relationship, that is Polish-German trade.

However, it should be remarked that there lies no particular contradiction between two approaches, despite of contrastive focus and methodological difference.

In a sense, my work developed below could be situated as an analysis to compliment the work of Brock & Koen in explaining real cause of why there has been such a conspicuous change of industrial structure leading to general TFP increase and GNP growth. Thus, I believe that combining two works, more utmost comprehension of Polish recent take-off would be at hand of the readers.

1: Polish economic growth in the recent decade

As observed in Fig.1 & Fig.2, Poland experienced a severe down turn of economy in the beginning of 1990s, which is usually understood as a natural result of so-called "shock therapy" carried out by solidarity government.

The policy became to be adopted when Poland faced with a hyperinflation in late 1989 triggered by price liberalization started in the middle of the year. Understanding that an abrupt price liberalization with so-called soft budget would inevitably result in hyper-inflation, the government, of which financial initiative was taken by Baruzerovich, introduced harsh income policy. Under the policy, wage compensation

¹ Mark De Broeck & Vincent Koen " The <Soaring Eagle>: Anatomy of the Polish Take-Off in the 1990s " *Comparative Economic Studies* XXIII, No2 (Summer 2001)

caused by inflations was strictly limited within 20-30 % of price index increase and subsidy given widely to states-owned firms became to be radically abolished. The policy, which is usually called to be "shock therapy", brought about a severe down trend of whole economy and living of ordinary people for the time being as its natural result.

However, what is more important here should be another result of the policy, that is "stabilisation" of hyper-inflation indispensable for the development of market economy. In this respect, Poland could be well contrasted with Russia in 1992, where price liberalization with still continued soft-budget brought about furthermore hyper-inflations and economic confusion throughout the 90s.

If we take those points into account, without any hesitation we can say that Polish shock therapy apparently worked at least one, though not all, factor to cause her economic growth aftermath so far as former half of 1990s is concerned.

It might be necessary to add some other factors to explain Polish economic growth even in the former half of the 90s.

Broeck & Koen pointed out followings as those additional factors.²

- ① Polish significant experience of price liberalization and trade liberalization during the 1980s.
- ② Relatively high quality of public sector institutions and legal system.
- ③ High level of human capital indicated by educational attainment.

The success of the shock therapy might have been impossible without those advantage of this country observed even before the implementation of the policy.

However, above points as well as the shock therapy itself could only explain the initial phase of Polish growth in the 90s. Furthermore continuation of the growth should be attributed to other factors than those factors.

As already mentioned a little, Broeck and Koen attribute such continuous growth mainly to continued change of industrial structure as observed in Fig 3.

As the graph is clearly indicating, Polish industrial structure radically changed from low value-added field towards high value-added field in during 1990s. In this respect, Polish change was most conspicuous among four central European countries (Poland Hungary, Czech and Slovak), which at the same time resulted in the highest increase of TFP (particularly in industry: see Table 7 of their article)³ as well as longest and highest growth rate.

Their analysis and explanation is quite understandable one. However, the question here is what actually caused such radical structural change of Polish industry.

2: An explosion of Polish-German trade

Exactly in this concern, what should be taken up first is nothing but an explosive upsurge of Polish-German trade in recent years, which is particularly concentrating in high value-added fields as observed from following charts.

As found in Fig 4, Polish-German trade on both sides of export and import has increased approximately 30% during the period 1996-2000. What should be remarked here is that in whole uprising of Polish-German trade particularly that of those industries as machinery, mechanicals, electrical machinery equipment, television

² Broeck & Koen, ibid p4

³ ibid p23-35

image and vehicle other than railways was enormously conspicuous. Polish export of those goods to Germany increased two or three times during the period, whereas also Polish imports has shown more than 40 % increase. Thus, it is doubtless that the trade is keeping near 40% share in whole Polish international trade throughout the period(Fig.5).

It is also observed that Polish-German trade occupied greatest percentage of all Polish international trade even in pre-war time(Fig 6). So that it could be conceived that the recent phenomenon might be a recovery of traditional relationship, but it should be born in mind that recent phenomenon is something more than a mere recovery judging from still greater percentage figure of the share.

More important difference here is doubtlessly the fact that the recent upsurge of the trade between two countries is being concentrated in high value added industries, the industries mostly developed in recent decades of advanced economies and not existed in 20s or 30s.

Additionally remarkable is that commodity flows of those industries from either side of the two countries have been acceleratedly increasing in the period. It is easily presumed that a sort of tightly coherent mutual interrelations ,stimulating relevant industries on each side more or less in technical terms, has been working to accelerate the trade.

To explain such explosive upsurge of trading based on accumulation of mutual interrelations of agent industries , any of traditional type economics doesn't look to be well useful. Complexity economics , in particular "self-organizing theory" summarised below might well take over traditional economics for this purpose.

However, before giving detail theoretical framework of the self-organization theory, another important phenomenon should be realised here.:that is an enormous increase of German direct investment and its conceivable relationship with trade explosion.As observed in Fig.7, German direct investment to Poland increased from 13.4% to 18.9% in total foreign direct investment since 1995 to 1998. Although the percentage figure is still lower than similar figure of Hungary(26.0%), absolute increase, as well as absolute value of the investment(5.74 billion dollars), well exceeded that of Hungary(absolute value is 5.0 billion dollars). This abrupt increase of German direct investment in Poland since 1995 coincides with the start of Polish adoption of NIF(National Investment Fund) policy , which was a final and uppermost step of Polish privatisation policy , so that it is apparently conceived the increase of German direct investment being triggered by the policy. However, analysis of such relationship between the German investment increase and NIF would be put aside for a while. Rather we try to see mainly how German investment worked in deciding the nature of the self-organization process. But before getting into those discussion, it is necessary to have a definite idea about self-organization theory itself, in particular biology-oriented self-organization theory which is called bioholonic self-organization theory here.

3: Bioholonic Self-Organization Theory

-a brief explanation through several keywords-

Here we try to give a brief explanation of the bioholonic self-organization theory through illustrations of several key words of the theory.

Holonic participant: [the basic unit participating the self-organization]

The most important point of the theory distinguishing itself from other self-

organization theory is to define the basic unit participating a self-organization as a complex living organism holding autonomous spontaneity as well as diversified character and dynamism(or changeability). In this respect it entirely differs from Krugman type theory. Stuart Kaffman's self-organization, on the other hand, could be understood to be the one covering both aspects. When he explains the birth of singular cell life, the unit is mostly understood as various molecule. The emergent result of self-organization is obviously a complexity and unit molecules have diversity. Each one molecule, however, is not clearly defined as a complexity at this step. But when he try to explain the birth of multi-cellular life furthermore, the unit of selforganization itself is nothing but a complexity holding autonomy for itself..

Self-organization theory of bioholonics, from the beginning , deal with self-organization where every participants of self-organization is living complexity, which nature could not be fixed to any restraint and which is transforming or changing all the time through its own autonomous spontaneity.

Taking it into account, Shimizu named the unit as "*holon(Kankeishi)*", which looks similar with holon defined by Arthur Koestler(1905-83). According to Shimizu, however, the connotation of the term is different from that of Koestler. Whereas Koestler defined the term as " both the autonomous properties of wholes and the dependent properties of parts" ⁴ , Shimizu put a greater stress on interacting relationship between holons and feedback or feedforward relationship between each unit holon and the self-organized whole(calling this two way relationship, he uses an expression as "holonic loop"). Shimizu particularly makes much of spontaneous participation of the unit in the self-organization, which is contained above "feedback" relationship. ⁵

Although I basically agree with his idea of *holon*, I don't think the term is so appropriate to point the essence as referred above. I rather prefer to use another term as *holonic participant* , which I believe better version.

Holonic-loop-- relationship between holons , and between each holon and the emergent whole: [mutual interaction and entrainment between holons]

In the concern with explanation of holon, the essence of holonic-loop has been already mentioned to some extent. But the connotation of "holonic- loop" is more profound.

As already referred, the essence of the holonic participant lies in its complex diversity and changeability. Put it in a different way, it means that one holonic participant has diverse possibility in regards to what nature, out of those possibilities, is actually vitalized and come up to the surface. Originally real appearance of the nature is undetermined. And decision about what potentiality is actually chosen is made depending on the relationship with other holonic participants and the emergent whole that the relevant holonic participant does have at each moment. For example , relatively talkative and a little entertainer mind appears when I face with students in the class room, whereas tender and softer character come up when I am meeting with my little 5 years old grand daughter. Also what aspects of diverse and complex

⁴ Arthur Koestler (1967)"The Ghost in Machine" Hutchinson,p383

⁵ Such kind definition of holon is also found in Geoffry Hodgson, because Hodgson says as "A holon is subject to the influences not only above and below in its own hierarchy but also through the connections with other hierarchies or system" (Hodgson, ibid: p246) . Difference left here are Shimizu's stress on spontaneous participation of the holon and self-organization thinking not found in Hodgson explicitly.

characteristics actually appears must be influenced by whole atmosphere of the emergent whole. If the class room as a whole get excited more than usual, due to several reasons partly including my own better teaching performance than usual day, I would be able to pull out further greater potentiality in teaching, thus the class room too would have emergent excitement as a whole. Off course, as just mentioned, each holonic participant is not merely influenced by others but also spontaneously affecting to others. And diverse holonic loop would be created depending upon actually formed interacting or entrainment⁶ relationship between holons or that between each holon and the whole.

Box column 1: Local information given to one cell and vitalization of a gene

It is somehow mysterious why one or only limited genes out of 100 thousand genes is vitalized in a definite cell in the ontogeny from an embryo. In present advanced biology, it is explained through local information given to one cell (in other words influence given to the cell by neighbor cells).

A simple explanation of such principle of local information given to a cell can be made in how two types of cell are differentiated in a very simple multi-cellular plant called *Anabaena* having only two types of cell, A and B ,each of which is distinguishable from both ostensible feature and function. Here only B can do cell division. It is observed ,in the process of cell division of one B cell, that B varies to A when the distance between neighbor A exceed definite length. Through this observation, it is understood that some information preventing B's variation must be working within this limited distance to extinguish beyond it.

Another proof indicating such working of local information is found in the case when an organ of human embryo is transplanted to other animal. The organ begins to repeat cell division indefinitely until it kills the relevant animal. It must be attributed to the lack of local information that should have been given when the organ has natural location in the human body.

Scenario(or restraint) for self-organization: [actual direction of the self-organizing move]

Each unit holonic participant has dual nature as mentioned above, spontaneity on one hand and passive response both to the neighbors and to the whole on the other hand. And how a definite feature out of diversified possibilities concealed in one unit holonic participant is chosen depends upon how interaction and entrainment between holonic participants would go on. But since each holonic participant is filled with too much diversified possibilities and there are too many probable interaction networks between holonic participants, it is still quite uncertain to see how actual self-

⁶ "entrainment" is originally a term in physics, where beams ,each having different wave length, finally became to have the same wave length through interacting affect to each other. The basic principle why strong laser beam is formed is understood to be caused by such entrainment affecting. Here the term is used to indicated intimate interaction between holonic participants.

organization develops. It resembles with simultaneous equations question inappropriately set up, where the number of variables exceed the number of equation and thus the question turns to be unsolvable. In case of the equation, some other restraints or conditions need to be put in to make it solvable. And here a sort of scenario directing the move of self-organization is necessary to be put in. For example, a class room where I meet with students should be that of some definite subject, say economics, and I also need to have some definite topic of the day. Without them, the room is nothing but an unstable chaos.

Thus an existence of a scenario should be listed as the third necessary requirement for the actual self-organizing move.

Box column 2: Flexibility of the scenario

The scenario don't have to be fixed so tightly. Rather if the scenario put in the drama has more flexibility, the drama can be more excitingly creative by actors(holonic participants).

Let me take up music in two different *genre*: classical music and jazz. It is known that the score of jazz is quite flexible compared with that of classical music. So that jazz players very frequently resort to ad lib, which gives the music at least exciting uncertainty. Off course, classical music too do have freedom of performance according to different interpretation of the score mainly initiated by the conductor, so that it must be quite unfair if we classify it as less exciting. What I want to stress here is just a clear difference between two genre music directly caused by the flexibility of the score.

However, it should be also recognized that if scenario for one self-organization is too tightly set, the procedure would more likely oppress the freedom of an holonic participant; a sort of slaving principle⁷ would work here.

Anyway, how scenario is set must be understood as a critical factor in deciding the real nature of self-organization.

Self-organizing process and an emergence

Being participated by holonic participants acting in mutual relationship of holonic loop, and being directed by a certain scenario(tightly fixed or not), a process of self-organization goes on.

The nature of the self-organization would be decided not only by the nature of scenario but also by an extent of mutual reacting relationship of holonic participants: such as how much widely the reacting networks formed or how tightly holonic participants reacting each other.

If the network would be narrowly formed and reacting relationship

⁷ The term was first used by Herman Haken, a German physicist who discovered the principle of laser beam, to indicate a situation where one beam of a certain wavelength is forced to be aligned to a definite wavelength under a pressure coming down from macro level. In a social self-organization context, I use the term to indicate where individual holonic participant is more or less deprived freedom or flexibility in deciding actual feature of him(her)self due to too tightly set scenario.

between holonic participants would be fragile one, the self-organization might be limited in a small scale and not bring about so great result. On the contrary, if the reacting network would be wide and vigorous enough to exceed some critical point (a threshold), there might be an explosive self-organization bringing about emergent and somehow non-linear result. Critical point (or threshold) actually reached can differ according to the degree of reacting network, thus various different degree of emergence could be conceived depending on the scale of critical points.

4: Self-organizing process in Polish-German trade

Turning back to the remarkable reality of explosive trade development in recent years between Poland and Germany, particularly in high-tech industrial fields, as seen in section 2 of the paper, with general understanding of self-organizing theory developed in section 3, we can now comprehend the phenomenon as a typical example of self-organization.

Here each holonic participant of the self-organization is nothing but each high-tech industrial area in each country. And all of those holonic participants have inter-reacted each other across the border. In other words a flow of such commodity from one side to another side stimulated the production of another related high-tech commodity in the latter side, which eventually flowed other way round. And the latter commodity flow has again stimulated other industries of the former side. Through such process of mutual reaction, particularly when the chain of reaction exceeded some critical level, there appeared an emergent explosion of industrial development causing continuous high enough economic growth especially on Polish side because of greater percentage of the trade to her GNP level.

Questions here would be what sort of scenario given to this process and who took initiative in presenting the scenario.

In this concern, enormous increase of German direct investment on Poland must be remarked above all. It is judged from it that German side took initiative in presenting the scenario of the self-organizing process, presumably expecting to utilize workforce with well enough skill level necessary for such high-tech industries at far lower wage than German workers. In this sense, the content of the self-organization is conceived to be more or less oriented to be vertical division of labor between two countries, giving a principal role to German industry whereas giving affiliate position to Polish industry. And if so, the self-organizational process may basically end at some point where fundamental framework of such division of works is performed: thus emergent and continuous high growth of Polish economy caused by the self-organization would also end shortly after now.

However, as discussed in section 3 of the paper, scenario of the self-organization does have some extent of flexibility depending upon the case. And each holonic participant can have some extent of spontaneity of its own; in other words each participant can make feedback affect to the whole, for example through revising or modifying the scenario from its side. In present context, it means it never unlikely that Polish side industries, although first established by German direct investment, can develop to the level enough to make the division of labor more horizontal one and to get themselves out of affiliate position. If such sort of scenario revision occurs, present self-organization process may be taken over by still more dynamic process. In that case, we can predict furthermore continuance of Polish economic growth.

To be frank, however, it is yet too early to decide this possibility. At least we need to have more detail statistical data of greater digit to do it. Hopefully we need some empirical case study indicating actual industrial relationship between trading industries of both countries, then we will be able to have more clear image of the self-organization.

Figure 1:
Real GDP in Poland and Neighboring Countries
Annual percentage rate of change

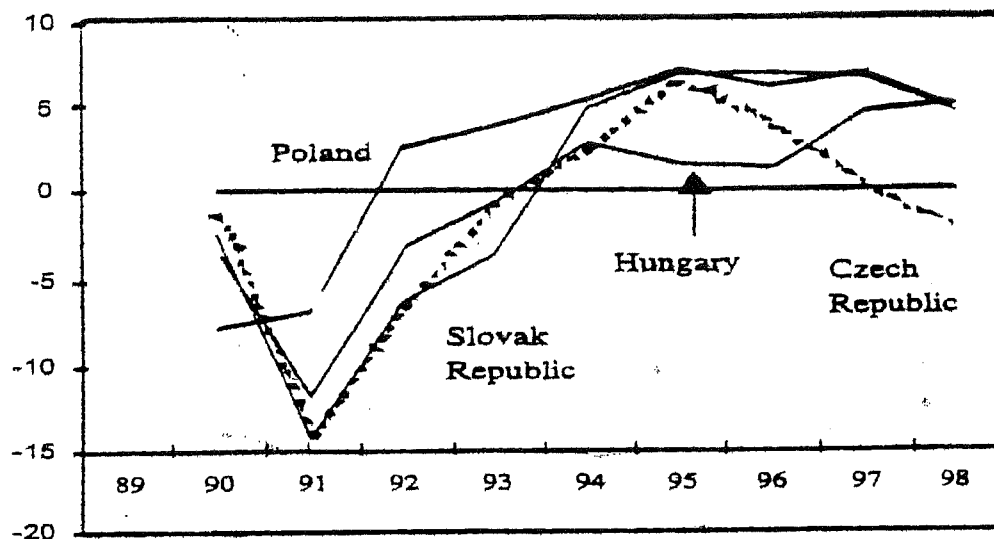
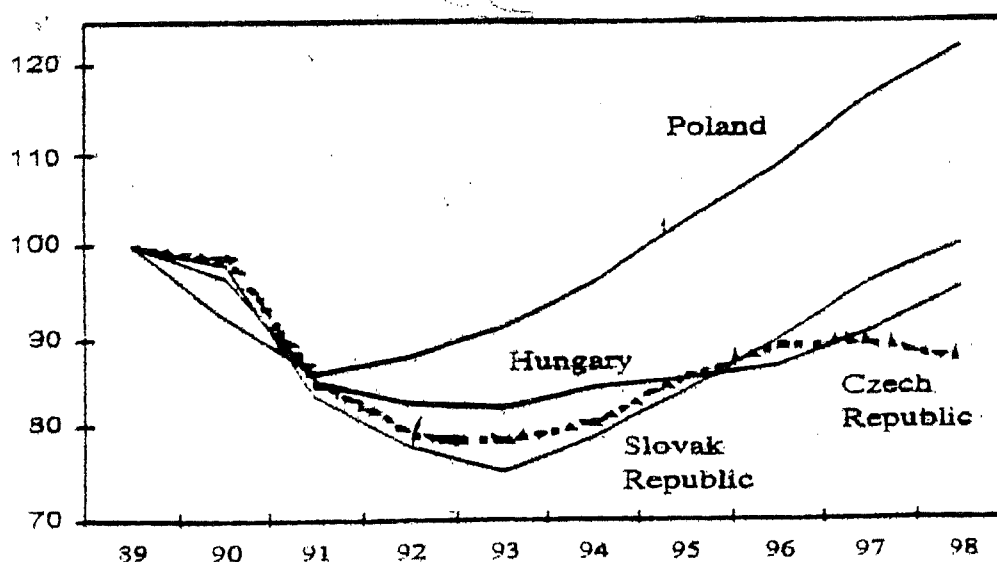
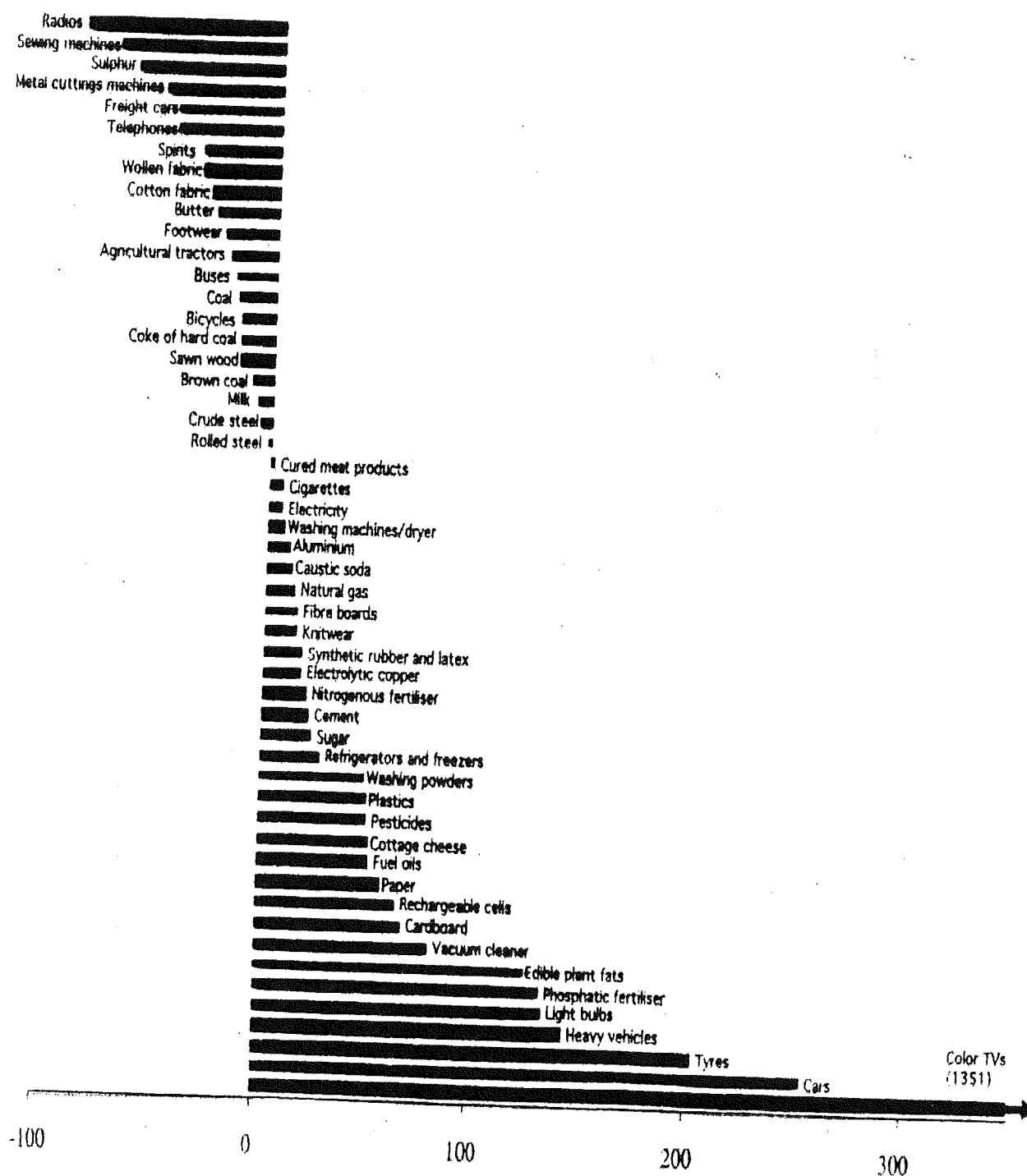


Figure 2: GDP Index of Central European Countries



Source: Mark De Broeck & Vincent Koen "The Soaring Eagle"—Anatomy of the Polish Take-Off in the 1990s, *Comparative Economic Studies XXIII, No2 (Summer 2001)*, p3

Figure 3
Production of Selected Goods
(Percent increase between 1991 and 1998)



Source: M. Broeck & V. Koen, *ibid* P17

Figure 4: Polish Trade with Germany

Export	1996	1997	1998	1999	2000	Total
	8,417	8,483	10,232	9,900	11,042	
	91	80	86	66	64	meat & edible meat
	102	109	142	131	123	edible fruits & nuts
	103	122	82	78	111	
	208	146	110	84	53	preparations of vegetable, fruits, nuts salt; sulfur
	288	347	424	371	440	mineral fuels, mineral oils & their products
	176	175	195	238	306	plastics & articles
	496	514	569	569	514	wood & articles
	1,254	1,143	1,198	1,050	813	articles of apparel & clothing accessories
	253	308	349	300	404	iron & steel
	656	603	666	636	636	articles of iron & steel
	200	197	206	173	218	copper & articles
	78	106	136	150	197	aluminium & articles
	450	429	557	696	1,288	nuclear reactor, boilers, machinery & mechanicals
	544	566	701	784	840	electrical machinery equipment & parts; sound recorders; television image
	447	512	804	968	1,242	vehicle other than railways
	172	35	738	224	271	ships & boats
	1,038	1,041	1,155	1,200	1,210	miscellaneous manufactured goods

source: GLS (Main Statistical Office. Statistical Information, foreign trade, January - December 2000)

Figure 5: Trade Partners of Central European Countries

Poland		1994	1995
Germany	a.	35.6	38.4
	b	27.3	26.6
Nederland	a	5.8	5.6
	b	8.3	8.6
Russia(Italy)	a	5.3	5.6 Russia
	b	6.7	6.8 Italy
Hungary			
Germany	a	28.2	28.7
	b	23.4	23.5
Austria	a	10.9	10.1
	b	12.0	11.9
Italy	a	8.4	8.5
	b	12.0	10.9
Czech			
Germany	a	29.5	31.9
	b	23.4	25.8
Slovakia	a	16.5	16.2
	b	14.3	13.1
Austria	a	7.2	6.5
	b	8.4	8.9

a:export b:import

Source; Takehiko Kimura "Polish Economy in Europe", Souseisha 2000, p255
(Japanese)

Figure 6: Polish Trade Partners (Historical Change, by %)

Wyszczególnienie Specification	Opółem w mln dol. USA Total in mln USD	Pierwszy partner First partner		Drugi partner Second partner		Trzeci partner Third partner	
		nazwa kraju country	w % opółem in % of total	nazwa kraju country	w % opółem in % of total	nazwa kraju country	w % opółem in % of total
1929 Import . . .	342,2	Niemcy Germany	27,3	St. Zjedn. Ameryki United States	12,5	W. Brytania United Kingdom	8,5
Eksport Exports	309,5	Niemcy Germany	31,2	Czechosłowacja Czechoslovakia	10,5	Austria Austria	10,5
Saldo Balance	-32,7						
1938 Import . . .	247,0	Niemcy Germany	14,5	St. Zjedn. Ameryki United States	12,2	W. Brytania United Kingdom	11,4
Eksport Exports	225,1	W. Brytania United Kingdom	18,2	Niemcy Germany	14,5	Szwecja Sweden	6,0
Saldo Balance	-21,9						
1950 Import . . .	668,2	ZSRR USSR	28,8	Czechosłowacja Czechoslovakia	13,2	NRD GDR	11,5
Eksport Exports	634,3	ZSRR USSR	24,3	NRD GDR	13,9	Czechosłowacja Czechoslovakia	9,2
Saldo Balance	-33,9						
1960 Import . . .	1495,0	ZSRR USSR	31,2	NRD GDR	12,5	Czechosłowacja Czechoslovakia	8,5
Eksport Exports	1325,5	ZSRR USSR	29,4	NRD GDR	9,4	Czechosłowacja Czechoslovakia	8,5
Saldo Balance	-169,5						
1970 Import . . .	3607,5	ZSRR USSR	37,7	NRD GDR	11,1	Czechosłowacja Czechoslovakia	8,6
Eksport Exports	3547,6	ZSRR USSR	35,3	NRD GDR	9,3	Czechosłowacja Czechoslovakia	7,5
Saldo Balance	-59,9						
1980 Import . . .	19089,3	ZSRR USSR	33,1	RFN FRG	6,7	NRD GDR	6,6
Eksport Exports	16996,8	ZSRR USSR	31,2	RFN FRG	8,1	Czechosłowacja Czechoslovakia	6,9
Saldo Balance	-2092,5						
1990 Import . . .	9527,7	Niemcy Germany	20,1	ZSRR USSR	19,8	Włochy Italy	7,5
Eksport Exports	14321,6	Niemcy Germany	25,1	ZSRR USSR	15,3	W. Brytania United Kingdom	7,1
Saldo Balance	+4793,9						
1995 Import . . .	29049,7	Niemcy Germany	26,6	Włochy Italy	8,5	Rosja Russia	6,7
Eksport Exports	22894,9	Niemcy Germany	38,3	Niderlandy Netherlands	5,6	Rosja Russia	5,6
Saldo Balance	-6154,8						
1999 Import . . .	45911,2	Niemcy Germany	25,2	Włochy Italy	9,4	Francja France	6,8
Eksport Exports	27407,4	Niemcy Germany	26,1	Włochy Italy	6,5	Niderlandy Netherlands	5,3
Saldo Balance	-18503,8						

Source: <http://www.stat.gov.pl/english/serwis/polska/rocznik16/obroha.htm>

Figure 7: Direct Investment of Central European Countries

Poland	1995	1998
Germany	13.4%	18.7%
International Organization	14.7	
U.S	23.7	18.0
France	6.6	8.7
Italy	9.5	7.4
U.K		7.0
Nederland	8.4	6.8
Total Sum	6.0BD	30.7BD
Hungary		
Germany	36.7%	26.0%
U.S	19.4	29.0
France	13.8	11.0
Austria	6.3	
Belgium	4.6	
Italy	3.7	5.0
U.K	2.7	
Japan		3.0
Total sum	12.8BD	19.6BD
Czech		
Germany	29.5%	27.0%
U.S	14.3	13.8
Switzerland	13.9	9.5
Nederland	13.8	13.2
France	8.9	7.2
U.K		8.3
Total sum	6.8BD	8.4BD

source: Kimura; ibid . p258,282

BD =Billion Dollars

Towards a General Theory of Transitional Economics

By Sheng Hong

I. The general problem of the transitional economics

So-called “transition” means a transforming process from a traditional planned economy to a market economy, which is a particular form of the general process of institutional changes. We call the economic theory, which focuses on the particular process, the transitional economics. What transitional process distinguishes from general institutional changes is that, the research on general institutional changes has two respects, one is on how to discover the new institutions with higher efficiency, another is on how to realize the institutions which are proved with higher efficiency, while the transitional economics only discusses the latter issue. Now that we assume that market economy is more efficient than planned economy, the transitional economics focuses on how to realize the market economy.

Different practices in market-oriented reform in various countries tell us that there are a lot of ways to complete the process from planned economy to market economy. These ways may lead to the same result but perhaps with different costs. There are lots of factors affecting the costs in transitional process; the most important one among them is that whether or not the specific reform way brings damage to some people, how many such people there are, and how much the damage is. Although in general the reform may result the growth of the social wealth, some people may still oppose it and cause the costs of reform increased, if the reform damage them while bring benefit to other people.

Therefore, the general problem of transitional economics is that, assuming there are two different institutional arrangements, or two different rules, given an institutional arrangement is more efficient than another. Whether or not we can find a way to complete the reform without damaging interest of any person when we replace the institutional arrangement with lower efficiency by the one with higher efficiency.

II. Interest distribution matters

In Neo-classical Economics, resources are allocated under an ideal market. Any improvement of resource allocation may increase benefit of the agents themselves, so that it is not necessary to discuss the problem of interest distribution that is regarded to be resolved automatically. People seem gradually to think that the problem of resource allocation is really irrelevant to that of interest distribution. Many regard the problem of allocation of resources as only or most important one. Any change, including that of interest distribution can be ignored as long as the efficiency of resource allocation is improved. We call this view “irrelevance of interest distribution”.

However, in most situations allocation of resources are realized through the cooperation and transactions between people, and necessarily concerned with interest distribution between

them. Any change of allocation of resources must be followed by that of interest distribution. In real world, not only there is no ideal market, but also there are many non-market institutions, such as firm, family and government, in which the problems of interest distribution is not likely to be resolved automatically with the improvement of allocation of resources. Furthermore, sometimes, the interest distribution may play more important role. Many states of resource allocation are determined by the structure of interest distribution, and many institutional changes leading improvement of resource allocation are the resolutions of interest conflicts.

It seems more important of the problem of interest distribution when institutional changes happen, since it is the interest conflicts and the resolutions of them that in fact determine the fate of institutional changes.

III. Rationing transactions

John R. Commons calls the transactions between government and citizens rationing transactions. This kind of illustration to government transactions makes the finishing point, which reveals the essential nature of the government transactions. Of course, the government is a product of the public choice and has coercion power, but these do not refer to the description on the nature of concrete transactions of the government. According to Commons, the nature of that is “rationing”.

So-called rationing means that some artificial limitation on some economic variables, which is not a contract achieved by au pair persons, but is determined “by an authority superior to them in law”(Commons, 1990, p.68). There are two kinds of rationsings, *output-rationing* and *price-rationing*. So-called output-rationing means to regulate the quantity of goods and services, without regulating their prices; while so-called price-rationing means to regulate the price of goods and services without regulating their quantities. From output-rationing and price-rationing, we may derive the third rationing, *value-rationing*, which is the product of output-rationing timing price-rationing.

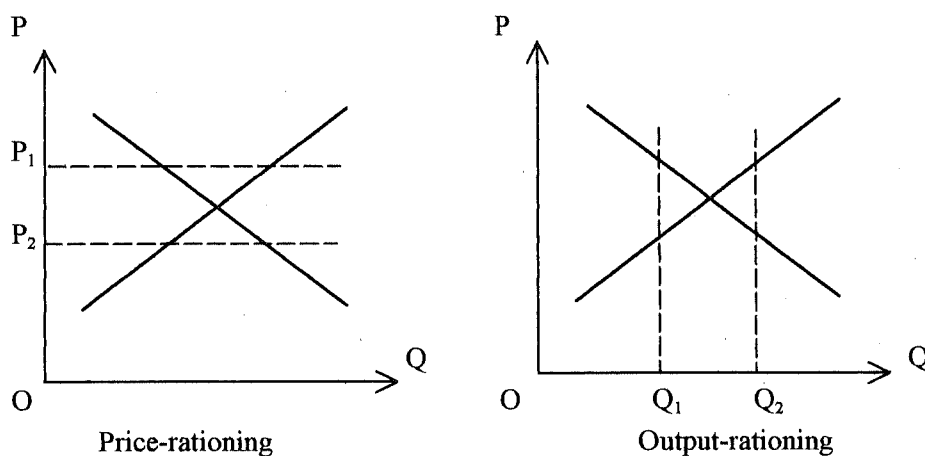


Figure 1 Price-rationing and output-rationing

Rationing transactions have two characteristics. Firstly, it is to be as a comparison of the market transactions; secondly, it is enforced by coercion power. People only accept market equilibrium price and output if there is no coercion. At large sense, coercion includes bargaining power as well as governmental power.

Considering carefully, we may find that almost all concrete transactions by the government are rationing transactions. We may make three examples: issuing money, imposing tax, and protecting human rights and property rights. The government issues the money through the way of rationing transactions, adjusting either interest rate (price-rationing) or credit quota (output-rationing). The tax rate is a price-rationing which is relevant to public goods, while the protection of the human rights and property rights behaves in the real world a series of injunctions which are the rationing with the amount of zero, such as to ban on trading human beings, impinging residences, and pirating books with other's copy rights. All these three activities of government lead to the violation from the market equilibrium prices and quantities, cause the incentive for the people to break the limitation by the government, and therefore the government must enforce the rationing transactions by coercive power.

In the traditional planned economy, such rationing transactions have spread to almost all fields in the economy. So-called plans in fact consist of various price-rationings, output-rationings, and combinations of these two rationings. The planned prices are various price-rationings, output targets and rationing quantities are various output-rationings, and the targets of production values are the products of the planned prices timing output targets.

Under the situation that there are externalities in market transactions, the public choice is often applied to determine the interest distribution and resource allocation. It leads to rationing transactions by the government to carry out concretely the public decision. Within the extent, the rationing transactions are efficient. But it would bring damage to operate rationing transactions when there are no externalities in market transactions (Sheng Hong, 1992). The key problem of the traditional planned economy lies in applying improperly the rationing transactions to where the market transactions work, and therefore the task of the market-oriented reform is to change this part of rationing transactions to market transactions. This kind of transformation is the basic content of so-called transition.

IV. The distributing natures of rationing transactions and bargaining transactions

In the market, any agent may avoid a damage that might be brought by a transaction by "disagreeing", as well as gain benefit through a transaction. A market price is formed through thousands upon thousands of "agreeing" and "disagreeing", and just at the point where average cost and average utility of the transactors at the margin. Under the market equilibrium price, there is no one hurt. Any rationing violating from that cannot benefit some without hurting others.

Since the rationing exists with the existence of the market equilibrium, the price-rationing is necessarily violated from the market equilibrium price. Therefore, the structure of the interest distribution would be changed, and some would be worse off while others better off, when the price-rationing is imposed. In short run, when the price-rationing is higher than the market equilibrium price, the buyers at that market would be worse off while the seller better off. In long run, assuming agents may enter into and withdraw from the market freely, some buyers may withdraw while some new sellers may enter, an over production would appear and hurt all sellers. If free entrance is not allowed, the current producers may maintain the benefit from price-rationing, but the society should pay the cost to prevent free entrance which in return is burdened by those who are benefited by the price-rationing (Sheng Hong, 1996a). So in long term, no one will be better off. The change of interest distribution brought by the rationing transactions leads to lower efficiency in the resource allocation. It would be similar to the conclusion if the price-rationing was lower than market equilibrium price.

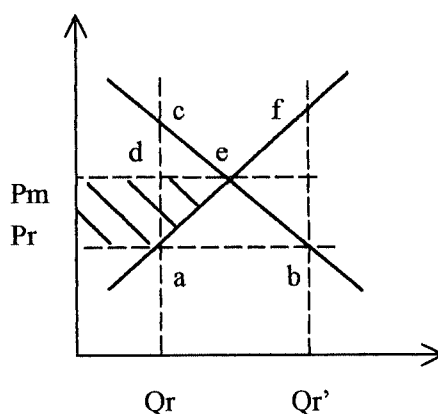


Figure 2 The distributing nature of the rationing transactions

The P_m is the market price while the P_r is the price-rationing, which is lower than P_m . If P_r is imposed, and if free entrance and withdrawal are not allowed, the sellers would lose the value equaling to the area $P_m-e-a-P_r$ and the buyers' interest would increase the amount of the area $P_m-e-b-P_r$; when the government subsidizes the lose of the sellers equaling to the area $a-b-f$; and if free entrance and withdrawal are allowed, in long run, the sellers would lose the value equaling to the area $P_m-e-a-P_r$, while the buyers would lose the area $a-b-c$ minus $P_m-d-a-P_r$. In the first situation, the society loses the value equaling to the area $d-c-e$ plus $e-b-f$, while in the second situation, the society loses the value equaling to the area $a-b-c$ plus $a-d-e$.

V . The nature of the transformation from rationing transactions to bargaining transactions

The transformation from rationing transactions to bargaining transactions is that of transaction forms, namely of institutional arrangements, and also of the rules to delimit property rights. This process includes to eliminate the old rules of institutions and to establish new ones. Rationing is arranged by public decision, so has to be eliminated by that; while the bargaining transactions are achieved voluntarily by agents, and in principle does not need the approval of the government.

There are two problems aroused by the situation: (1) the transformation from rationing transactions to bargaining transactions itself has some characteristic between public goods and private goods; it would be a rather complicated problem that by which way people can accomplish the transition; (2) if the transformation is characterized by public goods, and needs to be implemented by public choice, in most situations, it would hurt some persons' interest during the process of transformation and change the current structure of interest, which is not consistent to our pursuit of reserving the current structure of interest while reforming. The problem is that, does the market-oriented reform have to apply the way of public choice (e.g. the coercion of the government), and necessarily hurt some persons' interest?

Institutions are the results of interactions repeatedly between people, and they themselves are continuative, namely, they serve not only for the transactions between agents at present, but also for those between agents in the future. Therefore, the death of old institutional arrangements may have two ways: (1) no longer serving for the transactions of all agents; (2) only serving for transactions of current agents while does not do so for those of future agents. The first way means to eliminate the existence of old institutional arrangements, while the second way means to eliminate their continuity.

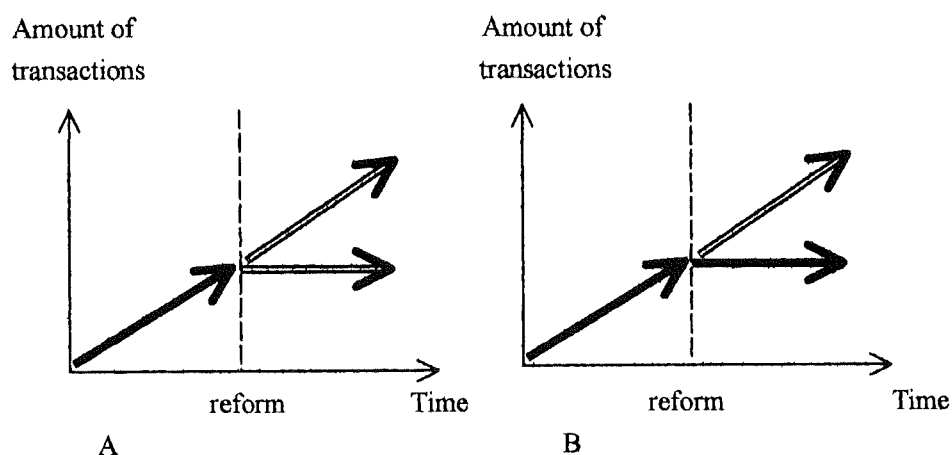


Figure 3 Ceasing the existence of and continuity of old institutional arrangement

Legend: \Rightarrow old institutional arrangement;
 \Rightarrow new institutional arrangement.

Then, what are the different results of the two ways? As far as we know, to replace the old institutional arrangements with new ones may directly change the boundary of property rights and the structure of interest, and cause the opposition of those whose interest would be damaged. As to the second way, it recognizes the current boundary of the property rights and the structure of interest, and only constrain the new increment in the economy with new institutional arrangements. Under such a way of reform, it is possible to benefit at least one while not to hurt all people.

Therefore, although we realize that changing a rule is a kind of public goods, and should apply the way of public choice, there would be a possibility that a public decision is passed unanimously

and does not hurt anyone, which is different from the ordinary results (minority abbeys majority) and the ordinary feature of public goods (there is external costs).

VI. Delimitation of property rights and the rule to delimit property rights

There are many different rules to delimit property rights. Of course, different rules may bring about different delimitations of property rights, however, they may also bring about same delimitation of property rights. In other words, whom the property rights belong to may be irrelevant with the rules to delimit property rights. Therefore, the delimitation of the property rights and the rules to delimit property rights are two different concepts.

Then, it would appear such a possibility to change the rule to delimit property rights without changing delimitation of property rights. Concretely, there are two ways to realize the change: (1) **to cease the continuity of old rule to delimit property rights, to make it invalid to delimit new properties, while to delimit them by the new rule;** (2) **to cease the continuity of old rule on current properties, but to introduce new rule to delimit property rights while not to change current delimitation of property rights, which may be changed after the introduction of the new rule.**

Among the rules to delimit property rights, we may distinguish **the rule to initiate property rights** from **the rule to transfer property rights**. Generally speaking, the first rule includes pre-empt principle, laboring principle, and legal principle, while the second has tow forms: not to allow transfer and to allow transfer. In the planned economy, the property rights were established by the coercive power of the government and cannot be transferred freely in the market.

What the transitional economics mainly involves is this kind of the rule to delimit the property rights which is relevant to state-owned property rights.

VII. The implication of tradability of property rights to institutional changes

It may be called “incremental reform” in the field of property rights to apply new rule to delimit property rights in the additional properties. During the process from planned economy to market economy, the increment reform created the condition for the bargaining transactions of property rights. On one hand, the incremental reform produce a lot of non-state assets and their rights, which are the necessary objects of the transactions with state-owned property rights. On the other hand, the bargaining transactions among incremental non-state property rights formed markets, and provided reference of market prices for the transactions with state-owned property rights.

Based on the increment reform of property rights, it is very important in changes of the property-rights institutions that current state-owned assets may be traded freely rather than only transferred at the planned prices, namely, which at last change the property-rights institutions themselves.

This transformation includes two stages. During first stage, the stocks of state-owned assets are evaluated for their market value when market prices are shaped by transactions among additional, non-state property rights. The market value is necessarily different from that is determined by the planned prices, which are mainly fixed prices for too high adjusting costs. The market value of some state-owned assets is higher than the planned prices, and that of others is lower than the planned prices. At that time, if simply to eliminate the planned pricing system, and to trade state-owned assets at market prices, would hurt some while benefit others. However, it would be another result if to recognize the structure of interest delimited by planned prices, and to allow trading so-called “planned rights”, the difference between market prices and planned prices, such as the trades of quota. Through the trades, no matter whether “giving up” the planned rights or “exempting” the planned obligations would be compensated; no one is worse off.

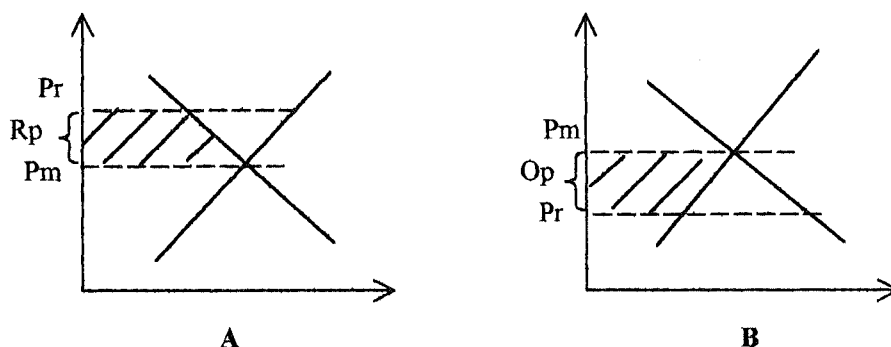


Figure 4 Planned right and Planned obligation

R_p in A is the planned right of the supplier, while O_p in B is its planned obligation. The supplier may offset its planned right by its planned obligation.

After the planned rights are allowed to trade, the planned rights and the planned obligations would disappear. For the old rule to delimit the property rights is ceased and there is no new planned rights established, the planned rights may be eliminated by “buying up” or “offsetting”. The latter means that the planned rights may offset the relevant planned obligations. In planned economy, most enterprises have planned rights as well as planned obligations, and the planned rights and planned obligations were borne between enterprises and between enterprises and governments.

After the state-owned assets are traded at market prices, any such transaction no longer has the characteristic of redistribution. At that time, the state-owned assets may be transformed as non-state assets through trades while non-state assets may also be transformed as state-owned ones. The property-rights institution of the state-owned enterprises may be changed through the trade of property rights.

The important reforms from the planned economy to the market economy, reform of pricing

system and that of property rights, are completed through trades or market transactions.

VIII. General conclusion

The analysis above tells us that it is possible that there theoretically is a reform way, which may transform a planned economy into a market economy without hurting anyone. This way consists several key points that are as follows:

1. To implement new rule to initiate property rights on the additional assets out of current property rights;
2. To wait for the increment assets increasing and being traded according to the rule of market;
3. To trade the planned rights of the current assets, which may be evaluated by the market, and to make the rights established in the planned economy disappeared through “offsetting”, “buying up”, and “capitalizing”;
4. The current property-rights institution may be replaced by the one with higher efficiency, and the reform of property-rights institution would be completed, when all assets (including state-owned ones) and their property rights may be transferred freely in the markets;
5. When maintaining the old rule to delimit property rights on the current property rights, while implementing new one on additional assets, there would be no one hurt, therefore in principle the way of reform may be consented unanimously in public choice;
6. Any transaction according to the market rule does not hurt anyone, for its being agreed by its both parties.

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Stable Undesirable Norms in Post-Communist Transition Economies

Aliya K. Kantarbayeva, Doctor of Economics (Kyoto University),
Institute for European, Russian and Eurasian Studies,
George Washington University (Washington, DC, USA)

In the present research, an attempt is undertaken to explain, why during the reforms (by and large aimed at the improvement of political and economic system) stable inefficient norms of economic behavior would arise. With this object in view, the institutional and evolutionary approach is applied.

Institutions and Their Selection

As is known (North, 1990), institutions are sets of rules and norms created by people, which act as constraints for agents and as the appropriate mechanisms for protection of and control under their observance. Modern institutionalism views economy as an evolving open system exposed to permanent external perturbations and responding to them.

As in the living nature, evolutionary self-organization of economic systems is characterized by heredity, variability and natural selection. Institutions, elementary units of competitive selection, fulfill the role of genes. The development of institutions is featured by self-supporting mechanism operating on the positive feedback principle, which T. Veblen (1961) called "cumulative causation".

At the same time, evolution is by no means identical to optimization (Alchian, 1950; Friedman, 1953). The evolutionary trajectory of development is fraught with chreodic effects. (This term was originally proposed in 1968 by embryologist C. Waddington.) Chreodity means, that by virtue of concurrence of circumstances a specific phenomenon begins to develop along a non-optimal path; in so doing the longer such a development proceeds, the more difficult is to

turn off this path to the highway. The natural selection in its traditional, Darwinian, understanding does not come into action.

J. Schumpeter (1934) warned against an erroneous interpretation of economic evolution by analogy with the Darwinian concept of continuous improvements referring to the latter as "uniform unilinear development". The notion of natural selection as applied to economy requires reconsideration. A nonlinear evolving system, generally speaking, may have multiple states of equilibrium. Selection may be defined as realization (fixation) of one among several possible stable states. In the light of the above, Darwinian selection corresponds to arrival of the trajectory of evolving system at the only possible equilibrium state. The result of such a selection is practically predetermined. What takes place is survival of the most effective institution and suppression of the rest.

If we assume multiple stable final states of equilibrium, each corresponding to predomination of one institution of those participating in competition, we arrive at another type of selection (Kantarbayeva and Mustafin, 1997). It may be referred to as Quastlerian selection after H. Quastler (1964) who was the first to prove that emergence of information is equivalent to memorizing of a random choice. Such a selection is an unpredictable realization of one out of several roughly interchangeable competing alternatives depending on the initial provision of the system. As this takes place, all equilibrium states corresponding to coexistence of all competing institutions are unstable and therefore unfeasible. Fixation of a random choice results in survival of an institution not necessarily having the greatest selective value.

We may think of the widespread phenomenon of dominating de facto standard which is known as "lock-in" (Arthur, 1989), chreodic effect, or hyperselection (Bruckner et al., 1994), to be a manifestation of the Quastlerian selection in economic evolution. The Quastlerian selection could be also

responsible for another well-known phenomenon, when further economic development is conditioned by "path dependence" (Arthur et al., 1987).

Thus, the Darwinian mechanism is a selection of the best traits, while the Quastlerian one is a selection of the initial conditions.

The Basic Achievements of the Transition

Ten years have elapsed since proclaiming the independence of the former Soviet republics. It is just an instant in the history. However, it is long enough to make a conservative estimate of the path covered while in some historical distance.

Impartial assessment of the achievement and mistakes, prediction of the consequences of specific steps undertaken by the government are important for timely adjustment of economic policy, as well as for outlining realistic future objectives.

What are the common features of post-Soviet transition? What from this experience should be taken into account in future?

Transition of the countries of the former USSR to the market economy was an imperative of the history. However, the problem is how this transition was put into practice. The estimates of the results shown by concrete models of transition are by no means ambiguous. The transformation proceeded mostly spontaneously and sometimes not thanks to, but notwithstanding the actions of governments.

The following may be attributed to the positive consequences of transition:

- Shift of paradigm of thinking at the people. A significant part of the active population succeeded to understand and put into effect a simple truth of the market economy: everybody is able to ensure a decent living standard for him/herself and his/her family without awaiting help from the state and others. Working for the benefit of him/herself the person creates wealth for society.

- The formal institutions of the market economy are formed. Freedom of entrepreneurship and free choice of activity and occupation are legislatively proclaimed. The state pledges not to meddle with business of its law-abiding citizens.

- The institutional basis of the market economy with all necessary infrastructure elements is created.

- Basic democratic freedoms and mutual independence of all branches of state authority are proclaimed.

- Privatization of the former state property is completed or close to completion.

- Private sector of the economy really functions.

- A certain macroeconomic stabilization is attained.

- The revival of extracting and fuel industrial sectors takes place.

- The prerequisites to ensure the first line of social security are created: most states have implemented the pension reform; the foundations of the modern labor legislation are approved.

At the same time, it should be noted that many positive undertakings bear declarative character and are not being put into practice.

Ineffective Institutions: Identification and System Analysis

The negative consequences of transition are mainly concentrated in the sphere of social development. According to the data reported by Kazakhstan's Agency for Statistics, over the period from 1992 to 1999 the level of human development in that country decreased. The GDP per capita dropped by 32 percent. In 1999, 34.5 percent of the population had income less than the cost of living (3,394 *tenge*, or \$26). 5.1 million people were beyond the poverty line. At the same time, the percentage level of general unemployment among the

economically active population constituted 13.5 (those officially registered amount to 3.9).

It is impossible to introduce market institutions overnight by a volitional decision. The only way is to let them to self-organize by means of a natural evolutionary selection, having set certain "rules of game" for economic agents, that is having determined the frameworks of a legal field by appropriate laws (Sachs, 1995). The majority of typical laws may be borrowed at countries with the advanced market economy. Just what it was done, however the set of institutions, which have arisen and fixed as a result of the "experiment" was found to differ markedly from expectations. This is completely inexplicable by minor differences between the modern economic legislation of the post-Soviet states and that of the West. The life has shown, that within similar legal framework selection of different, including undesirable, norms of economic behavior is possible.

From our viewpoint (Kantarbayeva and Tsukatani, 2000), the reason of the apparent paradox was oversimplified treatment of economic evolution as pure Darwinian selection by the reformers-neoliberals. Existence of multiple equilibrium states in the system has not been taken into account. The real economic system is rather Quastlerian, than Darwinian, and may have more than one stable state of equilibrium, each of them being characterized by its own set of fixed norms. Arrival at a given specific state is determined by the initial conditions. This is a manifestation of the path dependence. It is because the countries of the former USSR were well off in the phase space of economic variables from the desirable state of equilibrium with "correct" set of institutions, they have been trapped by domains of attraction of other states of which the reformers even had no idea.

The following stable undesirable norms may be assigned to the most frequent ones: corruption, rent-seeking behavior, tax evasion, barter, non-payments, lobbying, voting paradox, log-rolling, tribalism, clanism, racket.

The stability of undesirable norm means that there are conditions for its self-reproduction, and that it cannot be destroyed by simple returning to initial conditions (phenomenon of hysteresis).

Consider for example evasion from taxes. The more is percentage of those avoiding tax payment, the less is probability of punishing concrete infringer. This in its turn promotes proliferation of evaders even more. There takes place reduction of the transaction cost associated with undesirable economic behavior of interest. The objective prerequisites for mass evasion from taxes to appear had established at the outset of the reforms.

Population in transition economy rushed in small business: "shuttle" trade, hotel management, operations with apartments buying, selling, renting and repairing, office and apartment cleaning, freelance translation and interpreting, mediation, etc.

Small-sized retail trade, which did not require any essential investment, was most popular and accessible by business. This trade has grown on the basis of large wholesale markets, where the prices at even small-sized purchases (starting from 10 units) allowed the people having no idea of the market laws to derive a certain income. Thus, the wholesale markets initiated spreading small-sized family business, which also began to be involved in informal sector. Existence of shadow economy, paradoxical it may be, partially compensated failures of reforms in transition post-Communist countries. Shadow economy, which has took over a role of the formal one in conditions of crisis enabled some population layers to rescue from famine and mass pauperization. In this group, those particularly "enterprising" persons not only survived, but also became rich enough.

Entrepreneurs seemed it unprofitable to pay huge taxes set by the state. Escaping from taxes and abuse of rent-seeking officers, entrepreneurs graded to informal sector of the economy. Their business could remain in the legal sector should the state offered them other alternative. Transaction cost of the businessmen associated with tax evasion, obtaining licenses and quotas, customs clearance, establishing and running their businesses were much lower, than the cost of law observance. On this background, quite new relations began to emerge among market participants. To H. de Soto (1989), high taxes in legal economy force out small businesses and individual entrepreneurs to the shadow sector of the economy, inducing thereby its further growth.

In conditions of increasing tax pressure big business which have to remain in the legal sector because of its inability to escape to the shadow imperceptibly resorts to another illegal actions corrupting authorities by means of bribes, lobbying and log-rolling.

Sometimes corruption covers political parties and parliament. They all begin to compete not for favor of the ordinary voter, not for the right to represent and champion his/her interests, but for condescension of the authority, which is at the sinecure and allots most lucrative posts and privileges to those who are especially loyal and obliging. It should be noted, that informal sector practically parasitizes on the legal one, competing with them and reducing its efficiency. In an effort to enrich, the informal sector intercepts a part of the taxes at the population. The public budget becomes depleted of this share of taxes. As we already mentioned, the reason for establishing an informal norm in case of tax evasion is the mistakes of fiscal policy. The informal sector behaves as a free rider. It drags the country in chreodic development because it does not bear public costs on a par with the state, however enjoys its services. Probably, to anticipate such phenomena in socium, it is necessary to develop new analytical tools. We propose to measure some "socium development index". The case in

point is estimating the levels of economic, social and political development of various states through some set of parameters, or aggregate parameters. However, it is a challenge for a special research and we do not touch it here.

Now a considerable part of the society in post-Communist nations is in the state of apathy and inertia. It got tired with instability, permanent change of government, fear of losing job, uncertainty about future developments. Mainly it is concentrated on private life. In such a society, any totalitarian regime may be established.

Transition Rent

As it turned out, market institutions in transition economy can perfectly coexist with some old institutions of the command economy. In such an economy various privileges, licenses, quotas etc., which can serve as a source of rent persist. The rent, which in the socialist conditions would come to state budget, now fills the pockets of those who "appeared just in time beside an appropriate valve". A struggle takes place for this rent in transition states. Those spheres of human activity and sectors, where a possibility exists to grab rent become most competitive. They are, first of all, customs service, tax police, law-enforcement agencies, and public service.

The lucrative appointments serve "sinecure" of a sort for those who "holds their hand on distributive valve". They are one of the factors increasing transformation cost that reduces the efficiency of transition.

By and large, such processes represent serious threat to national security, to future of the society and the individual. Therefore, the state in transition economy should be concerned with counteracting those groups of population, who build various artificial barriers (for example, before entrepreneurs) in search of rent. The behavior of economic agents aimed at profit should be supported,

while the activity of those engaged in rent seeking should be suppressed in every possible way.

Path Dependence

The reforms in Hungary, Slovenia, Czech Republic, Poland, and in Baltic countries proceeded more successful and effective, than in other post-Communist states. Historically, the countries of interest experienced greater influence of the West; elements of entrepreneurship always existed there; the population of these countries practically already had western mentality. All the above eventually served as damper of a sort for social environment and allowed to pass the transition with smaller cost (in the sense of impact on human development).

In the mean time, in the former USSR entrepreneurship was considered illegal and prosecuted. However, the underground entrepreneurial business existed. Soviet citizens learned about it from articles published by the official newspaper *Pravda* devoted to scandalous disclosures of businessmen who have organized underground factories for production of fur coats, jeans, and other deficient consumer goods. They were severely sentenced up to capital punishment.

When implementing structural transformation the factor of path dependency was not taken into account. Fast transition of the administrative-command system to the market one was counteracted by historical memory of old institutions. In any society, relics of obsolete institutions of last epochs persist, as a rule, alongside with new institutions. Those may be conservative attitudes at the population, as well as inertia of the social environment. The entrenched old norms, traditions, rules, and customs allowed some groups of population to get the habitual rent. Nobody wished to give up the habitual rent at any circumstances. "Transplantation" of institutions of the Western culture to

other culture of Eurasian mentality required careful actions in order to prevent emergence of institutional incompatibility and tearing away.

The development of a specific institution requires the creation of favorable conditions (protection) for its establishment. This is a field for activity of various non-governmental organizations, volunteers, international sponsoring organizations, democratic organizations, civil society, and citizens proper.

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