TEN YEARS AFTER 'THE ROAD TO A FREE ECONOMY': THE AUTHOR'S SELF-EVALUATION

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Introduction[1]

Ten years have passed since the publication of my book The Road to a Free Economy: Shifting from a Socialist System—the Example of Hungary (referred to hereafter as Road.) It was the first book in the international literature to put forward comprehensive proposals for the post-socialist transition. This paper sets out to assess the book as the author sees it ten years later.[2] Is this not an extremely self-centered undertaking? An advertisement for an old book nobody is buying these days? No, there are good ethical and intellectual reasons for re-assessing the book, and I hope the motivation will become clear in the course of the discussion.

The customary indices of success in the academic world, such as the number of citations, attempt to measure the impact that a work has had on its author's colleagues. Here I could be satisfied. Several hundred references have been made to the book, including, of course, ones by scholars who disagreed with what I said. Authors are gratified also if their work turns out to be controversial.

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[1] I delivered an earlier version of this paper in Stockholm, as the Keynote Address to the Nobel Symposium held on September 11, 1999, marking the tenth anniversary of the beginning of the post-socialist transition. I am grateful to the symposium participants and to Zsuzsa Dániel, Stanislaw Gomulka, Karel Kouba, Mihály Laki, Peter Murrell and Kazimir Poznanski for their stimulating comments and suggestions. I am grateful to Mária Barát, Ágnes Benedict, Andrea Despot, Cecília Hornok and Julianna Parti for their efficient research assistance, and to Brian McLean for his excellent translation.

[2] I deal mainly with Road (1990), but there were a few other public lectures and publications at the beginning of the post-socialist transition that gave me a chance to clarify my views. The Tinbergen Lecture (1992a), delivered in 1991, concerned privatization. The Myrdal Lecture (1993a), which I gave in 1992, was about hardening the budget constraint. I have included these in this retrospective evaluation.

With the work discussed here, this is not a sufficient criterion of success. The book offered policy recommendations, which means that a much more serious question has to be put. What was its impact on the outside world? I am not like a meteorologist, who makes a forecast, but the weather develops of its own accord. When I launched my book, I could expect it to have at least a modest impact on public opinion and political decision-makers, and ultimately, therefore, influence the course of events.

History is not simply shaped by blind forces. It is influenced by conscious people who bear responsibility for their actions. The main historical responsibility falls on political decision-makers, but in addition, in the second rank, stand advisers from the academic world. They too are accountable for what they say.[3]

A heated debate broke out at the beginning of the 1990s on what strategy should be adopted for the transition. I will return to that debate, but let me

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[3] The word 'adviser' in a narrower sense means people whom a government, a state or an international organization, a political party or a movement has officially called upon and invited to advise it. Many economists in the countries of the region and outside them, undertook to do this at the beginning of the post-socialist transition. For my part, I turned down all invitations of that kind.

However, there is a broader, literal meaning to the word 'adviser': people who not only do positive research, but make policy recommendations as well, without anyone commissioning them to do so. As the author of Road (1990), I can count myself an adviser in the broader sense. When I was a young man, just before the 1956 Revolution, I belonged to a working group that made recommendations for reforms. After the defeat of the revolution (and here I quote from the postscript to Road), 'Thirty-three years have gone by in which I have never once undertaken to draw up another comprehensive economic policy proposal.' I concentrated my energies on positive research. My role did not change radically until the first free elections were announced, at which point I realized that 'if some proposals have formed in my mind, this is the moment when I must present them.'

emphasize in advance, not in a combative form. I will contrast my views with those of others, but without pointing a finger at anyone. There is a Hungarian proverb: ‘If not your shirt, don’t put it on.’[4] Perhaps this approach may help to prevent the debate from becoming personal and direct attention to the problems themselves.

The emphasis in this study, as the title shows, is on self-evaluation. I will do all I can to avoid self-justification at any cost, and self-congratulation. I will aim to be self-critical. On the other hand, customary modesty will not deter me from subsequent endorsement of my earlier views, if I feel it is legitimate to date.

How can it be established, after the event, whether the message of the book was right or wrong? It is not enough simply to compare it with the facts. A case where the actual course of events has coincided with my advice could be unfortunate, if my recommendation was mistaken. Alternatively, it could be fortunate that subsequent events did not coincide with my recommendation, if it was mistaken.

Whatever approach is taken to judging the recommendations subsequently, the task is really to assess the events themselves, the actual course of history. That cannot be done without making value judgements. I will refrain from stating here in advance the system of values by which I view the events, which will be revealed step by step. Ultimately, the judge is my own conscience.

The book was written originally for a Hungarian public.[5] It appeared in altogether 16 languages with minor alterations. The foreword to the foreign-language editions contained a warning that the recommendations could not be

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[4] Excellent summary of the debates at that time are provided by Roland (2000), especially Chapters 4 and 10.

[5] The Hungarian edition appeared in 1989, before the country’s first free elections to Parliament.

applied mechanically to other countries. Although I considered that many aspects of them had universal validity, they needed adaptation to each country's conditions. So it seems expedient to concentrate in this lecture mainly on the Hungarian experience, augmenting it occasionally with references to the Polish, Czech and Russian developments.

A full and detailed account would have to cover all 15–20 issues discussed in the book. With hindsight, I see that I was right on many of them but wrong on quite a few. I hope I will have a chance to make a more detailed assessment one day, but in this paper I will confine myself to just two issues.

The first is ownership reform. According to my present beliefs, my recommendations at that time were fundamentally correct. The second is macroeconomic stabilization. Here my report card is mixed. My present view is that I was partly right and partly wrong in the position I took at that time.

Ownership reform and development of the private sector

Road took issue with the basic concept of 'market socialism'. It rejected the idea that the dominance of state ownership should be retained, but connected up with market coordination. My position on this irritated the advocates of market socialism. It incurred the wrath of many reform economists in Eastern Europe and many old-style social democrats in the West.

The book reflected its author's credo, supporting an economic system in which private ownership would dominate. In this respect, the views in the book did not differ from many proposals originating from the West. However, this broad agreement leaves open important questions. Which is the best road to such a system? Once the transition is over, what will the ownership structure of the economy be like? Which formation, of the many possible variants of capitalism based on private ownership, is the one to aim for?

Many ideas arose. This paper sets out two pure strategies in compact form. Most of the detailed, practical proposals came close to one or other of these strategies and confrontation between them lay at the center of the debates.

Strategy A. Retrospectively, I would call this the strategy of organic development. It has five main characteristics.

1. The most important task is to create favorable conditions for bottom-up development of the private sector. The main impetus behind the growth of the private sector is mass de novo entry. This development has to be assisted by several means:

* The barriers to free entry have to be broken down.
* Private ownership has to be guaranteed security. Institutions have to be founded that enforce the fulfillment of private contracts.
* ‘Affirmative action’ applied with the requisite caution is needed to promote the development of the private sector, for instance in tax and credit policy.

2. Most of the companies hitherto in state ownership will have to be privatized. The basic technique for doing so is sale. The state assets have to be sold mainly to outsiders, giving preference to those who are not only paying a fair price for it, but in addition, make a commitment to invest in the company. If the buyer is an insider, a genuine price must still be paid. Insider privatization cannot be allowed to degenerate into a concealed form of give-away.

3. It follows from characteristic No. 2 that any give-away distribution of state property must be avoided.

4. Preference must be given to sales schemes that produce an ownership structure with the following features:

The company has a dominant owner. This may be a business person or a group of owners, or a privately owned company that has already a history of private ownership. The last may be domestically owned or foreign-owned. A particularly desirable type of owner is a strategic investor who is prepared to back the company by giving it a significant injection of new capital.

Where the form of a public limited company is chosen, there is no need to avoid a situation in which some of the shares become dispersed. However, it is desirable every company, where possible, having a ‘core owner’ in the sense just outlined.

5. The budget constraint on companies has to be hardened. This is the key to ensuring the financial discipline essential to operating a market economy. A set of new laws will have to be passed, including bankruptcy law, accounting law and banking law. Following the legislative phase, all these laws should be consistently enforced. The ‘trinity’ of privatization, liberalization and stabilization will not suffice for a successful transition. Hardening the budget constraint has equal importance with these.

State-owned companies that are making chronic losses do not need to be privatized at all costs or sustained artificially for too long. As the budget constraint hardens, it performs a process of natural selection among them. Those that are profitable can be sold, sooner or later. Those that are unsaleable, because they have zero or a negative value, must have bankruptcy proceedings taken against them, not be given away. Privatization through bankruptcy and liquidation is one of the main techniques used for changing ownership.

The private sector’s proportion of gross production will grow on the one hand because new private businesses are appearing, and on the other because the state sector is shrinking. The second process takes place in two ways: state-owned companies may be sold to private owners, or they may go bankrupt and exit.

<u>Strategy B.</u> This I would call retrospectively the <u>strategy of accelerated privatization</u>. It can be described in terms of three characteristics.

1. The most important task is to eliminate state ownership as fast as possible.

2. The main technique for privatization is some form of give-away, for instance a voucher scheme, whereby the property rights in state-owned companies to be privatized are distributed free and equally among the country's citizens.

This approach may be linked with toleration or even encouragement for take-overs by managers. In many cases this turns out to be a pseudo management buy-out, as the managers pay a very low price, which is almost tantamount to receiving the property rights in the company free of charge.

3. There is no need to show any dispreference for dispersed ownership. In fact, it may actually be preferred. What needs to be emphasized is that all citizens will share in the property rights of the formerly state-owned companies, so that 'people's capitalism' develops.

Here there are only three characteristics, not five, as with strategy A. As for the two attributes not mentioned:

Advocates of strategy B also approved of 'bottom-up' private enterprise developing, but they did not give it emphasis in their proposals, whereas it was placed in the forefront of ownership reform by advocates of strategy A.

If the supporters of strategy B had been asked at the time, they would have approved of hardening the budget constraint in principle. They did not press in their writings for the retention of a soft budget constraint, but the requirement of a hard budget constraint became lost in their proposals, and not by chance. They expected that privatization will automatically harden the budget constraint. I will return to this in the context of the Czech and Russian experiences.

The most important difference between the two types of strategy is not the items in each set of characteristics, but which items receive greatest emphasis. Where should political attention, legislative and administrative capacity, intellectual interest and research activity be focused? There is a strong difference between the two strategies in this respect. A emphasizes healthy growth of the new private sector, while B underlines rapid liquidation of the state sector.

Road and other writings of mine that appeared about the same time outlined and recommended strategy A. I was not alone in doing so; quite a few others put forward similar views. Here and throughout the rest of the paper I confine the survey only to the views taken by the Western profession, in the academic world and at the international financial institutions.[6] I would like to underline with high appreciation here the positions taken by Andreff (1992), Bolton and Roland (1992), Brabant (1992), McKinnon (1992), Murrell (1992a, 1992b and 1992c), Murrell and Wang (1993), and Poznanski (1992). However, it was certainly a small minority of Western academic economists who supported a strategy of organic development of the private sector. The vast majority of the profession accepted and popularized the strategy of rapid privatization, often using quite aggressive arguments to do so.

Ten years after, I am reassured that strategy A, promoting organic growth of the private sector, was the correct position to take. Strategy B, a forced rate of privatization, was inferior at best and expressly harmful at worst.[7]

Before presenting comments to the performances of four countries, a brief statistical comparison will provide some background information. There is close causal relation between healthy development of the private sector, hardening of

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[6] Economists working in the post-socialist countries were deeply divided. A highly informative insight into the debate between political parties in Hungary is provided by Laki (2000); that was the political environment in which the first publication of Road appeared. The analysis and ex post evaluation of the debate on the strategy of transition within the post-socialist region would go beyond the limits of this paper.

[7] Dyck (2000, p. 38) shows that most countries with direct sales, and concentrated ownership with openness to outsiders, had growth rates higher than the mean for the post-socialist region. At the same time, countries adopting the voucher scheme with predominantly dispersed ownership had growth rates lower than the mean.

the budget constraint, forceful restructuring of production, and as the ultimate result, the growth of labour productivity. The last of these indicators is more expressive, in the present context, than the figure for per capita GDP, because it sheds a clearer light on the effect of restructuring. The state-socialist system left behind it a legacy of mass unemployment on the job. Strategy A is prepared to dispose of this legacy, even if it means taking painful and unpopular measures. Strategy B shrinks from doing so. Now the labour productivity in Hungary in 1998 was 36 per cent higher than in 1989, while in Poland it was 29 per cent higher. In the Czech Republic it was still only 6 per cent higher than in the last year of socialism. The situation is especially serious in Russia, where labor productivity in 1998 was still 33 per cent lower than in 1989 (Economic Commission for Europe, 1999, pp. 128-131).[8]

Clearly, Hungary has followed strategy A.[9] In terms of all the five characteristics described earlier, the Hungarian transition came closest to following a line of organic development of the private sector.

Not by any means should the Hungarian road be idealized. Many misuses

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[8] The outstanding embodiment of the success of Strategy A is, of course, China. Nevertheless I do not include it in the cross-country comparison. A careful evaluation has to include a comparison of initial conditions and the prevailing political structure, which are vastly different in the post-Soviet and Eastern European regions on the one hand and in China on the other. This analytical task is far beyond the scope of this paper.

[9] It is not possible to say how far Road influenced the Hungarian governments that succeeded each other at four-year intervals. Government politicians do not usually make acknowledgements of their intellectual debts. At the time, the book was hotly debated in Hungary, not only in the specialist press, but also in daily papers and on radio and television. Certainly, many leading politicians and their advisers must have read it.

happened, as they can appear not only with free distribution, but with privatization by sale. Although none of the great corruption scandals came to a head, experts and the public strongly suspect that abuses were not rare.

Nonetheless, the economic achievement is impressive. Hundreds of thousands of new small and medium-sized firms came into being. Tightening of the budget constraint in the first half of the 1990s allowed a process of natural selection to sweep over the corporate sphere. This coincided with a perceptible strengthening of financial discipline. The chains of mutual debt among companies were broken and the standing of private contracts improved. A start was made to consolidating the banking sector. All these developments exercised a strong attraction on foreign capital. The strong inward flow of capital was one of the main factors explaining Hungary's productivity and export performance.

In Poland, occasional statements appeared to flirt with the idea of strategy B, but economic policy in practice remained close to strategy A. A high proportion of Polish economists today recognize that the main explanations for the successes of Polish development, apart from the successful macro stabilization, included the mass of new entries, the vigorous 'bottom-up' growth of the private sector, and the inflow of foreign capital.[10]

At the beginning of the 1990s, the leaders in what became the Czech Republic were the first who wanted to apply strategy B. Václav Klaus, the country's economist prime minister, championed the voucher scheme, arguing for its adoption in the international arena.[11]

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[10] See Dabrowski, Gomulka and Rostowski (2000).

[11] The idea did not originate in the Czech Republic. It had appeared earlier in Poland, in a paper by Lewandowski and Szomburg (1989). Of the Czech program, Klaus wrote in 1992, 'Our nonstandard voucher privatization proved to be rapid and efficient' (1997, p. 72).

The program was applied energetically. Since then, the question of why it did not yield the results expected by its initiators has been the subject of several analyses.[12] In the first phase, the assets were dispersed among millions of voucher owners, just to be concentrated again afterwards in what are known as investment funds. However, the funds lacked the capital strength to develop the backward companies or put in real investment. They were intertwined with the large commercial banks, where the state was dominant or even the sole owner. Such an ownership structure was incapable of building up strong corporate governance. The restructuring dragged on. Despite the strident, Chicago-style free-enterprise rhetoric directed at the outside world, the budget constraint remained soft in reality. Whereas privatization by sale engenders natural selection, the transfer of property rights by give-away distribution conserves the existing structure.

The performance has been disillusioning. Strategy B seems to have been a significant factor behind the problems, although some serious mistakes in macroeconomic policy also contributed to the way the economy has lagged and relapsed.

Perhaps the saddest example of the failure of strategy B is provided by Russia. Here every feature of the strategy appeared in an extreme form: a voucher scheme imposed on the country, coupled with mass manipulated transfers of property into the hands of management and privileged bureaucrats. In this environment a historically unprecedented 'ownership reform' occurred, one in which the ownership of natural resources, especially oil and gas, was expropriated by the 'oligarchs'.[13]

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[12] See Coffee (1996, 1998), Ellerman (1998), Nellis (1999) and OECD (1998, 2000).

[13] For a profound critical analysis of the micro and macro consequences of Russian privatization, see Black, Kraakman and Tarassova (2000) and Filatotchev, Wright and Bleaney (1999). About the barriers of free entry, see Broadman (2000) and Desai and

All these occurrences are closely connected with the survival of the syndrome of the soft budget constraint, in a form where it infiltrates and does even greater damage to every cell of the economy and body politic. Russia has become a 'non-payment society', as a recent study appropriately described it (Pinto et al., 1999). Companies do not pay their suppliers, any more than employers their employees or debtors their lending banks. This is all tolerated by the executive and the judiciary. In fact, the state sets a bad example by often falling behind with the wages and insurance contributions of state employees and with pensions.

What were the intellectual sources for those who advanced the two strategies? It should be remembered that no one came forward with a strict line of thinking or produced a model that drew conclusions from exactly formulated assumptions. The advocates of both strategy A and strategy B blended knowledge drawn from economics with intuition, or it could also be said, with some vision of how capitalism was going to develop and consolidate. So my purpose now, having reread the writings of those times, is not to discover to which authors the footnotes refer. It is more a question of reading between the lines in another way, to work out what ideas inspired the visions. I realize that I am treading on uncertain ground and could well put a false construction on things. Nonetheless, I will try to answer the question.

Let me begin with the easier part of the task, the introspection. Which works and intellectual strands influenced me most as I thought about ownership reform at the end of the 1980s?

One source was the work of Hayek, or more precisely his ideas on the development of the market economy and its opposition to 'constructivism' (Hayek 1969 and 1990). I felt it was grotesque that our Czech colleagues, while referring

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Goldberg (2000).

to Hayek on several occasions, should be sitting at their desks concocting the rules of the game for the voucher scheme and state prescriptions for putting it into practice. Hayek attached enormous importance to the spontaneity of capitalism, to the way it picks out, by evolutionary means, the viable institutions that are capable of survival.

My other intellectual source was Schumpeter—not the Schumpeter of Capitalism, Socialism and Democracy (1929), placing naive hopes in market socialism, but an earlier Schumpeter (1911), identifying the entrepreneur as the central figure of capitalism. Schumpeter's market economy is not a sterile, equilibrium-bound, Walrasian world, but a world of real rivalry, in which live people set about founding new firms, conquering new markets, and introducing new products. I felt that Eastern Europe, after its numbing dose of bureaucracy, needed thousands and tens of thousands of Schumpeterian entrepreneurs. Closely connected with this is Schumpeter's other, oft-quoted idea of creative destruction. This combines in my current of thinking with hardening of the budget constraint and the painful, but essential process of natural selection by the market that ensues from it. A powerful process of exit and entry is the driving engine for reallocating resources from less productive to more productive firms (Caballero and Hammour, 2000, pp.10-11).

A third source is the image of the beginnings, the development and the consolidation of capitalism, formed in my mind from a variety of readings. This includes the French Annales school, the writings of Fernand Braudel and others, which clarify the evolutionary nature of the process, and studies of the commercial laws and financial discipline introduced with a firm hand under early capitalism.[14]

Finally, I was certainly strongly influenced by the study of socialist systems. I

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[14] See primarily Braudel's great summarizing work (1975).

did not use the term "institution" in every second paragraph as it recently has become fashionable to do, but I think I understood what a system means, and what the difference is between socialism and capitalism; and I was sufficiently aware that this difference will not disappear just by privatization, stabilization and liberalization.

What intellectual influences could have worked upon the advocates of strategy B, to produce their vision of how to ‘construct’ capitalism at a rapid pace? It is not sufficient to refer in general terms to the influence of "mainstream economics". Even if the adherents of Strategy B do not refer to them, I am convinced that they were strongly influenced by two authors. One (by an irony of fate indeed) was Marx and the other was Coase. I concede that they make strange bedfellows.

Sophisticated Marxists would call what strategy B adopted ‘vulgar Marxism’. I might add that what it took over from Coase is ‘vulgar Coase-ism’ as well.

Vulgar Marxism in this context means a simplified formula: the change of ownership is not just a necessary condition of capitalism, but a sufficient one. Capitalist property relations form the base that goes on to create its own superstructure: the institutions, political organization and ideology required to operate the capitalist base.

The real course of history showed earlier and the post-socialist transition confirmed that the relation of base and superstructure is far more complicated than that. The mere existence of capitalist property relations is not a sufficient condition for the consolidation of capitalism. Transformation of the economy and society in their various spheres often proceeds in parallel, with many types of interaction occurring. Now one sphere advances and now another, reacting on the first. There is no universal rule governing the sequence in which the interactions occur. If a drastic reform of ownership should happen, in one place, to precede the transformation of political, legal and cultural institutions, the latter may only follow very slowly and painfully, at grave social cost. So, even if it is feasible under certain conditions, it is not certain that having a rapid and drastic ownership reform before the transformation of the auxiliary institutions is the most beneficial sequence.

I would express the simplified formula of vulgar Coase-ism like this. It does not matter if the initial allocation of legal entitlements is inefficient. An efficient allocation will ultimately appear.

This statement is imbued with the optimism of Voltaire’s Pangloss. I think Coase, if he had taken part in this debate, would have added three warnings to the second sentence of the formula (Coase 1960). An efficient allocation will appear provided:

* the exchange is on a perfectly competitive market,
* the exchange is free, there are no barriers to recontracting, and
* the recontracting involves no transaction costs, or at least, the costs are very low.

But what is the situation if these conditions fail to apply? In fact, this is the case with the post-socialist transition: there are serious problems with these conditions. The renegotiation and recontracting of the allocation of property rights may be blocked by interest groups with enormous power (as they have been in Russia.) It is no less worth considering that appalling social costs appear in the reallocation period, which is accompanied by suffering and victims.

Let us return to the arguments heard in the debate.

1. The advocates of strategy B were eager to cite ethical considerations. Every citizen must be given an equal share of the former property of the state for reasons of fairness.[15] Experience has proved conclusively that this is a hypocritical

[15] The majority of the Russian public looked on the vouchers with suspicion from the

argument. The initial allocation remained for a very short period, before it gave way to a high degree of concentration of the ownership of the former property of the state. In the case of Russia, it obviously led to an absurd, perverse and extremely unfair form of oligarchic capitalism developing.[16]

The sale of state assets, if it takes place at a correct price, does not alter the distribution of wealth or income. The wealth of the state is not reduced; it simply changes form. Revenue from privatization has to be invested usefully, not consumed. Hungary managed to employ its receipts to reduce foreign debt, at least during the big wave of privatization, when much of the energy and telecommunications sectors were sold. The consequent reduction in interest payments and marked improvement in the country's credit rating brought real benefits for all the country's citizens.

2. Great emphasis was placed on the sociological aspect in the line of argument pursued by the advocates of organic development. The process of embourgeoisement of society, with the development of a property-owning class, is essential to the consolidation of capitalism. It is well known that at a certain stage in the maturity of capitalism, a great role is played by the fragmented ownership of shares, coupled with institutional ownership. However, there can be no running ahead, no attack without strong rear-guard. The appearance of institutional investors cannot substitute for a radical transformation in the stratification of society.

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outset and did not expect them to bring an appreciable improvement in their financial position. (See Blasi, Kroumova and Kruse, 1997, pp. 76–7.)

[16] From the ethical viewpoint, I am not claiming that privatization by sale, as opposed to give-away, is necessarily 'clean'. I mentioned earlier in connection with Hungary that there were presumably several shady transactions. All I seek to do here is to refute the argument that free distribution, by its nature, is 'fair'.

This argument was confirmed by the first decade of post-socialism. There is a close correlation between the measures of economic success and the restratification of society.

3. The arguments that most appealed to economists concerned economic efficiency. This field has demonstrated the superiority of strategy A the most convincingly. It has been shown that de novo private companies are generally more productive than those that remain in state ownership or those that were formerly in state ownership and privatized during the transition (Konings, Lehmann and Schaffer 1996; Konings 1997). Experience supports the proposition that diffuse ownership and the preservation of the soft budget constraint is retarding the increase of productivity (Djankov and Murrell 2000). The Schumpeterian spirit of enterprise, sweeping aside inefficient, non-viable companies, new, real owners intent on establishing order, foreign capital glad to make large, modern investments—these together boosted the growth of productivity and enhancement of export performance.

4. Finally, there are the political arguments. There is no disputing today that the voucher program and the postponement of painful restructuring were crucial to the victory of the governing party in the second free Czech elections. That was the single case in the Eastern European region in the last decade in which the same government continued for a second term. By that yardstick, the privatization campaign was a success.[17] By contrast, the coalitions that ruled in the first parliamentary cycle in Hungary and Poland fell at the second general elections. The rival coalitions that took office pursued basically the same strategy A as their predecessors. Four years later, after abstaining from using a give-away privatization as an election weapon, they suffered defeat in their turn. So strategy

[17] On the other hand, the same government fell two years later, in the middle of the

B proved more favorable according to the Machiavellian criterion of retaining power.

The advocates of strategy B everywhere, and especially in Russia, cited repeatedly the argument that if the 'window of opportunity' opens for privatization, the opportunity has to be seized and the privatization carried out <u>rapidly</u>. It has to be done while the state bureaucracy is still in a confused, weak state and unable to resist. While that is still the case, the change in ownership relations has to be made irreversible, lest there never be another chance of doing so.

This argument can be neither confirmed nor denied by purely logical, speculative means. No contrafactual scenario can be defended sufficiently. Although it is clear retrospectively that Czech democracy, for instance, was not under any threat of communist restoration or a reappearance of Soviet tanks, it has to be admitted that the matter was not so clear in 1991.

Reassessing the Russian events is especially problematic from this point of view. The following line of argument has been constantly heard. The mass privatization had to be carried out swiftly before the communist party gained its electoral victory. No kind of privatization could have been pushed through the Duma once the communist party had become the tone-setter there.

I think there is a faulty, upside-down causal explanation behind this argument. If the privatization had taken another course, without so many glaring abuses and vain social losses being associated with it, there would not be such strong nostalgia in Russia for the communist system. An ownership reform thrust on society may bring irreversibility. Nonetheless, a more solid foundation for an irreversible advance of capitalism would be provided if a broad bourgeoisie

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parliamentary cycle, not least because of economic-policy mistakes it had made.

developed, property rights and private contracts applied consistently, democracy were institutionalized, and the market economy enjoyed political support from the majority of voters.

Macroeconomic stability

When I was preparing this study, I took up Road again and felt satisfied as I read the chapter on privatization right through. I cannot say the same about the chapter on stabilization. If some miraculous time machine could take me back to that time (with my thoughts as they are today), I would rewrite the chapter before sending it to the press. The chapter dealt with several questions, of which I will pick out three here.

The timing. When I wrote the book in 1989, the Hungarian economy was suffering from a series of severe macroeconomic problems, which required strong correction. It was clear that the adjustment would be painful, and the question arose as to when it should be done. My book recommended doing it straight away, in the next one or two years. That recommendation was repeated not long afterwards in the Czech, Polish and Russian editions of the book and in several other foreign editions. The main argument was that a new chapter of history was being opened. At that precise moment, a freely elected government would have the moral legitimacy to call upon the public to make a sacrifice. It would still be possible to claim that the government was trying to remedy the previous regime's worst omissions (and it might be added, those that could be corrected most swiftly). In case of postponement, people would feel, justifiably or unjustifiably, that the troubles had been caused by the shortcomings of the democratically elected government, not the previous system.

I still think this position is a correct one. A dramatic step of this kind was taken in Poland, with the Balcerowicz program of 1990. In the first chapter of this paper, I criticized the Czech government several times, but here I would like to pay tribute to the Klaus government for the boldness of the drastic measures of adjustment to its macro policy that it took in 1991.

As a Hungarian citizen, I sincerely regret that the government of my country rejected that proposal and the opposition at the time did not press for its acceptance either. Their decisions depended on political will, not the objective economic conditions. The leading political forces were afraid to take unpopular action. Adjustment was postponed for several years, through the whole of the first four-year Parliament until eight months into the second. It was eventually taken in 1995, when Hungary came close to a financial collapse, in the wake of the Mexican crisis. Considered advice was not sufficient. It took 'catastrophe signals', at the frantic, last but one minute, before the government could bring itself to take corrective measures to <u>avert</u> the crisis.

Most experts agree that this postponed adjustment cost more than it would have done if it had been implemented earlier. No one should be lulled into thinking that such a decision is taken in a purely rational, economic context. There is an ethical and political dilemma posed here. It is a question of the inter-temporal distribution of pain and gain, and concurrently, acceptance of the political price of unpopular measures.

<u>The predictions.</u> The proposals I made rested on definite forecasts of the macro consequences of the post-socialist transition. My prognosis was wrong. I did not predict the deep recession that followed; I was too optimistic in my expectations of future growth. I have to recognize that many colleagues of mine in Hungary and abroad made predictions that were more realistic.

I can fault myself because I really had available to me the information on which I could have made a better forecast. For instance, I could have read more carefully at least my own book, <u>The Socialist System</u> (1992b), which might have initiated in me the following line of thinking:

The socialist system left as a legacy a badly distorted structure of input and output. Correcting this called for creative destruction. However, while destruction is rapid, creation goes much more slowly, so that the balance of the two processes in itself implied that there would be a deep recession.

The socialist system established a special mechanism for coordinating activities. Although this mechanism operated at a low level of efficiency and went wrong in the end, it did at least operate. With the change of system, the old mechanism broke down, but the new market mechanism had not yet managed to take over all the tasks of coordination. In the study I wrote later on the transformational recession (1993b), I called this situation an institutional no-man's land and disruption.[18]

These changes, along with several other factors, led to the region suffering the deepest recession in international economic history. The classic recipes for macroeconomic stabilization had to be altered and augmented before any program of adjustment and transformation could be really successful.

What action at one stroke can achieve. My book recommended that a radical program of action should be taken at one stroke. As I assess that advice retrospectively, I will try to consider both the Hungarian case and the experience in other countries.

Even today, I do not reject the notion of a radical adjustment package, in which several measures are taken simultaneously. A well-compiled package of correctly calibrated measures is capable of restoring the equilibrium in several important dimensions of the macroeconomy at once, or at least bringing the economic state

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[18] Olivier Blanchard (1997), analyzing this phenomenon on a theoretical plane, termed it 'disorganization'.

much closer to a tolerable degree of disequilibrium (for instance, reducing the deficit on the current account or the budget deficit to a sustainable level).

What I criticize in that proposal today is its misplaced emphasis. Too much attention went to what could be achieved rapidly with a drastic adjustment package and too little to how to consolidate this quick fix and produce a further, lasting improvement.

It is hard to achieve economic equilibrium, but very easy to lose it again. It seemed time and again, in Hungary, Poland, the Czech Republic and Russia, as if the macroeconomy was on the right track again. Then came another jolt: deceleration or even an absolute deterioration in certain indicators. For growth to be sustainable, there has to be not just one macroeconomic intervention, but a deep, comprehensive program of institutional reforms.

My work dealt adequately with everything connected, directly or indirectly, with the budget constraint, but I cannot acquit myself of a mistake many people made, of not pointing sufficiently to the importance of other reforms. It is easy to improve the budget balance rapidly, at a single stroke, for instance by raising the rates of existing taxes. But a lasting improvement needs radical tax reforms, a broader tax base, the introduction of new taxes, and a consistent system of tax collection. And that is only one side, perhaps the easier side of fiscal reform. The other means reducing state expenditure, which involves reorganizing the state apparatus and the financing of education, health care and other welfare systems. It is relatively easy to declare that the currency is convertible. It takes much harder work to organize an effective system of international payments, to develop well-oiled connections between the domestic and international banking systems, and to guarantee that international payment agreements will be observed.

It is not the task of this paper to analyze in detail which features of the Gajdar package of 1992 were favorable and which were unfavorable. However, I can say this much: the problem was not that the Gajdar government sought to end the slide towards hyperinflation by taking drastic measures. The trouble (not the only trouble, but the main one) was that no institutional system for consolidating the macro equilibrium was ever built, either before or afterwards.

Macro stabilization is not a battle, but an endless war. Stabilization cannot be gained by a Blitzkrieg. Institutional reforms can only be obtained step by step, by a series of larger and smaller blocks of reforms. I see that now. I regret that this idea did not feature in Road.

Conclusion

The polemics of the early 1990s concerned the choice between 'gradualism' and 'shock therapy'. In those days, that was one of the favorite topics of classroom discussion on comparative courses. That was what many students had to write about in their exam papers.

In my view, the question was badly put, and so I am not going to try to answer it. The question itself implies a yardstick: speed. I am convinced that speed, while important, is not the primary measure of success. In those days, many participants in the post-socialist transformation suffered from an obsession with speed.[19] The Czech Republic was warmly congratulated on being the first to complete the privatization of the bulk of the economy. Hungary's private sector was not making an equivalent contribution until two years later and Poland's not until perhaps

[19] Anatoly Chubais, the leading figure in Russian privatization, gave a lecture to the Carnegie Endowment in Washington DC, on May 17, 1999. Let me quote from the report issued by the inviting institution: 'Asked about his role as privatization minister from 1992 to 1994, Chubais conceded that his privatization efforts could be characterized as "Bolshevik-style"—lacking public support and quickly executed... His strategy was to privatize as quickly as possible, using every minute of the day to privatize: "I did not speak, I privatized," Chubais proclaimed.'

three years later. But so what? The transformation of society is not a horse race. The main indicator of success is not who passes the winning post first.

Excessive emphasis on speed leads to impatience, aggressiveness and arrogance. ‘We can do everything we want.’ It sounds ironic, but the truth is that the expression ‘mass privatization’, used as a synonym for give-away and voucher schemes, is the inverse of the ‘mass collectivization’ familiar from the history of Stalinism. Stalin did not want to spend long bothering with voluntary collectivization. Using brutal, merciless violence, he imposed collective ownership on the peasantry within two or three years. I do not want to exaggerate the comparison. Luckily, no gulags were required and no brutality in the 1990s. The forcing of the change was done by milder means. Nonetheless, there were similarities: the subordination of the ownership reform to political and power purposes, the horror of gradual change, the impatience, and the obsession with speed.

The transition from socialism to capitalism has to be an organic development. It cannot be done otherwise. It is a curious amalgam of revolution and evolution. It is a trial-and-error process, which retains or liquidates old institutions, and tries out, accepts or rejects new ones. Each element in the process might be very rapid, fairly rapid or slow. Each has its own appropriate speed. Some episodes call for a one-stroke intervention. Many other processes advance by incremental changes.

There are more important criteria than speed. I start from the conviction (not the assumption, but the conviction) that the capitalist system is superior to the socialist system. From that, it follows that the firmer capitalism’s foundations are, the better the medium and long-term performance of the system will be. So the emphasis has to be placed on consolidation and stability, and at the same time, on sustainability of growth, not on breaking records with it.

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