

Systems Research Institute, Polish Academy of Sciences

Preprints

# ***TRANSITION TO ADVANCED MARKET ECONOMIES***



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# SESSION 1

## TRANSITION TO FREE MARKET: DILEMMAS AND SOLUTIONS

### Part 1A



## TRANSITION TO FREE MARKETS: THE DILEMMA OF BEING AND BECOMING

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There is still time, even though there is very little of it. Economic reform must be decentralized: taken from the hands of the Central State and its bureaucracies, given to the Parliament and worked out locally, according to economic sectors and regions and their long-term development plans. Parliamentary commissions are responsible for coordination of regional, sectorial and local plans: the Central Government, which does not own anything in Central Europe, has to get out of the picture.

The following steps must not be scrambled or violated for any political reasons:

1. Prepare the Constitution, laws and assurances which guarantee, finally and irrevocably, the sanctity of private property, freedom to do business, reliability and enforceability of private agreements and contracts.

2. Remove the responsibility for economic reform from the government and its institutions and transfer it to the Parliament and its Commissions.

3. The decentralized, distributed and locally rooted privatization must be accompanied by vigorous demonopolization.

4. According to the success with privatization and demonopolization in individual industries and regions, there is going to be a phased liberalization of prices and wages in those successfully privatized and demonopolized industries and regions.

5. Proceeds from privatization must stay in the company or in the locality: no proceeds can be siphoned off into Central State emergency and insurance funds.

6. State has no right to sell, close or otherwise tinker with any business. Only the new private owners have such rights.

7. All this reform progress must be continually, reliably and publicly monitored by the Parliament.

The above sequence of steps is plain and simple. It would take some years, but it cannot miss its target: the free market economy. It should be tried very soon if the Central State of the Communists is not to come back rapidly, swiftly and with vengeance.

## THE HERRING BARREL METAPHOR EXTENDED: HOW THINGS CAN EASILY GO WRONG?

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The paper presents a simple but powerful metaphor describing the manner of working of a "line-and-distribute" system of economy, the forces that keep it together, and its inherent features. The causes of unavoidable ineffectiveness of the system are outlined, together with the nature of the main economico-political problems facing the rulers and the functionaries of the system. The paper then goes on to describe the difficulties which appear when trying to "reform", "transform" or "replace" the system. These difficulties can be classified into two groups: those which are common to any quasi-revolutionary situation and those which are specific for the efforts of dealing away with the "line-and-distribute" system. A few hints are offered as to the main mistakes usually made on the way and the obvious traps usually overlooked.

# AN INSTITUTIONAL APPROACH TO COMPARATIVE ADVANTAGE

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A country's comparative advantage in products depends not only on its factor endowments but also on its set of institutions affecting production and distribution. Traditional factor proportions theory explains comparative advantage in terms of the factor endowments of countries and the factor intensities of commodities, under the assumption that technology is the same in all countries. It seems clear that countries differ not only in the overall level of efficiency or total factor productivity, but also in the relative efficiency with which different commodities are produced. Given differences in relative efficiency across commodities, a country may have a comparative disadvantage in a product that makes intensive use of its abundant factors; for example, a country with abundant human capital may lack a comparative advantage in certain human-capital-intensive commodities because of the low level of efficiency in the production or distribution of these commodities.

This paper explains why the relative efficiency of commodities depends on the set of institutions affecting production and distribution in the country. For example, the set of institutions affecting contract compliance will affect the relative efficiency of production of commodities that are particularly dependent on contract compliance. For another example, the set of institutions affecting the protection of intellectual property rights will affect the comparative costs of research-intensive commodities.

The paper sketches some reasons why societies develop different sets of institutions. Institutions can be thought of as sets of convergent expectations about how other people will behave. The expectations converge around different sets of practices and norms in different societies. The paper describes some of the forces that lead societies to evolve toward different equilibria of rule obedience among the citizenry and among government bureaucrats.

# THEORETICAL FOUNDATIONS OF REFORM STRATEGY IN CHINA AND EAST EUROPE

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This paper formulates a theoretical model of transition strategy which is useful for evaluating and understanding the vastly different perspectives of economists and policy makers in East Europe and East Asia, principally China. According to the model, the government's choice of optimal transition strategy is analogous to the decision of the firm in formulating an optimal investment program. While firm invests to raise the expected discounted value of the firm, reform-minded governments may undertake reform to raise the expected discounted welfare of their citizens. Analogous to physical investment, economic reform involves three dimension: (a) an underlying technique which maps specific inputs (i.e. reform instruments) to the production (reform) process into output space, where, in the case of reform, output is measured in term of accelerated productivity growth; (b) costs of adjustment, including social disruption as well as conventional adjustment costs associated with rapid investment; and (c) uncertainty relating both to the effectiveness of specific reform initiatives and to the kinds of economic and social arrangements that are desirable at the conclusion of the reform process. This model is completely general and provides a set of principles against which to evaluate the relative merits of strategies of sweeping versus gradual reform.

# THE ROLE OF DOMESTIC MARKET IN CHANGING THE ECONOMICAL CLIMATE OF EAST BLOC TOWARD ADVANCED ECONOMIES

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In the transition of Eastern European countries to free and advanced market economies the role of the domestic market should not be ignored.

The main concern of this paper is to investigate the value of domestic market in the economic growth of Eastern European countries, in their way towards the market economies.

After a short look at domestic economies of Western European countries as the key for their economical success, a general trend of a successful domestic economic is studied. The importance of domestic economies as the first step for speeding up the transitional process toward free and developed market economic has been investigated. Enough attention has been paid to possible solutions for the survival of individual domestic markets in the integration process of EEC.

The impact of fast privatization on domestic economic is another topic of discussion. Both the philosophy and methodology in transition of the undeveloped domestic markets in the EEC to free and active markets have been discussed.

At the end, as a case study the current situation of domestic market in the economy of Bulgaria has been examined and detected problems are proposed accompanied by some possible solutions.

# THE THEORY OF BIG PUSH AND THE ECONOMIC DEVELOPMENT OF EASTERN EUROPE

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Using the framework developed in Murphy, Shleifer und Vishny's article ("Industrialization and the Big Push", JPE, 1989) we will address problems of economic development of Eastern Europe. In the presence of spill over effects we will examine conditions under which simultaneous industrialization will take place even if investment is unprofitable for any firm alone. Regional multipliers and conjectural variation seem to be appropriate tools in explaining the existence of multiple Pareto ranked equilibria.



# TRANSITION TO DEMOCRATIC STATE AND TO ADVANCED MARKET ECONOMY: SYSTEMIC REFORMS

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In the paper I try to show that there is a whole complex of theoretical, methodological political and problems, defining the interconnection reforms in postcommunist countries. The fall of communist and quasi-communist regimes, and political democratization is the most important, but not the only factor of consistent economic reforms.

In the Soviet Union the representatives of both the ruling elite and the democratic groups seem to be united in regarding that in transition from the administrative-command economy to the market system the role of state is - and will be in the foreseeable future - extremely important. The very emergence and effective functioning of full-fledged subjects of market economy under Soviet conditions is possible only as a result of purposeful policy of the state.

Presentation deals with tendencies which manifested themselves in late 80-s - early 90-s in the sphere of functions of state for transforming property relations, ensuring proper selection of targets for economic policy, and construction of a social security system.

Social orientation of reforms is one of the most important factors of reforms and of their success. Here under "social orientation" I mean establishment of "pro-reformist" social coalitions, which are to become moving forces of transition to market economy.

There is also a brief discussion of economic aspects of state organisation in a poly-ethnic state.

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