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THE TRANSITION FROM COMMUNISM TO CAPITALISM

University of Wales Swansea

THE TRANSITION FROM COMMUNISM TO CAPITALISM

Inaugural Lecture

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by

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1. Introduction

When Nikita Kruschev became Soviet president in 1957 he declared that, economically, the Soviet Union would 'bury' the West, and the Sixth Soviet Five-Year Plan boasted that by 1960 the US would be surpassed in output per head. These claims were taken seriously in the West, particularly in view of the Soviet Union's impressive economic growth up to that time and the massive build-up in its military strength. Yet, thirty years later the communist economic system of both the Soviet Union and its East European satellites was crumbling and, now, it is widely agreed that communism was an experiment that was doomed to fail.

In the first part of this lecture I shall consider why the breakdown occurred. I shall then discuss what the transition from communism to capitalism actually involves and I shall look at how economies have performed during the initial years of the transition. I shall also consider some of the mistakes that have been made and what the policy priorities should be in the immediate future. Throughout, I shall concentrate on the former Soviet Union and Eastern Europe, ignoring China.

As a preliminary, I shall briefly describe a highly stylized version of a communist economy.[1] In practice there were organizational differences between the various economies and in the way each evolved over time. But for the issues discussed in the lecture, I believe the differences between the economies were not of fundamental importance.

The basic features of a communist economy are summarized in Table 1. Virtually all firms are owned by the state. On behalf of the state, the planning authorities negotiate with each firm, deciding on how many raw materials and other inputs the firm will receive and what its production target will be. The managers of the firm will be given bonuses according to how well the firm achieves this target. A firm can only undertake a significant investment if the planning authorities approve. Each firm provides its workers with various social benefits (perhaps with housing,

Table 1: Basic Features of a Communist Economy

(1) Firms are owned by the state; their behaviour is governed by the plan, not the market.

(2) Loss-making firms are subsidized; they are never closed down.

(3) The official prices for consumer goods are set very low; this allows bureaucrats to profit from the black market.

(4) In terms of either money or queuing time, households have to pay more than the official prices for goods.

holidays, medical care and so on). An inefficient firm is never closed down. It is kept open both to fulfil the state's obligation to give employment to its workers and because of the importance of the social benefits it provides. Whenever a firm makes a financial loss the state gives it a corresponding subsidy.

State bureaucrats set all wage rates and the official prices for nearly all goods. In practice they tended to set very low official prices for consumer goods: households were actually willing to pay much more for the limited supplies available. The bureaucrats preferred to set low official prices because this gave them an opportunity for gain. Instead of making the entire supply of consumption goods available at official stores for sale to the public, networks of bureaucrats and the producers of goods would buy up a portion of the output themselves, paying the (low) official price. After retaining some goods for their own consumption, they would sell the rest to the public on the black market at the high prices the public was willing to pay. The main explanation for why the bureaucracy set low official prices for consumer goods was not their feeling of comradeship for ordinary households. Rather, it was to create the opportunity to make profits for themselves through the black market.[2]

With substantial amounts of money being made on black markets, inequality of income

was much greater than official statistics showed and communist ideals were being violated. At the same time, with a limited supply of goods reaching official shops and being sold at low prices that everyone could afford, ordinary households were each keen to buy as much as they could in these shops. They therefore spent many hours every week queuing outside those shops where they believed supplies were available. From a social point of view such queuing was a complete waste of time: it was one of the costs of an inefficient system.

2. Communist Economic Decline

Black market profits gave the general population a justifiable cause for resentment and queuing was a huge frustration. But neither of these factors explains why, after decades of muddling through, the communist economic system then began to break down. However, they do provide a partial explanation of why, when the economic breakdown began, the population was so inclined to let the system be overthrown.

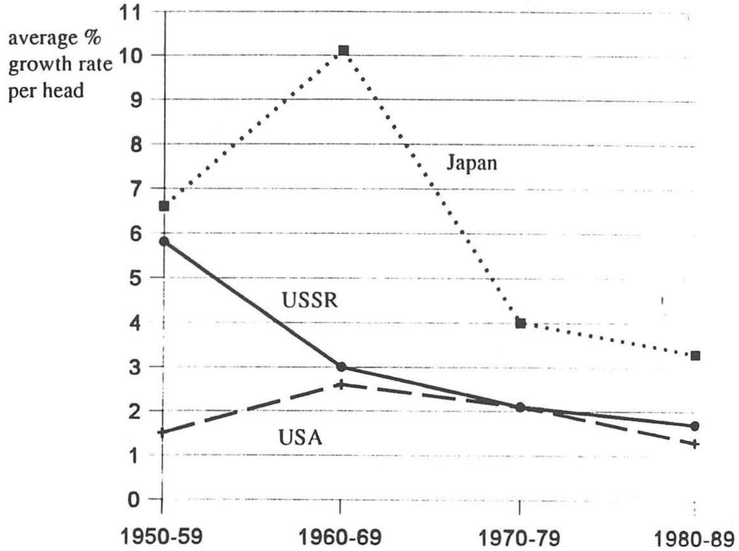
Before examining the main cause of the breakdown it is worth noting two other potential explanations that turn out *not* to be supported by the evidence.[3] Many empirical studies were undertaken of communist production on the assumption of a given technology, i.e., disregarding the question of whether the technology itself was efficient. In this framework, it was found, first, that there was little evidence that communist firms were more wasteful in using the inputs they were allocated than capitalist firms are in using the inputs they buy. It seems that the communist system of bonuses for target achievement worked quite well in this respect. Secondly, turning to the question of how well the planning authorities allocated inputs between firms, there was clear evidence of inefficiency, i.e., of sending inputs to the 'wrong' firms, not to those that could use the inputs to greatest effect. However, this inefficiency should be set against the tendency of capitalism inefficiently to leave a significant proportion of its labour force unemployed.

Admittedly, the evidence indicates that communism was more inefficient than capitalism: it has been calculated that if the USSR had operated at the US level of inefficiency its GNP would have been 2% higher.[4] But this figure does not appear to be so big as to suggest that communism was not a viable economic system. Nor does it explain the recent crisis.

A first step in considering this crisis is to look at how the growth rate of total output per head evolved under communism. For simplicity I shall concentrate on the USSR; a broadly similar performance was achieved by the other communist economies. For any individual year there are wide discrepancies between different estimates of Soviet growth, but when averages are taken over ten-year intervals, the various estimates all tend to show the same pattern. Using the calculations from a recent study, this pattern is illustrated in Figure 1. A steady decline can be seen from the high growth rate of the 1950s, though the growth rate remained above zero, even in the final years of communism.

To put this performance in context it may be compared with that of capitalist economies. In fact most capitalist economies also had declining growth rates over much of this period. As shown in the figure, even Japan suffered a massive fall in its growth rate after the 1950s, though it maintained growth at a relatively high level. More significantly, it can be seen that from the 1960s onwards the US showed a declining trend not greatly different from that for the USSR. Yet despite declining growth in the US and other capitalist economies the virtues of capitalism went virtually unquestioned. It is therefore difficult to see the Soviet data presented in the figure as being clear evidence that communism was doomed. To reveal that there was an underlying problem we must look at how the growth was brought about.

Figure 1: Per Capita Growth Rates 1950-89 for the USSR, Japan and USA



Sources: USSR: Easterly and Fischer (1994), Fischer (1994)
Japan and USA: Gregory and Stuart (1992)

In the years after 1950 the communist economies all invested at a high rate, e.g. the USSR typically devoted in the order of 30% of its GNP to investment. Of capitalist economies, a similar percentage was invested in Japan, but about only half of this percentage in the US.[5] Taking into account the data in Figure 1, we have the following:

	Rate of investment	Rate of growth
Japan	high	high
USA	low	low
USSR	high	low

Although a variety of influences were at work, it is generally agreed that Japan's high rate of investment was one of the significant contributory factors to its high growth rate.[6] Similarly, the low rate of investment in the US was a significant cause of its relatively low growth rate.[7] But in the USSR (as in other communist economies), whereas investment was kept at a 'Japanese-type' rate, growth was only achieved at a 'US-type' rate. In devoting a large proportion of its resources to investment every year the USSR was denying these resources to household consumption. But, at least from the 1960s onwards, there was a continually low payoff from investment. Consumption was continually being sacrificed without much expansion of the productive base in return.

Although the data for Soviet consumption are still the subject of great dispute, a rough guide to what was achieved can be given by using figures calculated by the most distinguished economist in this field. Table 2 shows consumption per head in 1985 in comparison with a selection of capitalist countries. The figures are given as a percentage of the US level.

Table 2: Consumption per head for selected countries, 1985 (% of US level)

US	100	Greece	37
UK	66	Portugal	32
Japan	66	USSR	29

Source: Bergson (1991)

Soviet consumption per head is estimated at 29% of the US level and rather less than half the UK and Japanese levels. It is also less than that for Greece or Portugal. Given the emphasis in Soviet propaganda on matching the West in terms of material well-being, it is clear (even allowing for data inaccuracies) that Soviet economic performance must have been a huge disappointment to its population. A similar conclusion would apply if we looked at figures for other communist economies.

Why was investment so unproductive in the latter years of communism? The standard explanation is that by about 1960 most opportunities for what is known as 'extensive growth' had been used up; diminishing returns to investment therefore set in.[8] To illustrate this argument suppose that investment is in the form of building new factories. If the jobs provided by the operation of the new factories are filled through an expansion of the economy's labour force (e.g. because more creche facilities are made available) then the output produced by the new factories is said to constitute extensive growth. But if the workers have to be drawn from existing factories the output of the existing factories will fall, and this limits the benefit to the economy as a whole of having the new factories built. In this case the growth is not extensive; the economy is in the phase of diminishing returns to investment.

However, the extensive-growth explanation begs the critical question, for Japan and other Asian economies followed a similar high investment strategy to the communist economies, but the diminishing returns they encountered were nowhere near as severe. The question is why diminishing returns were more severe under communism. One possible explanation for the USSR is the heavy burden of military expenditure. But the empirical evidence is unclear, largely because the principle rise in military expenditure as a proportion of GDP occurred well before the 1960s, without any obvious adverse effects on the growth rate. Also, military expenditure was not particularly high in the other communist economies, yet they still suffered the growth slowdown.[9]

The most convincing explanation for communist economic decline relates to the limited ability of a communist economy to innovate, either technologically or in terms of organizational form. This seems to be the fundamental weakness of a communist economy, a weakness that became more serious in latter years.[10]

There are three main reasons why innovation was weaker under communism than under capitalism. First, the planning authorities gave relatively little financial reward for innovation. The managers of a firm might even be penalised if, to institute an innovation, they halted production temporarily, for this could well result in the failure of the firm to achieve its production target for the current period. The poor rewards for innovation were an important factor in practice, though perhaps not a fundamental flaw in the communist system, for it would have been relatively easy for the planning authorities to give bigger rewards. The remaining two reasons for weak innovation are more fundamental in that it is hard to see how they could be resolved without abandoning basic principles of organization of the communist economy.

To see the second reason for weak innovation under communism, note the way in which in a capitalist economy the market operates as a selection mechanism, allowing the growth of firms whose innovations are seen as good ideas and of those firms that are able to imitate these ideas effectively. Other firms decline relatively and may go out of business. The market mechanism is impersonal in sorting the ideas out: nobody knows in advance which ideas it will see as good. In this process a major role is played by new firms, which generate a substantial portion of the ideas that succeed. An important role is also played by the closure of unsuccessful firms, freeing resources for use by others. In communist economies, however, the market was not allowed to be a selection mechanism. The planning authorities decided what firms to set up and, to a large extent, how they should be organized. Once set up, a firm would remain in business indefinitely, regardless of how well it performed. If a firm came up with a new

technological idea that would take a significant investment to implement, it was the planning authorities that decided whether the investment would be made. Without market competition to select the best ideas the communist economies were forced to rely on the guesswork of the planning authorities, and there is overwhelming evidence that this guesswork was ineffective.[11]

The third, related, reason for the relatively poor innovation record under communism concerns the motivation of the decision-makers in individual firms. A major spur to innovation or imitation by an existing capitalist firm is to try and survive in the face of competition. Profits are desirable, but survival is generally the more basic aim. Yet, as already emphasised, poorly performing firms were never closed down under the communist economic system. Innovation was not necessary for survival and so occurred only to a limited extent.

In the Soviet economy a handful of sectors, in particular space and defence, did have good innovation records, but this was because they were given top priority and were pampered with all the resources they required. For the rest of the Soviet economy and for Eastern Europe innovation remained problematic. In the 1950s this did not create great difficulties; but by the 1960s, when diminishing returns threatened, the communist economies could not generate the innovations necessary to hold them off. In contrast, the pace of innovation picked up in capitalist economies and a switch began towards the high-tech industries of today. In the 1980s the communist economies were still growing, but consumption remained low and simple, and there was an increasing awareness of the sophisticated consumption habits of households in capitalist economies. This set the stage for the political revolutions that then took place.

As an aside here, it is interesting to note the irony in what is presumably the Marxian view of these events. According to Marx, when there is a widespread fundamental change in the best methods of production, the social and political system of a country may become obsolete, holding back production - just as feudalism would have held back factory production. Eventually, the social and political system will therefore be overthrown and replaced by a system that is more suited to the new methods of production. Thus, feudalism was replaced by capitalism. In recent decades methods of production in the world have moved on. Among the defining characteristics of the new best-practice techniques are flexibility and the ability continually to innovate. The communist social and political system is entirely unsuited to these techniques; but capitalism is quite appropriate and is the only feasible alternative for the foreseeable future. It seems that Marxian theory would predict the downfall of communism and its replacement by capitalism.

3. Beginning the Transition to Capitalism

On the rebound from communism, all countries fervently embraced the idea of capitalism. But there were no precedents in world economic history for the transition from communism to capitalism and economists had not considered the problem. This meant that in the first years of the transition, policy was being implemented at the same time as, or often before, the principles behind the policy were worked out. There wa soon general agreement on the broad components of the transition, but not on how to achieve them. These components are listed in Table 3.

Table 3: Components of the Transition

(1) microeconomic liberalization

(2) institutional reform

(3) structural reform

(4) macroeconomic stabilization

Microeconomic liberalization, which has generally been the first step, involves the freeing of most prices from controls and the repeal of laws that, at least in theory, prevent various types

of buying and selling. This allows the growth of independent private traders and producers. Initially, the bulk of the economy remains state-owned, but microeconomic liberalization allows state-owned firms to act more independently, in particular to pursue profit, which in practice their members are able to pocket for themselves. But at this stage of the reforms the legal status of the state-owned firms is unclear and for members of these firms there is great uncertainty about the future. This leads them to short-sighted behaviour - failure to replace worn-out machines, a continued lack of interest in innovation, and so on.

To deal with this problem, more deep-rooted *institutional reforms* are necessary, especially to the way firms are owned and run. Consequently vast programmes of privatization have been formulated. The idea of privatization has gained widespread support in transitional economies partly through a desire to try and copy the economic systems of the West and partly because of an urge to free economic (and other aspects) of life from the control of what is generally regarded as the dead hand of the state. A second critical institutional reform is the framing of new laws, e.g. company and contract law, to enable the market system to operate as smoothly as possible.

The third component of the transition, *structural reform*, in theory occurs automatically after microeconomic liberalization and institutional reform have been implemented. It involves changes in the mix of goods produced in the economy. In response to the new set of prices that have evolved in the economy and the new opportunities for buying and selling that have appeared, new firms will be set up and many existing firms can be expected to switch into different lines of production. At the same time, other firms will eventually have to close down, particularly those former state-owned firms that find it difficult to adopt newer technologies.

The fourth component, *macroeconomic stabilization*, is not itself a reform; rather, it involves the control of economy-wide problems generated by the other components. As we shall see, adjustment of economic activity during the transition has in practice been associated with large declines in total output and high rates of inflation. The large declines in output seem to have been inevitable, but the high rates of inflation were, to a great extent, the result of imprudent government policies.

Finally, underlying all four components in Table 3 there are two further issues. One is to construct a safety net to prevent individuals from suffering too badly in the transition. The other is to deal with international aspects of the transition. This is related to structural reform, for the mix of goods that is imported and exported will change. It is also related to macroeconomic stabilization, one element of which is to deal with balance of payments problems.

The components overlap in various ways, but it does not follow that any country should or could accomplish them simultaneously. The country that came nearest to doing this was East Germany, which in 1990 became part of what was formerly West Germany, embracing all West German laws. Even in this case, however, the privatization process extended over several years and structural reform is still taking place. Countries other than East Germany did not have a rich cousin to deal with their problems and so proceeded more slowly. This was a safer strategy as it avoided making too many mistakes at once. Also, since any reform hurts someone, this strategy limited the number of interest groups opposing reform at any time. Its major drawback was that it left many reforms undone during what has been called the 'period of extraordinary politics' at the beginning of the transition when the enthusiasm of the population and its willingness to make short-term sacrifices was at its greatest.

I shall now consider aspects of each component of the transition in turn.

3.1 Microeconomic Liberalization

In late 1989 Poland undertook what is usually called its 'big-bang price liberalization', lifting the bulk of its price controls, and, after some hesitation, the other transitional economies followed. Russia had freed most of its prices by the beginning of 1992. Under capitalism, market prices tend to reflect relative scarcity: when a good is more wanted by consumers it tends to have a higher price and so firms have more incentive to produce it. By freeing prices the transitional economies not only gained this benefit, but they also eliminated black markets, with their associated corruption, and they ended queuing. Furthermore, the freeing of prices domestically was a step towards exposing firms to world prices and so world competition.

The delay in freeing prices in Russia and several other countries was partly because of mistaken advice given by the IMF, amongst others, which argued that the lifting of the price controls on consumer goods would be inflationary.[12] In practice, serious inflationary problems did occur, but this was not directly *because* of the lifting of price controls. The IMF's advice seems to have been based on the observation that the introduction of a free market would lead to prices greater than the low official prices set under communism. It did not take into account that under communism the costs to consumers of buying goods far exceeded the official prices. Prices on black markets were high, and when goods were bought at official stores the consumer paid not just in terms of money (the official price) but also in terms of queuing time. Allowing for these factors, and calculating a monetary equivalent for the time spent in queues, it can be shown that for most consumers the costs of buying goods under communism are actually greater than the prices that rule when free markets are introduced.[13]

There are two exceptions, i.e. there are two groups of people who suffer directly from the freeing of prices. The first of these is the bureaucrats and black marketeers whose illegal gains under communism were only made possible by the existence of price controls. The second group that is hurt directly are those people who are among the poorest in the population at the time that prices are freed. Under communism these people could well afford to buy goods in official stores because the money prices there were low and, like anyone else, the poor are able to queue. With a free market, queuing disappears, but money prices tend to become unaffordable for the poor.[14] In fact when the Russian government freed prices many local authorities introduced their own price controls for some basic consumption goods, thereby helping the poor. However, this also gave the local bureaucrats a renewed opportunity for personal gain through black markets.

3.2 Privatization

During the 1980s privatization in the UK shifted about 4½% of output from the state to the private sector. In the transitional economies, however, the current privatization programmes are estimated to cover about 75% of output and at least 90% of industrial output.[15] With privatization on this scale it is virtually impossible to find enough buyers willing and able to pay fair prices for firms, i.e. prices that reflect the firms' expected profitabilities. The privatization of 'small' enterprises (primarily shops and other traders) has proceeded relatively smoothly in all countries, with sale either by auction or direct to those already operating the enterprises. But the privatization of 'large' enterprises (primarily industrial firms) has proceeded more slowly. The main exception is East Germany, where the privatization programme has been completed, while extensive privatization has also taken place in the Czech and Slovak Republics and Russia. The methods that have been or will be used in transitional economies are broadly characterized in Table 4.

Table 4: Methods of Privatization for Large Enterprises

(1) Voucher privatization (e.g. Russia, Czech and Slovak Republics, Poland)

(2) Sale to insiders (e.g. Russia, Hungary)

(3) Sale to outsiders (e.g. East Germany)

(4) 'Spontaneous privatization' (e.g. Hungary, Bulgaria)

(5) Restitution (e.g. East Germany, Bulgaria)

(1) With *voucher privatization* the ownership of firms is transferred to the general public. Each person is allocated an equal number of vouchers by the government, either free of charge or for a nominal fee. Shares in firms are then put up for auction, where the bids must be made, not in amounts of money, but in numbers of vouchers. Each person gives up vouchers in return for shares in his or her chosen firms. This method of privatization brings the government (almost) no revenue, but is seen as fair by the general public and so reinforces their support for the overall reform process. Its main drawback is that it does not provide firms with any funds to undertake modernization. A further concern is that with each person acquiring a relatively small number of shares in any given firm there is little incentive for him or her to attend shareholder meetings and vote out management if it is inefficient. The transitional economies have devoted considerable effort to the design of investment funds, which are essentially devices to try and overcome this problem.[16]

(2) With privatization by *sale to insiders*, the state sells the whole or a portion of a firm to its current managers or to a combination of its current managers and workers. As with voucher privatization this does not directly bring any new investment funds into the firm. Also, it tends to entrench the managers in their posts more or less indefinitely. Yet the managers will have acquired their jobs during the communist era and so may well be unsuited to operating the

firm in the new economic environment. These drawbacks were clearly recognized in Russia, but there has nonetheless been widespread sale to insiders because of the political power of the industrial lobby.[17]

(3) *Sale to outsiders* essentially involves a takeover, with the whole or a portion of a firm being bought directly by a new operator. It was hoped that a substantial amount of the sales would be to foreign firms, who would bring in investment funds and modern management techniques. But economic and political uncertainties have kept such foreign participation on a small scale in most transitional economies. The foremost case of sale to outsiders is the East German economy, which was taken over largely by West German firms. Unfortunately, however, many takeovers by West German firms seem to have been motivated not by the desire to build the East German firms into efficient world competitors, but to remove the competitive threat the East German firms might eventually pose to the survival of West German plants.[18]

(4) For the next method, *spontaneous privatization*, governments often turn a blind eye. The insiders in a firm either exploit loopholes in the law to take the firm over free of charge or they simply steal its assets and set up their own firm. This has caused considerable discontent among the general public, but when political debates about privatization policy are deadlocked, as they have been in Hungary, spontaneous privatization at least resolves the uncertainty faced by a firm, allowing it to look to the future.[19]

(5) Finally, with privatization by *restitution* the firm is either returned to the last private owners from the pre-communist era or it is given to their descendants. This leads to virtually endless legal disputes because various people will all claim to be the rightful owners of any given firm.[20] In most cases it is also unfair, for there will generally have been extensive investment in the firm during the 40 or more years of the communist era. The cost of this investment was borne by the population as a whole and so there is a good case for regarding them

as the rightful owners of the firm.

3.3 Structural Reform

An ultimate objective of the reform process is to adapt the mix of outputs in the economy and the techniques of production firms use so as to compete effectively, both at home and abroad, with Western firms. As an indication of the size of this task, it was estimated that at the beginning of the transition between 78 and 93% of East European industry would have been unprofitable if exposed to world competition.[21] The size of these figures also indicates that a policy of *immediate* closure of a significant proportion of inefficient firms would have been socially unacceptable. Instead, nearly all firms have been allowed to try and succeed in the market system. The main policy tool that governments have used to influence the behaviour of firms has been the programme of privatization.

There is now a large body of evidence about how well firms have performed in the transition.[22] Disregarding the special case of East Germany, it is generally found that both privatized and state-owned firms have undertaken some reorganization of their activities, but few have undertaken much reorganization. The reason why privatized and state-owned firms have performed similarly is that the privatization that has so far occurred has been predominantly by voucher and by sale to insiders and so has generally not led to a change in who manages the firms. In other words, privatization has only entailed a change in *ownership*; it has tended not to involve a change in who *controls* the operation of a firm.

However, there is also a third category of firms in transitional economies: the new firms that have been set up by private entrepreneurs since the fall of communism. There is clear evidence that these firms are considerably more efficient, on average, than either state-owned or privatized firms, especially because of their use of smaller-scale, more modern techniques. In several East European countries new firms may be regarded as the leading sector in the transition. In Poland, for example, they already provide over half of all employment and 40% of manufacturing output.[23] Until now, investment in small firms has been financed largely by the owners' personal savings, and supported by tax evasion and theft of assets from the state sector. But further growth of the new firm sector will require additional sources of finance, and these may be difficult to find.

In principle, the finance might come from stock markets, but these have hardly begun to be developed in transitional economies. Alternatively, finance might be provided by the banking sector. Under communism banks would automatically finance any losses made by firms, but since the fall of communism banks, like other enterprises, have been expected to work according to commercial criteria, and many have now been privatized. Nonetheless, their inexperience in a market environment and close ties with their old clients have led them, indiscriminately to continue lending to these clients. As a result, many of the loans they have made are 'nonperforming', i.e. they have been made to firms (state-owned and privatized) that are not in a position to pay the loans back and cannot even afford to pay the interest due. To try and avoid having banks' funds tied up in this way many governments have used public funds to pay off firms' bad debts to banks. The Hungarian government, e.g., has spent the equivalent of $3.2b doing this four times in four years.[24] However, this has added to the government's budget deficit and has given banks the signal that they can continue in their old ways because the government will probably bail them out again.

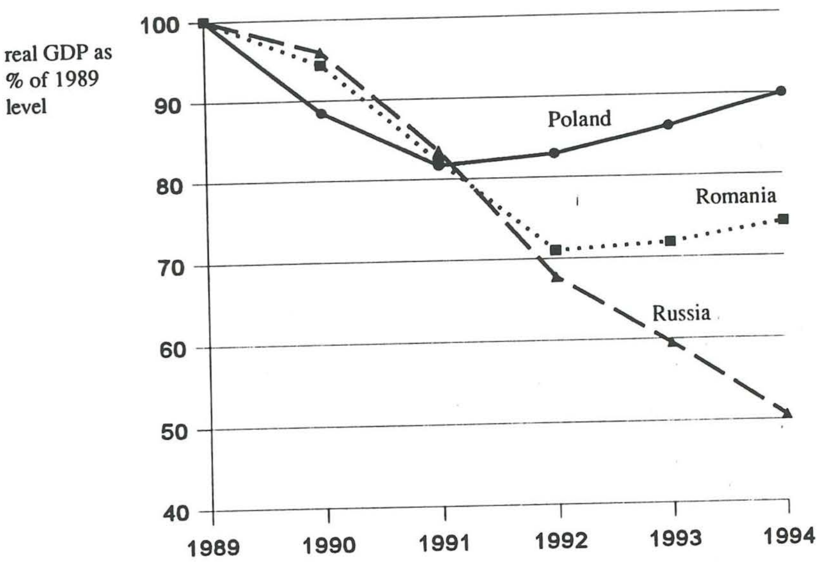
In Russia the new firm sector has not been so successful; its growth seems to have been held back by the rise in crime since the fall of communism. New firms typically have to pay between 15 and 20% of their total turnover as 'protection money'.[25] And crime is particularly pervasive in the Russian banking sector because the legal system does not give banks the ability

to exact payment from debtors, and so banks use gangsters to force payment. (One-third of bank employees are classified as 'security guards'). Given that the Soviet Union had a huge internal security system it might not be difficult to organize a clampdown on crime in Russia today. But it is widely believed that the government is unwilling to do so because members of the government themselves profit from the crime.[26]

3.4 Macroeconomic Stabilization

At the level of the economy as a whole the main feature of the transition has been a large fall in output, though there is controversy about how large the fall has been. Some estimates that have been widely quoted are shown in Figure 2. For each country, output is shown as a percentage of the 1989 level. Of all the transitional economies the smallest fall in output was experienced by Poland, where output is estimated to have dropped by over 18% in 1990-1991. Since then, however, Polish output has risen steadily. In the second country illustrated, Romania, output is estimated to have fallen by 29% in three years, but it too has since been rising, though slowly. Of the main East European economies not shown in the figure, Bulgaria's performance has been about the same as that of Romania, while the performances of Hungary and the Czech and Slovak Republics lie between those for Romania and Poland; in all these countries output is now rising. In contrast, the estimate for Russia is that there has been a calamitous drop in output of nearly 50% and in 1994 the decline was still continuing. However, other estimates put the Russian experience closer to Romania's, with an output fall of 30% and an upturn beginning in 1995.[27]

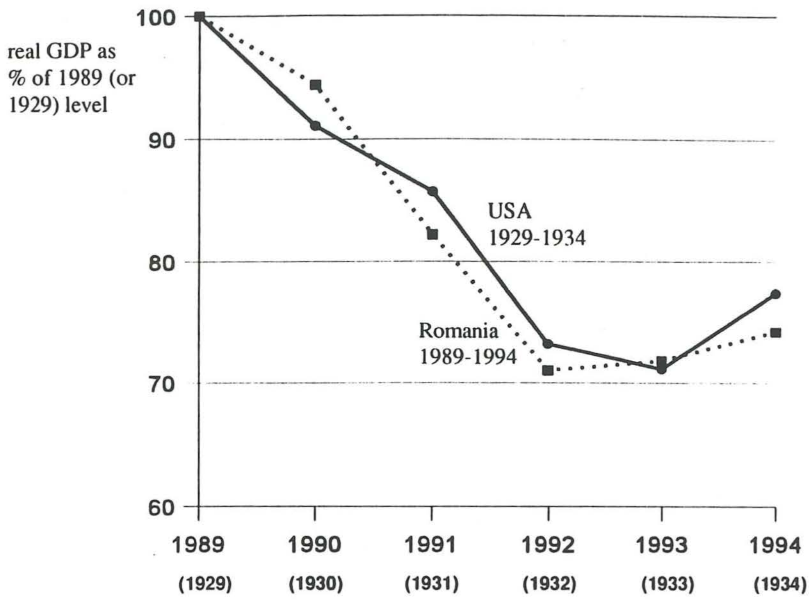
Figure 2: Cumulative Changes in Real GDP (1989=100)



Source: Economics of Transition 3(2) 1995

To put the performance of the transitional economies into perspective, the data in Figure 2 for Romania are reproduced in Figure 3, together with data for the US from 1929-1934, i.e. from the Great Depression. It can be seen that in terms of both the depth of the decline in output and the length of time before the upturn began the recent Romanian experience seems to have been as bad as that of the US. Similarly, depending on which estimate we use, the fall in output in Russia was at least as large as that in the US, and may have been considerably larger.

Figure 3: Cumulative Changes in Real GDP: Romania (1989=100) and USA (1929=100)



Sources: Romania: Economics of Transition 3(2) 1995; USA: Temin (1976)

In the USSR a substantial, but unknown, proportion of output was for military purposes, and in all the communist economies significant quantities of consumer goods were so shoddy that they were left unsold and were eventually just thrown away. Insofar as the output decline during the transition has related to these types of goods, it may not be a matter for concern. Also, the introduction of competition has almost certainly raised the quality of most output, partially compensating for the decline in quantity. However, it was inevitable that large output falls would occur for virtually all types of good because, when the communist system of state direction of the economy was abandoned, it was not *possible* to replace it immediately with a fully-functioning market mechanism.[28] Competition was soon introduced, but competition alone was not enough.

An effective system of contract enforcement and commercial law (including bankruptcy law) was also needed. In the absence of this, people have often been discouraged from buying or selling by the fear of being cheated. Some of the appropriate laws were introduced relatively quickly, especially in Eastern Europe, but it has taken longer to train lawyers to operate the system. Also, governments have been slow to devote resources to policing. Meanwhile, production has been inhibited and financial systems have remained quite undeveloped.

Unemployment has risen in the transitional economies, but not to the extent that might be expected, given the size of the fall in output. At the end of 1994 the average unemployment rate for the six leading East European economies and Russia was 10.5%, less than the average for the European Union.[29] State-owned and privatized firms inherited labour forces that were larger than they needed, but the absence of effective bankruptcy mechanisms has limited the pressure on them to shed labour and has in nearly all cases prevented them from being closed down.

The figures for inflation, however, have been more dramatic. This is illustrated in Table 5, which is based on official government statistics. The first column shows for each country the highest annual rate of inflation recorded in the transition, while the second column shows the most

Table 5: Consumer Price Inflation in the Transition

	highest annual inflation rate (%)	1994 inflation rate (%)
Poland	586	32
Hungary	35	19
Czech Republic	57	10
Slovak Republic	61	14
Bulgaria	334	87
Romania	256	131
Russia	1354	220

Source: Economics of Transition 3 (2) 1995

recent annual inflation rate.

However, the figures in the first column of the table, although often quoted, are highly misleading, for they show the extent to which, when prices were freed, they rose above the *official* prices that ruled at end of the communist era. But, as we have seen, consumers generally paid more than the official price: they either paid the black market price, which was higher, or if they paid the official price they also paid in terms of queuing time. Taking this into account, 'true' rates of inflation were much lower than has been recorded for the year that prices were freed.

Nonetheless, even allowing for this correction, there have been serious inflationary problems, to which governments have generally responded by imposing tough wage controls. In Russia and Poland a major cause of inflation has been the rise in government expenditure.[30] This has been partly because the provision of some social services has shifted from firms to the state sector, but mainly because the governments in these countries have been too willing to grant subsidies to state-owned firms. In Russia these subsidies reached 25% of GDP in 1992.[31] A related factor contributing to inflation has been the undisciplined provision of credit by banks to state-owned and privatized firms. Also, inflation was stimulated by the policy adopted widely at the beginning of the transition of making extremely large devaluations, thereby causing the prices of imports to become very high. However, this has discouraged imports and, as devaluation has generated some exports, the main transitional economies have largely avoided balance of payments problems.[32]

4. Concluding Comments

Although the difficulties of macroeconomic stabilization have attracted much attention, the key economic problem in the transition remains at the level of the individual firm. The theme of the first part of the lecture was that communism broke down because of its limited ability to generate innovations. This was related to the absence of an effective mechanism for closing inefficient firms and opening new ones. Since the fall of communism governments have put their faith in the introduction of competition and programmes of privatization; but they have given insufficient priority to developing the legal framework required for competition to operate effectively. In Russia, at least, this has inhibited the setting up and development of new firms. Also, in all the transitional economies failing firms have been bailed out rather than closed down. In providing financial resources for failing firms, governments and banks have denied these resources to potentially more successful firms, especially new ones.

A potential alternative source of finance is foreign aid. A parallel that is sometimes mentioned is that between the transitional economies today and the economies of Western Europe after World War Two, for whom US aid under the Marshall Plan was instrumental in reviving industry.[33] However, the parallel is not a strong one. Unlike the transitional economies today, the West European economies emerged from the war with their legal systems and property rights intact. Also, Western Europe had largely to *rebuild* what was there before, but the transitional economies are more like depressed regions which have to build industries afresh because their traditional outputs are no longer in demand. The financial resources they need are, by any reasonable measure, many times greater than the amount of aid given under the Marshall Plan.[34] A more cost-effective way of helping the transitional economies would be to give them easier access to European Union markets. There would then be a greater incentive for multinational enterprises to set up plants in the transitional economies in order to sell in the European Union.

Finally, I want to comment briefly on the issue of economic justice, focussing on the case of Russia, where the problems are most acute. The communist era saw extensive privilege and corruption on the part of the ruling élite. During the transition this élite has kept a disproportionate share of wealth and influence, with former bureaucrats and industrial managers staying in their old jobs. The industrial managers have used their influence to extract massive subsidies from the state, thereby fuelling inflation, and the government has then held down workers' wages to try and combat this inflation. Industrial managers have also been involved in the theft of firms' assets and have delayed paying workers' wages for weeks at a time.[35] In conjunction with the economic power of criminal gangs, this has caused great anger amongst the general population. Unless priority is given to ending such abuses and raising the standard of living for ordinary households there may be a political backlash that will threaten the whole reform process. So, although economic justice and the other ideals that inspired the founders of communism were cynically disregarded during the communist era, more attention may now have to be paid to these ideals if the transition to capitalism is to be completed.

Footnotes

1 For an overview of communist economic systems see Kornai (1992). The theory of communist planning is surveyed in Bennett (1989).

2 This argument was first formulated by Shleifer and Vishny (1992). For further information see Boycko (1991).

3 See Murrell (1991) for further discussion of these explanations.

4 Whitesell (1990).

5 See Gregory and Stuart (1992).

6 See Ito (1992).

7 See e.g., Thurow (1992, Ch.9).

8 The extensive growth hypothesis is discussed by Easterly and Fischer (1994).

9 See Easterly and Fischer (1994).

10 In support of this view see Gomulka (1986) and Murrell (1990, 1991).

11 See, e.g., Murrell (1990).

12 See IMF *et al* (1991).

13 See Bennett and Dixon (1995). It was argued by the IMF and others that because (official) prices were low under communism and goods were in short supply, households had accumulated unwanted savings - a 'monetary overhang'. With the introduction of a market system, the argument went, households would spend this monetary overhang, thereby fuelling inflation. This argument turned out to be false (see Bennett and Boycko, 1995, on the theory and Portes, 1994, on the practice). Households have been keen to keep up their saving for precautionary reasons in the uncertain climate. Anyway, the inflation that nonetheless occurred quickly reduced the real value of any monetary overhang that existed.

14 See Bennett (1994).

15 These figures are taken from Estrin (1994).

16 See Estrin (1994).

17 This argument is made by Aslund (1995), among others.

18 See Carlin (1994).

19 See Canning and Hare (1994).

20 Details are given by Sinn and Sinn (1992).

21 Hughes and Hare (1992).

22 A useful summary is provided by Carlin, Van Reenan and Wolfe (1994).

23 Aghion *et al* (1994).

24 Borish, Long and Noel (1995).

25 Aslund (1995).

26 Crime in Russia is discussed extensively by Aslund (1995).

27 *The Economist* October 7th, 1995 describes one recent estimate.

28 A similar argument is made by Schmeidling (1993). On this and other explanations of output decline see Rosati (1994).

29 See OECD (1995).

30 See Gomulka (1994, 1995).

31 Fan and Schaffer (1994).

32 See *Economics of Transition* (3) 2, 1995 and *World Economic Outlook* May 1995. Hungary is an important exception, with a current account trade deficit in 1994 equalling 10% of its GDP.

34 See, for example, Dornbusch *et al* (1994) and *The Economist*, 30.9.95.

35 A calculation for East Germany is given in *The Economist*, 30.9.95. A more general estimate is provided by Gomulka (1994).

36 See *Russian Economic Trends*, 4(1), 1995.

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