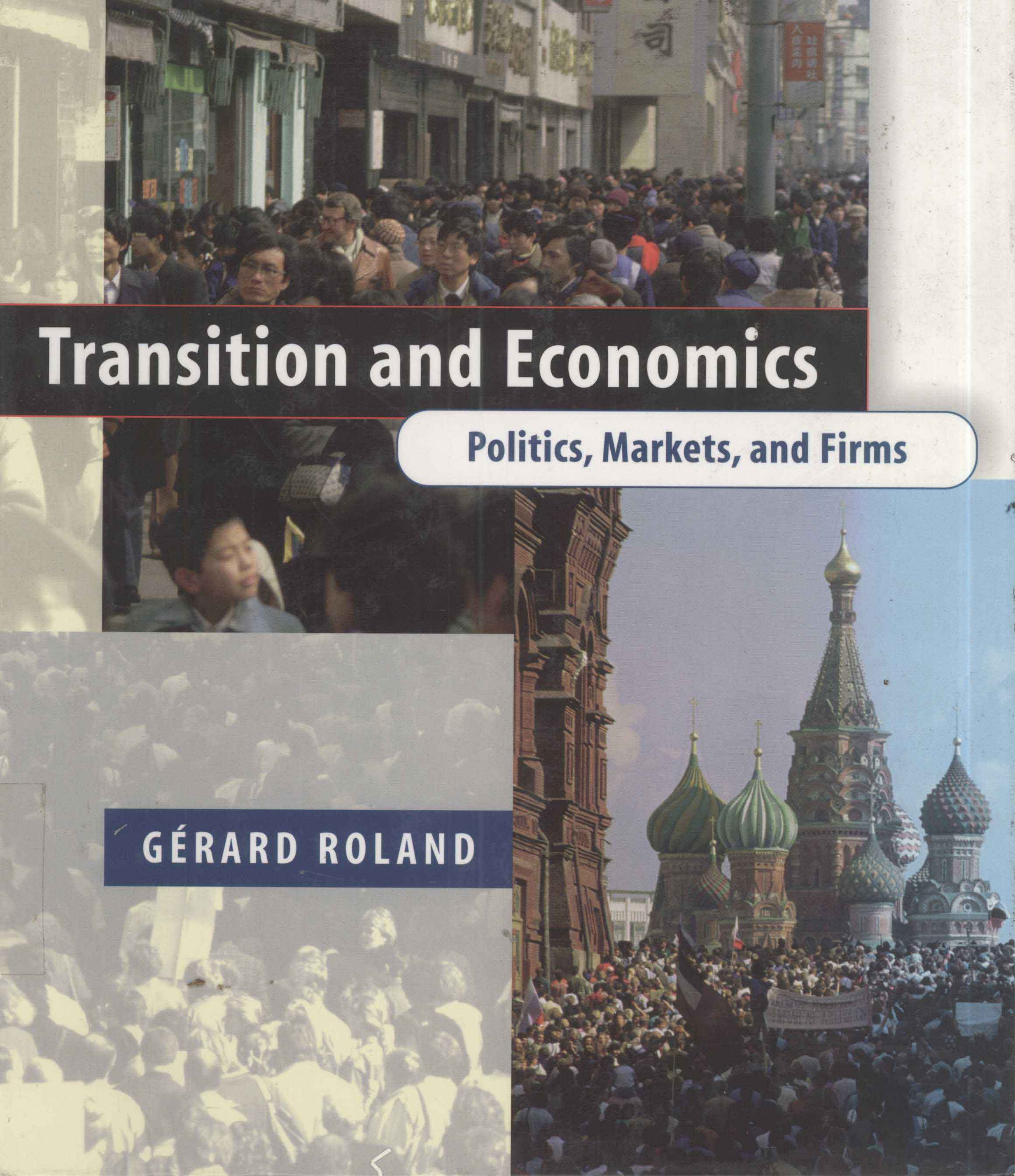

Transition and Economics

Politics, Markets, and Firms

GÉRARD ROLAND

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1. *Toward a Comparative Institutional Economics: The Evolving Diversity of Economic Systems* by Masahiko Aoki (forthcoming Spring 2001)

2. *Transition and Economics: Politics, Markets, and Firms* by Gérard Roland

To Heddy, Elsa, Florence, and Juliette, and to my parents

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Transition and Economics: Politics, Markets, and Firms provides an overview of academic research on the transition processes. It emphasizes the new issues for economics that were raised by transition processes when economists had no ready answers from economic theory. It should be of interest not only for researchers working on transition economies but also for the economics profession at large. The research covered intersects with the fields of political economics, development, public economics, corporate finance, and, more broadly, microeconomics and macroeconomics. It can be used as a graduate textbook on transition, and most of the material can be used in advanced undergraduate courses.

In the academic year 1997–98, I was asked to give full Ph.D. courses on transition in Oslo, Stockholm, Brussels, and Gerzensee. That same year, I was asked to give two shorter courses at the summer schools of the European Economic Association and at Central European University in Budapest. It is out of the notes for those lectures that this book has grown. The invitation to Mathias Dewatripont and myself to write a survey paper on the economics of transition for the 1995 World Congress of the Econometric Society in Tokyo had provided a prior opportunity to think about the structure of the exposition. During the academic year 1998-99, I benefited from a fellowship at the Center for Advanced Studies in Behavioral Sciences at Stanford, where I wrote a first draft. Without that fellowship and the unique environment of the Center, this book would have taken much longer to write.

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Introduction: Transition and Economics

Why Do Research on Economics of Transition?

Since the fall of the Berlin wall in the fall of 1989, a sizable group of economists has been studying the process of transition from socialism to capitalism in former socialist economies. The field is called transition economics, or sometimes transformation economics. This group includes some of the most prominent macroeconomists and microeconomists from the best universities in the world.

Interest in research on transition has grown over time, but the focus of interest has changed. The first wave of interest in transition was mostly dominated by policy papers that attempted to influence various aspects of transition policies. The policy excitement in the West has abated somewhat after the first years. Nevertheless, academic research in the area, both theoretical and empirical, has kept increasing, as witnessed by an impressive flow of publications in academic journals (including top journals), numerous sessions at congresses of the American Economic Association and the European Economic Association, and many specialized conferences. In Europe, the Center for Economic Policy Research (CEPR) has set up a research program in transition economics together with its traditional programs in such areas as international macroeconomics, industrial organization, trade, public policy, finance, and labor. Various economics institutes have been set up with the main objective of undertaking research on the transition process: the William Davidson Institute at the University of Michigan, the Stockholm Institute for Transition Economics (SITE) at the Stockholm School of Economics, LICOS at Katholieke Universiteit Leuven, the Center for Economic Research and Transition (CERT) at Heriot-Watt University in Edinburgh, the Center for Economic Research and Graduate Education–Economics Institute (CERGE-EI) in Prague, the Russian-European Center for Economic Policy (RECEP) and the New Economic School in Moscow, and others.

This growing interest in the transition process within the economics profession can be explained both by its policy importance and by its relevance for economic theory.

The Policy Importance of Transition

The transition process affects the lives of about 1.65 billion people.[1] The comprehensive transformation of the economic institutions of the countries concerned has brought about a complete change in the economic conditions of the population. It is surely one of the most important economic events of the twentieth century, along with the transition from capitalism to socialism and the Great Depression. Economic historians of the future will most probably remember the twentieth century (apart from the tremendous technological progress it has witnessed) for the specific contest that took place between the socialist and the capitalist economic systems, and for the defeat of the former by the latter. It will also surely be remembered for several important failures of the capitalist system, the Great

[1] *This figure should be seen as a lower bound given the likely underestimation of Chinese population statistics.*

Depression being the most important, and for the attempts, successful and unsuccessful, to improve the system or to prevent depressions.

Despite its victory over socialism and its important successes, capitalism has not been introduced successfully everywhere. At the beginning of the third millennium, there still remains the major challenge of bringing about prosperity and growth via well-working market institutions in the poorest (and highly populated) continents, countries, and regions in the world. By introducing capitalism in former socialist economies, the objective, one hopes, is to bring these countries, within an appropriate period of time, to levels of prosperity comparable to those of the most advanced industrialized countries.

Such an objective is by no means assured for countries having undertaken the transition process. Developments in the former Soviet Union, for example, have been increasingly worrying since the beginning of transition. In August 1998, seven years after the failed putsch against Gorbachev that precipitated the end of the communist regime in the former Soviet Union, an unprecedented political crisis, against a background of economic disaster (continued decline in output, high inflation, fall of the ruble, lack of fiscal revenues, proliferation of organized crime, generalized asset diversion, and capital flight), made international stock markets plunge and shiver for several months when fears of an international crisis were looming large. The observed output stagnation, the lack of institutional stability, and the absence of rule of law in transition economies like Russia pose important risks that could lead that big country to prolonged economic stagnation, and even underdevelopment. Devising transition policies that deliver successful capitalist development in former socialist economies is thus an important task.

The results of policy advice given to transition countries have been particularly humbling for economists, to say the least, and remain a subject of controversy. The titles of some books on Russia (*How Russia Became a Market Economy,* Åslund, 1995; *The Coming Russian Boom,* Layard and Parker, 1996; *The Success of Russian Economic Reforms,* Granville, 1995) suggest the exaggerated optimism about Russia that still existed a few years ago. Transition policies have delivered unexpected failures (Russia being one of the most spectacular ones) as well as unexpected successes (China being the best example). The large-scale institutional changes involved in transition are among the most complex economic and social processes one can imagine. Given these complexities and the important stakes at play for hundreds of millions of people, economists cannot claim to know the right answers a priori. Open debates and serious research are of fundamental importance to help formulate adequate policies for a successful transition to capitalism.

The Importance of Transition for Economics

Policy advice, however elaborate, is not delivered in a vacuum. It is based on theory and representations about the way economies and societies function and react to reforms and large-scale transformation. In the beginning of transition, much of the policy advice was derived from basic textbook economics, the so-called Washington consensus, with strong emphasis on (1) liberalizing prices, (2) tight monetary policy and balanced budgets to stabilize the macroeconomy, and (3) privatizing state-owned enterprises in order to induce profit-maximizing behavior. The experience has revealed important shortcomings in that vision of transition. Liberalization mostly did not yield a positive supply response; it led to a major unpredicted fall in output. Organized crime has sprung up faster than markets in some transition countries. Stabilization attempts were stubbornly unsuccessful in various countries, and the soft budget constraints of enterprises have lingered on and taken various forms even when enterprise subsidies were slashed (bad bank loans, tax arrears, barter chains). Mass privatization has often led to massive asset stripping and plundering by incumbent managers.

These various surprises have further contributed to a change of focus in thinking about economics and have very much reinforced the institutionalist perspective, emphasizing the importance of the various institutions underpinning a successful capitalist economy. Successful institutions of capitalism are already present in advanced economies, and we tend to take them for granted when reasoning about economies in transition or about developing economies where such institutions are absent. If anything, the experience of transition shows that policies of liberalization, stabilization, and privatization that are not grounded in adequate institutions may not deliver successful outcomes. Much of this change of focus toward the institutionalist perspective had already been taking place with the development of contract theory, political economy, law and economics, regulation theory, corporate finance, and other areas in applied economic theory. However, the transition experience has helped to accelerate various changes of focus in the way we think about economics. Thus, there is a shift of emphasis from markets and price theory to contracting and the legal, social, and political environment of contracting. Transition has not only helped to reinforce this change of focus in economic thinking. It has also renewed interest in thinking about the interplay and complementarities between the various constitutive institutions of capitalism. Finally, transition has forced us to think about institutions not in a static way but in a dynamic way. To understand transition, one must understand the dynamics of large-scale institutional change: how momentum for reform is created and how institutions can evolve, but also how momentum can be lost and how one can get stuck in inefficient institutions. In that sense, transition has reinforced what I would call the evolutionary-institutionalist perspective, insisting on the institutional environment of agents at any moment in time and also on its evolution.

The word "transition" itself can be misleading in various ways. It may give the impression that transition is "simply" a short-run policy issue that should take a few years at most, analogous to stabilization policy where a new government can make all the hard decisions early in its tenure, then reap the benefits before the end of its mandate and hope to get reelected. In reality, nobody can tell for sure how transitional the transition is or whether the countries engaged in this process will end up transformed into successful capitalist economies. It is useful to draw a parallel here with development. Development policies were formulated decades ago with the objective of helping underdeveloped economies catch up with the industrialized countries. Some countries, like the East Asian tigers, have been successful in their development, but other countries, in particular in Africa, have not been catching up and have even undergone a process of further impoverishment. The transition from socialism to capitalism is a process whereby there is a given coherent set of institutions as starting point. Formulating specific objectives for the end point (like adopting the U.S., Swedish, or German model) is no guarantee that such an end point will be reached, however much one exhorts policymakers to be bold, just as was the case with development. Institutions of other countries cannot so easily be copied or imitated, and attempts at imitation may yield unintended outcomes. These outcomes are strongly dependent on the initial set of institutions that form the starting point of transition. The starting point cannot be neglected because any process of change must take that starting point and the initial economic behavior and expectations of agents as given. This statement implies that there is not necessarily an institutional shortcut whereby institutions of successful capitalist economies are simply copied. Russia copied many successful laws from Anglo-Saxon countries in the domain of corporate governance, but these laws could not be enforced (Black, Kraakman, and Tarassova, 1999; Stiglitz, in press). On the contrary, it may be necessary to devise "transitional institutions" as necessary steps towards more successful institutions. China in its pragmatic reform process developed specific transitional institutions such as dual-track liberalization and township and village enterprises (TVEs) in a far from perfect institutional context where the rule of law is basically absent (Qian, in press). Nevertheless, the question is raised whether "transitional institutions" represent stepping-stones toward better institutions or whether they create vested interests that block further institutional transition.

Seen from the institutional perspective, research on transition can help to improve (1) our understanding of capitalism as an economic system and (2) our understanding of large-scale institutional change.

A Better Understanding of Capitalism as an Economic System

The rise and fall of centrally planned economies probably constitute not only one of the greatest events of the twentieth century but also one of the most important failed economic experiments in human history. Even though it is clear with hindsight that the advent of central planning and its intellectual support were based on a wrong understanding of the costs and benefits of the coordination role of markets and on a strong overestimation of the coordination capacity of hierarchical organizations, the relative role of market coordination and coordination in hierarchies remains a fundamental question in economic theory. Hayek's (1945) vision, more than forty years before the demise of central planning, of the informational limitations of planning and of the capacity of market prices to convey decentralized information has proved truly prophetic. The coordination role of markets and hierarchies has been the object of important advances in formal theory (Weitzman, 1974; see chapter 4 in Milgrom and Roberts, 1992) and in economic history (Chandler, 1962). The question of the boundaries of the firm and the costs and benefits of vertical integration have also been at the forefront of economic theory in recent decades (see, e.g., Williamson, 1975; Grossman and Hart, 1986). Capitalism is composed of markets and organizations that operate within those markets and of complex interactions between both that depend on the constitutive building blocks of capitalism.

Despite the important advances in economic theory of the second half of the twentieth century, we still do not understand well the interactions between the constituent elements of capitalism as an economic system. Thanks to general equilibrium theory, we now understand the interaction between interdependent markets rather well, but we still need to improve our understanding of various other important interactions between systemic elements of capitalism.

The Link between Incentive Structures and Markets What happens in an economy where prices are liberalized but the incentives of enterprises are different from profit maximization (and where enterprises are subject to soft budget constraints, for example)? This question is of direct relevance for transition economies where price liberalization takes place in an environment of state-owned enterprises (SOEs) accustomed to the incentive schemes of the centrally planned economy. The question, however, is also extremely relevant in the context of modern capitalism, where in most big corporations there is separation of ownership and control, a fact that has been the object of scholarly research at least since the 1930s (Berle and Means, 1932). In that context, understanding the incentives of enterprise managers is a key issue, especially since the private interests of managers may differ from those of the shareholders.

Managers operate according to incentive schemes set by the shareholders. Managerial behavior depends on these formal incentives schemes but also on other variables such as the financial situation of the firm (in particular the degree of indebtedness) (Jensen, 1986; Grossman and Hart, 1982; Hart and Moore, 1994), career concerns (Holmström, 1982; Dewatripont, Jewitt, and Tirole, 1999a, 1999b), and other factors. There is thus a relationship between managerial incentives and enterprise decisions or market behavior (see, e.g., Aghion, Dewatripont, and Rey, in press, on the link between managerial incentives and growth). In many sectors of a capitalist economy, private firms coexist with state-owned firms. Not only do state-owned firms pursue different objectives from private firms, but the coexistence of both affects the behavior of private firms as well (see, e.g., Crémer, Marchand, and Thisse, 1989).

The Relation between Property Rights and Incentives Stating that the difference between private and state ownership has a key effect on the incentives of the firm seems a commonsense proposition, but it is by no means an uncontroversial proposition in economic theory. Indeed, why can't one mimic the incentives of private firms inside state-owned enterprises? In the context of transition economies, such an ability would mean that, once communist political regimes collapsed, there would be no urge and even no need to privatize SOEs, since the new democratic promarket governments could set up the appropriate incentive schemes for managers to behave in a profit-maximizing way. Needless to say, this position met with a lot of skepticism in transition countries. However, it is also fair to say that few logically convincing reasons were put forward to explain why the incentives of private firms cannot be mimicked inside SOEs. If this is the case, what then are the irreducible differences between them?

Until very recently, the role of ownership played no role whatsoever in economic theory. According to general equilibrium theory, there is no difference between private and state-owned firms as long as they maximize profits. *Mutatis mutandis*, there is no difference between capitalism and market socialism as long as markets are perfectly competitive. Most incentive theory is done in the context of complete contracts. With complete contracts, ownership is not a relevant issue, since the same incentive schemes can be applied in a private or a state-owned firm. Provided all the other conditions facing the firm are the same, economic behavior should be the same and should not depend on ownership per se.

It is only with the introduction of incomplete contract theory (Grossman and Hart, 1986; Hart and Moore, 1990; Hart, 1996) that the role of ownership has started to play a central role in economic theory. If contracts are incomplete, ownership gives residual rights of control that will affect enterprise decisions. Finding theoretical foundations to explain why contracts are incomplete is currently an important challenge for economic theory and the object of many research efforts among economic theorists (see, e.g., Maskin and Tirole, 1999; Segal, 1999; Hart and Moore, 1998).

The Relation between Legal Arrangements and Social Norms Are legal arrangements necessary to guarantee given norms of behavior? Are legal arrangements sufficient to guarantee given norms of behavior? Are legal arrangements and social norms substitutes or complements? These are important questions for an understanding of social systems.

More specifically, will laws be enforced against social norms? Can existing legal codes be introduced overnight, as has been argued by various policy advisers in the transition context? As stated earlier, the transition experience has raised considerable doubt about such a proposition. More generally, the question is raised of why law is enforced in some countries and not in others. This is also a very important question.

Important scholarly work has shown that the introduction of the rule of law—in particular, of credible legal guarantees against predation of private property rights by the sovereign—played a fundamental role in explaining the early and successful development of capitalism in England (North and Weingast, 1989; North, 1990). In contrast, in continental Europe such legal guarantees were absent, and there were no real limits to royal despotism. These conclusions have been implicitly challenged by Weitzman and Xu (1993), who, in the context of transition in China, have pointed to the fact that, despite the absence of clear legal arrangements, economic development in the Chinese countryside has been extremely successful, even spectacular, with the phenomenon of township and village enterprises. This Chinese puzzle raises questions with respect to the relative role of social and cultural norms, on one hand, and legal norms, on the other hand, in the establishment of a successful capitalist system. Weitzman and Xu emphasize the role of cultural norms and advance the hypothesis that Western individualism requires solid legal arrangements to foster cooperation, whereas Asian values, which are more collectivist, can rely more on the reputational effects associated with social norms.

Clearly, much research is still required on these issues to better understand the role of culture and social norms in economic development.

The Relations between Government and Economic Agents In any capitalist economy, government activity is deemed indispensable, even though there has always been a lot of controversy as to what its size relative to the private sector should be. Governments generally have a monopoly over the use of violence that they use to enforce laws. On the one hand, government power, everywhere and always, creates the scope for possible abuses of power. From the economic point of view, such power can be used to prey on the private sector and on economic agents. On the other hand, anarchy, or the absence of government, destroys legal guarantees for the protection of private property and paves the way for unbridled organized crime and racketeering, violent competition between competing Mafias, and general insecurity of property rights. In order to have successful growth and development, the dilemma, as stated by B. Weingast (1997) is to have a government that is not too strong, so as to make credible the absence of predation on private agents, but that is still strong enough to enforce the rule of law.

These questions are of immediate and practical relevance in the transition context. When transition starts with inherited communist government structures, as in the case of China, the Soviet Union during the Gorbachev years, or reformist Hungary, private sector development is hampered by fears of predatory taxation or of policy reversals that will lead to the spoliation of private economic agents. These fears were not unfounded, since private enterprise was never officially tolerated and had to be called by other names, such as "cooperatives" in the Soviet Union. At the other extreme, with the collapse of communist regimes, especially in the former Soviet Union, government structures usually also quasi-collapsed, leading to absence of law enforcement and to the emergence of Mafias.

Weak governments not only allow the emergence of organized crime, but they may also divert the efforts of economic agents from productive activity to rent-seeking activities, especially under initial conditions where markets are repressed. This will be the case in particular if the return to influence activities and rent-seeking behavior is higher than the return to productive activities. The question is then, What institutional conditions and what forms of organization of government are needed in order to encourage productive rather than rent-seeking activity?

The Relations between the Political System and Economic Interest Groups The relationship between political systems and economic interest groups is a very important topic that has been the subject of important research in the field of political economy, now more and more often called political economics. What is the sustainability of given legal and economic arrangements under various political systems, given the relative strength of interest groups that have an interest either in the continuation or in the reform or reversal of given arrangements? How good are various political systems at getting efficiency-enhancing reforms adopted, and at overcoming the resistance of interest groups who have an interest in the status quo?

These are key questions in the context of transition. One popular question was whether the early introduction of democracy in Central and Eastern Europe, compared to China, which has remained a dictatorship, has made economic reforms more difficult to get through or not, and whether or not it contributed to economic stability. Quite opposite answers have been formulated to that question.

In thinking about various political systems, one must not only distinguish between dictatorship and democracy, but also between the various kinds of dictatorships (see, e.g., Rodrik, 1992) and various kinds of democracies, such as presidential and parliamentary systems (see, e.g., Persson, Roland, and Tabellini, 1997), different electoral systems, and so on.

All these questions pertaining to the understanding of capitalism as an economic system can be seen from a positive as well as from a normative angle. From the positive point of view, we may simply try to understand better the internal mechanics of the capitalist system. The normative angle is never absent, however. Indeed, a better understanding of the capitalist system may help us improve it and adjust institutions in various countries in order to move to more efficient institutions.

Naturally, the preceding questions, though of obvious relevance for transition, are general questions about capitalism as an economic system and are equally relevant in many other contexts. What can be the specific contribution of transition economics?

In transition economies, the constitutive parts of the capitalist system are instituted at various speeds, in different variants, in varying order and different initial conditions. The economic observations from these economies are not generated from a system that is already in steady state but from a system that is emerging. By observing systems that are not yet in steady state, we may better understand the system itself, the interactions between various constitutive parts, and the relative importance of various elements in the system in generating outcomes. In a way, transition can be compared to a controlled experiment where the action of some variables is suppressed to better understand the interaction of other variables. Of course, the transition process is not a conscious experiment in social sciences, and much of the process itself is spontaneous rather than controlled. Nevertheless, the unique historical process of transition generates "out of steady state" observations, reflecting different initial conditions and policies in different countries. Such observations should tell us more about the interaction between the constitutive parts of the capitalist system.

Understanding Large-Scale Institutional Change

Throughout history, economic, social, and political systems have developed, evolved, and died or been replaced by other systems. History has many discontinuities: prolonged periods of slow changes or even stagnation are followed by short periods of very rapid changes, often changes on a very large scale that deeply affect the economic, social, and political spheres alike. These periods of rapid change, which often last less than a generation, sometimes less than ten years, may exert a decisive influence on future periods, even in the very long term. The reign of the first Chinese emperor Qin Shi Huang lasted only eleven years after he unified China (221–210 B.C.), but in those eleven