Getting to Market

Charles Wolf, Jr.
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OVER THE PAST century, economists and other intellectuals have produced an enormous amount of literature on how to convert capitalist market economies into socialist centrally planned ones. Among the better known contributors to it are Sidney and Beatrice Webb, Oskar Lange, Abba Lerner, Joan Robinson, Nicholas Kaldor, Paul Sweezy, Wassily Leontief, and J.K. Galbraith; but there are many, many others.

It is ironic that the reverse problem of converting socialist economies into capitalist ones has received scant attention. The writings of Friedrich Hayek, Joseph Schumpeter, Milton Friedman, and P.T. Bauer are partial exceptions, but their focus has usually been elsewhere: namely, exposing the errors made by the advocates of socialism rather than charting the transformation. Hence, there is no general theory to draw on in addressing the crucial economic policy problem of the 1990s: how to transform command economies into market economies.

Recognition of the failures of command economies and the need to transform them is the reason the rhetoric of "markets" and "marketizing" is fashionable in the 1990s. But the unanimity and ubiquity with which markets are advocated—in the Soviet Union, Eastern Europe, China, and the Third World—obscure the profound divergences about what the terms mean and what they imply for transforming command economies into market-oriented ones. These divergences are latent in such frequently used oxymorons as "market socialism" (a term invented by Hungarian economist Janos Kornai, but subsequently rejected by him), "regulated socialist markets" (a term favored periodically by Gorbachev and certain "conservative" Soviet economists), and what some Chinese leaders envisage as a system between capitalism and socialism which they describe as "socialism with Chinese characteristics."

The underlying disagreements concern the details about transforming command systems into market systems. In this case, as in others, the details are crucial. They relate to whether markets should be "free" or "regulated," competitive or "social"; whether the market's intended reach should be extensive and predominant, or partial and limited; whether transformation should be rapid or gradual; whether the emergent system should be open to international competition, allowing free movement of capital and commodities, or protected from it; and finally, whether the scope of the government sector, at the end of the process, should be extensive, or narrowly circumscribed.

That these divergences are so deep is not surprising. The rhetoric of markets and mar-

Charles Wolf, Jr., is dean of the RAND Corporation's graduate school in Santa Monica, CA and director of RAND's research program in international economics.

ketizing has been adopted by a remarkably diverse group of advocates, including Communists, ex-Communists, erstwhile central planners, Social Democrats, "liberals," and "radicals," and new and aspiring entrepreneurs in the transforming command economies. The advocates also include an ideologically mixed set of experts, advisers, consultants, and commentators in the West, including some—like Jacques Delors, secretary general of the European Community, and Jacques Attali, head of the new Bank for European Reconstruction and Development—who have until recently favored transformation of capitalist economies into socialist ones.

As a result of this diversity of views and viewers, the ensuing policy debate has often been muddled, the essentials of the transformation process frequently misunderstood, and its costs generally exaggerated. Indeed, transforming command economies into market ones, although a challenging problem, is more tractable, and the costs and "pain" of the transition should be considerably less than much of the debate has implied—provided the transformation is pursued comprehensively and aggressively.

**Transformation as a Systems Problem**

The generic problems of transformation are essentially the same whether the locale is the Soviet Union, Eastern Europe, China, or any one of the centrally controlled economies of the Third World. To be sure, there are differences in historical circumstances, cultural affinities, institutional antecedents, and the existing physical, social, and political infrastructures. But the differences, while important, are incidental to an essentially similar task. Transformation depends on implementing simultaneously, or at least contemporaneously, a package of six closely linked and mutually supporting elements:

- Monetary reform to ensure control of the money supply and credit;
- Fiscal control to assure budgetary balance and to limit monetization of a budget deficit if one occurs;
- Price and wage deregulation to link prices and wages to costs and productivity, respectively;
- Privatization, legal protection of property rights, and the break-up of state monopolies to provide for competition as well as worker and management incentives that reflect changes in relative market prices;
- A social "safety net" to protect those who may become unemployed as transformation proceeds; and
- Currency convertibility to link the transforming economy to the world economy and to competition in international markets.

The first two elements (monetary reform and fiscal control) and the fifth (the social safety net) create the broad macroeconomic environment that enables the incentive mechanisms of the other three to move resources toward more efficient and growth-promoting uses. The government's role is both crucial and paradoxical: crucial in initiating all of the elements, yet paradoxical because the process that the government initiates is intended to diminish its ensuing role, displace its overextended functions, and reduce its size in favor of market mechanisms.

Each of the six elements is less likely to be effective without the reciprocal support provided by the others. Hence, attempts to reform non-market economies by piecemeal steps are more likely to founder than to succeed.

Consider, for example, the link between the first two elements. Monetary reform is necessary to limit growth of the money supply to a rate that accords with the growth of real output. It is also a necessary means of providing access to credit on the basis of borrowers' economic capabilities and their associated risks, rather than on the basis of their political connections or credentials. A competent entrepreneur with a good idea should be able to obtain credit not available to someone whose principal distinction is mem-
bership in the governing political party or kinship to a government official.

Fiscal reform requires a budget process that constrains government expenditures to a level close to revenues, and precludes or limits "off-budget" subsidies and other transactions that would disrupt monetary discipline, as well as budgetary balance. Recourse to extra-budgetary subsidies to bail out deficit-ridden state enterprises has been standard practice in the Soviet Union, China, and other command economies. Fiscal and monetary reform should preclude its recurrence. Usually, the complementarity between monetary and fiscal reform is facilitated by institutional separation between the finance ministry (or treasury), and the central bank or banking system.

In turn, the third element—deregulation of prices and wages—requires monetary and fiscal restraint if prices and wages are to be linked to real costs and productivity, while avoiding general inflation. Goods that are in short supply or are costly to produce should experience price increases relative to those that are more abundant and less costly. In turn, these price increases provide signals and incentives for increased and more efficient production. Similarly, wages paid for more productive labor and skills should be expected to rise relative to those that are less productive. The newly established parities among costs and prices should operate in the public sector as well as the private sector.

For deregulation of prices and wages to promote efficient use of resources, the fourth element—privatization, legal protection of property rights, and the break-up of state monopolies into competing entities—must be implemented at the same time. This requires an appropriate legal code and appropriate procedures for resolving disputes over property transactions and acquisitions, as well as litigation associated with prior ownership claims. It also requires a choice among several ways of changing from state ownership to private ownership—an issue about which there is considerable controversy among policy-makers, economists, lawyers, and financiers.

For example, equity shares in state enterprises can be issued to workers and management, while reserving some of the shares for local government and foreign investors (resale of the shares with or without a specified holding period can also be invoked). This method, favored by Paul Craig Roberts among others, has the advantage of simplicity and clarity; its putative disadvantage is the ostensible unfairness of a process in which some of the new shareholders would be losers while others would realize gains, due in both cases to the arbitrary circumstance of where they had been previously employed.

Another mode of privatization is to issue enterprise shares to the general public on a random basis rather than determining enterprise ownership on the basis of employment. In this case, everyone has an equal chance of picking a winner or loser among the hundreds or thousands of state enterprises that typically exist in command economies. Windfall gains that result from a random process are, it can be argued, more equitable than those that result from the accident of prior employment.

Perhaps the simplest method of privatization is to auction enterprises to the highest bidder—limiting or excluding participation by non-nationals. This method, favored by Czech economist (and Finance Minister) Vaclav Klaus and others, has sometimes been criticized on the grounds that those most likely to have ample funds to win the bidding are black marketers and former Communist Party nomenklatura.

Still another method is to issue public vouchers representing potential claims on the shares of enterprises to be privatized. Foreign bankers or mutual fund managers would be invited to bid for the public vouchers. The public would then trade their vouchers in return for shares in the mutual funds that appealed to them. Variants of this method of privatization have been advanced by Jeffrey Sachs and several Polish economists.
All these methods would result in the creation of a resale market for equities and mutual fund shares. Contrary to some of the debate on this issue, none of the methods requires that state enterprises be carefully evaluated before privatization is accomplished. Choosing among the alternative methods does require assessment of their respective advantages (for example, simplicity, comprehensibility, and speed), as well as their disadvantages (for example, distributional unfairness and inequity).

In any event, whichever method or methods of privatization are selected—and experimentation with several is advisable because none is clearly preferable to the others—their success remains linked to the other elements of the transformation package. Unless rewards are tied to asset ownership, and unless such rewards can be accumulated legally, incentives to innovate and to increase productivity will be impaired. Effective supply responses to price and wage deregulation depend on the incentives provided by private ownership and accumulation. Moreover, private ownership is essential for market forces to provide an effective "stick," as well as "carrot." If ownership is in the hands of the state, the discipline imposed by market competition will be attenuated, if not eliminated. When state enterprises are confronted by losses, they typically evade or ignore the threat of bankruptcy that private enterprises would face if confronted by similar losses.

It has sometimes been argued—by Gorbachev, Li Peng, and others both inside and outside the reforming command economies—that privatization is neither necessary nor effective. The argument is that a "culture of envy" has become strongly pervasive and ingrained, especially in the Soviet Union. Since privatization leads to wide gaps between rich and poor, it is said, privatization won't be tolerated, and won't be effective if it is imposed.

This "culture of envy" may be attributable to the long-standing, widespread experience in communist societies that sharp disparities in income and living standards are associated with political favoritism and corruption, rather than with private ownership, innovation, and productivity. Such resentment is not unknown in market economies. Nevertheless, in moving from command to market economies, private ownership plays a crucial role by providing the incentive structure required for markets to function efficiently. Avoiding socially unacceptable disparities in income distribution is a responsibility of public expenditure and tax policies, within the context of private ownership and market competition.

The fifth element—establishment of a social security system as a "safety net"—is also essential for the transformation process to succeed. Without it, the process may create fear of widespread unemployment, social stress, and political instability, thereby seriously impeding the transition.

In most command economies, social protection—against illness, disability, age, and unemployment—has principally been the responsibility of state enterprises. As privatization proceeds, these responsibilities are likely to become one of the principal functions of government, financed by taxation and by payments levied on the insured. In the initial stage of transformation, taxation will probably have to bear most of the burden, although, for reasons to be discussed later, the real incremental burden imposed on the economy by the social safety net is likely to be less than is usually assumed.

The final element—currency convertibility—is essential to complete the transformation process by linking internal markets and their prices, wages, productivities, and technologies to those of international markets. This linkage provides the opportunity for comparative costs and competitive advantage to operate for the benefit of the transforming national economy. With a convertible currency, the transforming economy can determine those goods and services it can produce at relatively low cost compared to the costs of other countries, and
those it produces at relatively high cost. In response to convertibility, exports of the relatively low-cost goods will expand, as will imports of the relatively high-cost ones.

If the other elements of the package—especially monetary and fiscal discipline and market-determined prices—are effectively implemented, currency convertibility with a floating exchange rate can be embarked upon and sustained with minimal hard currency reserves, contrary to a frequent argument about the need for large reserves as a precondition for convertibility. Poland’s establishment of a convertible zloty at the beginning of 1990 was accomplished notwithstanding the country’s net foreign exchange indebtedness of over $50 billion. Although Poland received a foreign exchange stabilization loan of over $1 billion from the United States, none of it was drawn upon in the ensuing year. Instead, with its convertible currency system, Poland accumulated hard currency foreign exchange holdings of over $2 billion in 1990.

The interactions and mutually supporting relationships among the six elements of the transformation process are summarized in Figure 1. The lines indicate the contribution by one element to the effectiveness of another to which the arrowhead points. (For example, monetary and fiscal reform contribute to the effectiveness of price and wage deregulation.)

In sum, the process of transforming command, non-market economies to market ones is both better understood and more tractable than might be inferred from much of the public debate. Transformation is a systems process encompassing the interactive and mutually supporting elements described above. The debate which disputes this systems view argues that one or another of the six elements is not essential, or is of higher priority than other elements, or should precede the others.

For example, as noted earlier, Gorbachev, Li Peng, and some of their “conservative” advisers contend that private ownership of productive assets, including land, is not essential because its incentive effects can be obtained through leases administered by the state. In opposition to this view is the position of American banker Leif Olsen, Soviet economist Nikolai Shmelev, and others, who assert that private ownership in general and privatization of state enterprises in particular are the most fundamental ingredients of economic re-
structuring. Along the same line, Canadian economist Reuven Brenner argues that reform of the legal system, to assure and protect property rights, is the essential precondition for any further reform efforts.

Another stance, associated with economists Gregory Grossman, Igor Birman, and Judy Shelton, emphasizes the primacy of monetary and fiscal reform and, in the Soviet case, substantial reduction of the existing monetary stock—the so-called “ruble overhang”—as an indispensable precondition for preventing the rampant inflation that would otherwise follow price deregulation and other reform measures.

Indeed, I have previously advanced some of these views myself. In earlier writings on the Soviet Union, I suggested that price and wage deregulation, combined with the mandatory conversion of large ruble holdings into long-term, non-tradable bonds to reduce the “ruble overhang,” were necessary and sufficient measures for moving the Soviet economy toward marketization. And in subsequent work in China, I focused on the central importance of currency convertibility in achieving marketization. Now, it seems clear to me that trying to transform a command system into a market system without the synergy provided by all of these elements is like trying to swim with only one arm and leg. To attempt the transformation process on a piecemeal and gradual basis would be—to use another simile—like trying to shift a country’s driving practices from the left side of the road to the right side in stages. The risk of serious accident is manifestly greater than if the change is accomplished all at once.

Some Recent Experiences

Among the command economies that have attempted to transform themselves into market economies, Poland’s efforts have been the most far-reaching. Yet these changes have been incomplete. On the positive side, Poland’s budget deficit has been reduced from approximately 8 percent to about 1 percent of GNP. Monetary discipline has been encouraged by separating the central bank from the treasury. Ninety percent of all prices have been decontrolled and convertibility of the zloty has been maintained at a stable rate since January 1990, with exports increasing, hard currency imports declining, and a resulting trade surplus of over $2 billion.

Though these are significant accomplishments, they are not sufficient. To date, the Poles have only partially privatized, have deferred the break-up of state monopolies, and have delayed the wage reform necessary to create proper incentives for labor and management. Hence, supply responses and sectoral resource reallocations have been inhibited, and output, employment, and inflation have suffered. Still, if one were grading the various country efforts, Poland would receive a strong B.

By contrast, Gorbachev’s faltering attempts to move toward a market economy and to combine the now-defunct Ryzhkov and Shatalin plans would barely rate a D. Thus far, controls remain on the prices of essential consumer goods and basic commodities like oil, gas, lumber, steel, and other key goods and services, such as transportation and communications. Although their “established” or official prices have been raised, the levels and parities among them are still determined by central planners. Gorbachev’s recent edict, making fifty and one hundred ruble bills worthless, is a meager and ineffectual effort to reduce the money supply at the same time as other measures continue to add to it. Budgetary spending is supposed to be curtailed, yet subsidies for many enterprises have been maintained. State enterprises are supposed to resort increasingly to “self-financing” to meet their financial needs. In fact, credit extensions are still available to them if stringencies arise, especially if the enterprises can argue that financing is needed to fulfill state contracts. Although Gorbachev has said state enterprises will be privatized, no timetable or operational plan for doing so has been established. And to the extent that convertibility of the ruble is mentioned at all, the intention is that it will be done “gradual-
ly," without any indication of when or how this will be accomplished. Even these limited measures have been set back as a result of recent increased reliance on KGB and military authority in running the economy.

China’s economic restructuring efforts probably rank somewhere between Poland and the Soviet Union—perhaps warranting a grade of C, probably higher for its rural reform in the early 1980s, but lower for its meager reform efforts in the urban sector before and after the Tiananmen tragedy of June 1989. While there has been extensive price deregulation, wages remain largely fixed. Limited progress has been made in the direction of privatization, especially through joint ventures with foreign investors. State enterprises remain largely responsible for social security, thereby burdening them with high-cost obligations and impeding any prospective progress toward the break-up and privatization of these enterprises. Although there has been no explicit move toward convertibility, the establishment of fairly effective monetary and fiscal discipline has helped to create a situation in which the black market value of the yuan is only about 30 percent below the official rate.

**Transitional Costs of Transformation**

It is widely assumed that the transitional costs of transforming command economies into market ones will be extremely high, as well as protracted. But this assessment is flawed by a fundamental measurement error. In fact, the costs and pain of the transition are likely to be less than is usually presumed if the process is pursued along the inclusive and expeditious lines described earlier.

The critical error arises from comparing real levels of output, employment, and prices in the post-transformation market environment with the spurious recorded levels of the prior command environment. For example, it has been said that Poland’s GNP has declined by 16 percent, unemployment has risen to more than one million, and inflation has increased by 35 percent more than wages since Poland’s “crash” economic reform program was initiated in January 1990. Similar or greater disruptions have been predicted by Gorbachev and others for the Soviet Union if “radical” restructuring were to proceed there. All these figures are wide of the mark.

In non-market systems, recorded output is typically and substantially overestimated due to several factors: first, underestimation of “hidden” inflation that takes the form of maintaining constant prices for products of decreasing quality, or establishing higher prices for products that are reclassified to reflect apparent, but not actual, increases in quality (in the Soviet Union, it has been estimated that the annual rate of inflation in recent years has probably been two or three times the previously acknowledged rate of about 2 percent); second, inclusion of physical, but valueless, output—for example, shoes that consumers won’t buy and bulldozers that are too hazardous to use and too costly to fix; third, fraudulent reporting—the padding of reported data (приводить in Russian) to meet or exceed established production norms; and fourth, data manipulation for internal or external propaganda purposes.

Such factors probably account for over-estimates of at least 25 percent of recorded GNP in the Soviet Union and other non-market systems. It is significant that estimates of the size of the Soviet GNP relative to that of the United States by the CIA (as well as by the Soviet State Committee on Statistics) have placed the figure at about 50 percent, whereas estimates by other economists—Soviet, American, and European—have placed the figure between 14 and 30 percent.1

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It is also significant that East Germany’s per capita GNP in 1987 was estimated by both the CIA and the World Bank at about 88 percent of West Germany’s, while more accurate estimates since reunification suggest a figure of less than 50 percent.

Similarly, comparisons between post- and pre-transformation unemployment are misleading because they are based on unemployment that is visible in the market economy, but do not allow for the make-work, featherbedding, and pay-without-product unemployment that is hidden in the non-market system. The employment realities are suggested by the familiar Soviet joke: “We pretend to work, and they pretend to pay us.”

Finally, it is misleading to compare post-transformation “inflation” with pre-transformation’s apparent price stability. Transformation to a market system converts inflation that has typically been “hidden” in the non-market system (but reflected in long and uncertain queues and declining product quality) into visible price increases in the market system.

When properly measured, the economic costs of the transition—in the accurate sense of opportunity costs—should be much less than suggested by most comments and estimates.

Why Is Transformation Falttering?

If transformation to a market system is more tractable and the attendant costs are likely to be lower than is commonly assumed, why has progress been lacking (as in the Soviet Union), or very limited (as in China), or at best only modest (as in Poland)?

The question relates more to the politics than to the economics of transformation, more to the motivation and capacity of potential leadership and organizations than to understanding the policies necessary for moving forward. Part of the answer lies in the fact that there are deep underlying divergences among many of those who intone free market rhetoric and slogans, but are themselves decidedly ambivalent about the desirability of real system transformation. Hence, they seek reasons or excuses for delaying and temporizing, even while solemnly acknowledging the necessity for eventual systemic change. To profess a belief in free markets, together with an intention of maintaining the political dominance of the Communist Party, as does the leadership of both the Soviet Union and China, is oxymoronic.

Transforming command economies into market economies inevitably means winners and losers, although in the aggregate the economy will gain much more than it loses. In the Soviet Union, the issue is further complicated by the likelihood that the economy that gains will be that of the republics, while the loser will be that of the union. The practical problem created by impending transformation is that the reigning leadership in the ostensibly transforming economies—especially in the Soviet Union, China, Romania, Bulgaria—is very likely to be among the losers in terms of their power, privilege, and prestige. Hence, while they may use the rhetoric of markets and competition, their interests induce, if not compel, them to temporize, to delay, and perhaps to incapacitate the transformation process.