

*To my wife, Csia, and my  
children, Zoli and Hedgehog:  
indebted for their love and  
endurance.*

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## STUDIES OF COMMUNISM IN TRANSITION

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# The Capitalist Revolution in Eastern Europe

A Contribution to the Economic  
Theory of Systemic Change

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László Csaba

STUDIES OF COMMUNISM IN TRANSITION

Edward Elgar

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## Preface

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Sooner or later any serious economist comes to the point of writing - possibly a book or at least a couple of articles - on transformation, as a brilliant Finnish mind noted recently. And, indeed, books and articles are flooding into and clogging up libraries. Some are illuminating, others are already out of date at the time of their production. The heavily overburdened observer of the scene might sigh with relief, since the endless row of newly produced output he has not yet read is one item less.

This author has also been guilty of contributing to this state of affairs, when hardly anyone has anywhere near a complete overview of the subject. Yet the main reason for this is the challenge of the times. The occasions in history are fairly rare when economics is supplied with such an excellent laboratory to test conflicting ideas and propositions as has been the case for the transforming economies. Over and above the traditional area specialists, much of the cream of the economics profession has been engaged both in studying and in shaping developments in the 'East'. This is a welcome development, both for the area and for the discipline: transforming countries may thereby capitalize on skills and knowledge developed elsewhere, while the discipline may acquire both new insights and new impulses to present questions in new ways, plus new modes of answering them by interpreting the feedback coming from this new area of application.

Such a historic encounter cannot, of course, be problem-free, and the art of interpreting, applying and operationalizing the feedback, in both directions, between science and reality allows wide scope for conflicting ideas. I tend to see the benefits of this *dynamizing effect* on both and believe that this encounter might be an important novelty for general economics as well as a major fountain of knowledge and a source of orientation for the societies concerned. Curiously enough, the inhabitants of Central Europe are both the subjects and the objects of systemic change. Through public choice the feedback of reality to

policy-relevant theories has indeed become fairly immediate. This is an important difference from the mainstream of the profession, which has evolved in fairly affluent and well-functioning societies, where at least the basics of how the system works have never been an issue in recent decades. Consequently, extra-economic and institutional factors could reasonably be assumed away. In Central and Eastern Europe, by contrast, the objects of previous scientific enquiry - the socialist firm and the bureaucratic economy have been disappearing. Meanwhile the conventionally presumed market economy - with its elementary agents and elementary rationality, has certainly not yet been established. The problem seems to be more specific than the customary reference to the underdeveloped country syndrome would suffice to explain, though its relevance is obvious. 'Transition' from socialism to capitalism proved to be neither more operational nor more immediate in terms of time and specifics than 'transition' in the opposite direction used to be. Thus both the nature of the problem and its international weight allow for this particular sub-field of general economics and of international economics to emerge as a lasting and separate subject of enquiry.

This monograph is an attempt to contribute to, rather than settle, the international debate on this particular area of general economics. I have always been affiliated with institutions whose major task lies in regularly producing primary data, interpretations and updates of the current economic situation in 'Eastern Europe' (for simplification, I retain this semantic cripple of the post-Yalta vocabulary). Thus I might well hope to be excused for the fact that my present focus lies elsewhere. That is to say, while duly respecting quantitative and statistical evidence, the search here is for what may be more or less constant: trends, fundamentals, theoretical interpretations of *what is or is not peculiar about transforming entire macro-systems in Central and partly also in Eastern Europe*. This is, of course, only one of the many possible ways of looking at phenomena in the area, and it does not need to be a dominant line of thought. However, experiences in the past fifteen years or so have brought about changes in paradigms among the policy-relevant theories. Thus we have witnessed the breakthrough of the monetarist counter-revolution in policy making in most OECD countries, the decay of the welfare state as an instrument for fundamentally reshaping capitalism, and the obvious superiority of

outward-looking industrialization strategies over self-sufficiency and dependency theories for rationalizing these. Searches for 'non-capitalist developmental models' have been overtaken by events, and the collapse of the myth of the 'third way' and others may count among the issues that have been settled. As Williamson and Haggard (1994, pp.529-30) aptly formulate it: 'The evidence that macro-economic stability, a market economy and outward orientation are beneficial to economic growth and (with slight qualifications) a relatively equitable distribution of income is by now reasonably compelling. What is new is the conviction that they are not just policies that are good for the First World, but that they are also needed to make the transition from the Second World and they are equally desirable for the Third World as well. At least in intellectual terms, we today live in one world rather than three.' However, there also remain within our narrow field of interest many questions and approaches which seemed to be relevant a few years ago but which today sound odd, even anachronistic. The idea of privatizing *before* liberalization, or the idea of treating the transforming economies as dual economies, or the prospect of a 'jump into the market' looks far-fetched nowadays. Thus the quest for posing *lastingly relevant questions*, and for finding some of the lastingly relevant answers, may be justified. Indeed, the very nature of a monograph is a direct call for a more abstract approach. Meanwhile, reflections on current developments and factual and statistical updates are deliberately left for articles in newspapers and periodicals, which I hope to be able to continue producing in those media in the future. The dynamic interchange of ideas and facts, mentioned above, will certainly make some parts of this analysis obsolete earlier than others. Still, this is the nature of history and one can only hope that retrospection will not lead this effort to be completely discarded.

As I completed the volume I intended to present a *comprehensive*, though by no means exhaustive, *overview* of the subject so I had to rely on some of my previous findings. The first version of Chapter 4 was originally published in *Acta Oeconomica*, Vol. 42, No. 3-4 (1990), at a time when both its circulation and general interest in reading primary sources was regrettably on the decrease. I feel that most of the points made there have stood the test of time and a revised and updated version is thus relevant even from today's

perspective in unfolding the subject. A preliminary, shorter and somewhat different version of Chapter 7 appeared in Hans-Jürgen Wagener (ed.), *The Political Economy of Transformation* (Heidelberg: Physica Verlag, 1994), reflecting the evolutionary development of the approach and also of the author. Both pieces – and some smaller fragments recorded among references – will, I trust, acquire a new dimension as parts of the *integrated* overview presented here. Gratefully acknowledging the permission of the respective copyright holders I feel the need to stress that my intention is to give one possible, even contestable, but still comprehensive overview in analysing and interpreting what is peculiar about transforming entire systems in countries of Central and Eastern Europe.

In finalizing my ideas a generous research grant of the Finnish Academy was most valuable: I was able to spend the months of May-July 1993 in the Department of Economics at the University of Helsinki, and the support of its Chairman at the time, Professor Jouko Paunio, was instrumental in facilitating my work. During the tremors of political and economic transformation, Kopint-Datorg, Inc., under its General Manager, Mr János Deák, and its Deputy General Manager and Director of Studies, András Köves, provided me with the background needed for research. From among the many colleagues with whom I had the pleasure to interact, the continually tough but always friendly criticism of Messrs László Szamuely and Pekka Sutela was particularly appreciated. Useful comments by Ms Kamilla Lányi and Mr Pál Tamás and all participants in the debate on the original version of the manuscript are greatly appreciated, with the usual caveats. Finally, my sincere thanks to the series editor for his devoted efforts of translating my Central European English into standard English.

László Csaba  
Budapest, October 1994

## PART I

### SETTING THE TASK

### 3. Towards a Theory of Transformation

It would be futile to try to summarize or conclude such a wide and continuously evolving subject as transforming entire macro-systems on the ruins of the empire. Evolution means not only a breathtaking pace of change in the empirical material but also a swift modification of the agenda. This may explain why relatively little use is made of source material preceding 1992-4: those questions that this author, along with most others, used to consider as dominant have been partly answered, and partly reassessed and reformulated, by events. This monograph is thus meant to be a first run in presenting an overview of the subject *in toto*. Without doubt, in five years or so a further attempt will be due, and that will also be conducted from different angles and with different priorities. For the present, it may be worth raising some of the theoretical issues and findings that may be of lasting interest - areas where this analysis offers something significantly different from many interpretations.

1. Our understanding of transformation suggested this to be a qualitative change which deserves the term 'revolution'. The concurring interpretation of Kis (1993, p.5) stresses continuity in institutions and in legislation, and thus - arguing on grounds of legal theory - questions our approach. As far as we are concerned, revolution does not require bloodshed: in fact in most such turns of events in Hungary, starting with 1848, not much violence was involved. Furthermore, from the economic point of view two elements seem to be decisive: (a) the entire construct has changed, and so even gradually evolving policies acquire a different meaning; and (b) the strategies followed by transforming countries have been truly revolutionary ones: Murrell (1993, pp.113-15) rightly talks about a top-down policy aimed at reconstructing society by the avant-garde according to its own priorities. Or alternatively, as Taylor (1994, p.84)

puts it, 'the fundamental difficulty is: how is capitalism to be embedded in societies in which for decades it hasn't been able to fit?' This behaviour carries the unmistakable imprint of a peculiar 'East European' type of messianistic intelligentsia, able and willing to redesign the world at virtually any cost. This feature has actually been truly uncovered by the change of guard that has replaced these people with predictable, grey and harmless bureaucrats right across the region (P. Tamás, 1993b). We have tried to pinpoint the severe limits to any social engineering on the ruins of the empire because of the omnipresent attempts to remould the world thoroughly. The fact that designs and results hardly overlap is not at all unusual, and even less surprising in a historical perspective. Thus, failure to attain the goals – of, say, liberty, equality and fraternity – does not invalidate the qualities of the French Revolution. Since the transforming economies did do away with the predominance of bureaucratic controls over economic activity, did produce growing shares of private sector GDP, did establish pluralism and stabilize purchasing power to a great extent, did bring about new motivations and traits of mobility in masses of socioeconomic agents, the *qualitative* – revolutionary, irrevocable – *nature of change* seems to have been substantiated.

2. Our analysis has portrayed continuing changes as a move towards a capitalist market order. One can, and indeed should, continue to debate the fine interpretation of the type of capitalism the individual transforming countries are driving towards. But one thing is certain: *they are not seeking a 'third road'* or a yet untested vision of social organization. We have tried to demonstrate why *pre- rather than post-capitalist structures* have been inherited in the region. Thus there is nothing akin to making an aquarium out of fish soup in this change: it is a *belated effort at modernization* and should be judged on its merits. Similarly, we could see nothing retrogressive in dismantling empires.

Stressing these features of Central and East European reality would certainly save us from the surprise experienced by many observers (for example, Ludassy, 1993, p.90) when confronted with the revival of truly pre-modern ideologies, such as ethnocentric nationalism, medieval collectivism and establishmentarian tendencies in religion. This is a direct reflection (or an indirect proof) of our diagnosis.

3. The modernizatory interpretation has at least two immediate consequences. First, the nature of the change is multidimensional, therefore only *interdisciplinary* attempts may be adequate in addressing it. If, as may be the case, the nature of the change is not even primarily economic, our economic focus will be distinctly narrow. The point was to make this first step: within the confines of one discipline laying the groundwork for a later synthesis. The second point, of course, involves the state and other *means of coordination of human behaviour*. Such broad concepts as the rule of law, of observing certain moral criteria, of the civilizing aspects of change, may dominate much narrower concerns inherent in any purely economic approach, including the need to foster the propensity to invest. Thus the limits of a given approach are clearly set.

4. History has proved to be a paradoxical 'weapon' in the analytical arsenal. Although it proved to be instrumental in interpreting the evolutionary path and, on occasion, in the divergent reactions to the same policy mix, it did not prove to be a particularly effective tool in making forecasts. The latter may sound trivial for historians, but for contemporary analysts it is well worth reiterating. Crisis scenarios based on historical analogies, or strategic and economic concepts drawn on perfunctory similarities, often make false impressions. For instance, the scepticism about the viability of small nations, or inflated fears of uncooperative attitudes, or the new fashion of appreciating protectionism as a legitimate policy line, all draw on this mistaken analogy. The world of global financial markets, global companies, the rise of the Pacific and the decline of Europe is simply too dissimilar to anything that has existed before.

5. What has been said above requires a *change in methodology* in analyses of transformation. Reducing these changes to programmes of stabilization or balance of payments readjustment thus becomes a serious error. Meanwhile, instead of trying to invent a new science, better and more extensive *reliance on the mainstream of established disciplines* such as economics, law, sociology, history and area studies would be helpful in advancing applied economics propositions. Conceptual categories such as shock versus gradualism, mass privatization, creating a middle class of owners, and so forth, may be calmly discarded. Also, the idea predominant until now, of trying to

capture salient features of transformation by a set of – possibly easily available and aggregate – quantitative indicators (for example, the number of companies sold) seems to have been a sterile exercise.

From these findings it also follows that there is *no place for a general theory of transformation that could be of universal validity and transferable to any society of the globe*. The tasks of transformation were shown to be peculiar to the crises faced by the ruins of the Soviet empire, which are quite unlike any attempt at liberalization made by a developing market economy. Building a market infrastructure and learning new rules of behaviour are quite different processes from deregulation (Schmieding, 1993, pp.236–8). Thus, in line with our Chapter 2, a sizeable and protracted fall in output must be seen even retrospectively as inevitable, rather than evidence of a crisis. Hopes for early recovery rested on liberalization and stabilization analogies, which were simply misplaced. The fall in output is not a problem in its own right, but needs interpretation as such. Eliminating unviable units is a part of the cure and a sign of improved efficiency.

A survey of two non-standard histories of transformation – those of Russia and Hungary – left us empty-handed as far as operationalizing any of the general concepts of transformation theory was concerned.

6. While calling for more methodological rigour than has been customary, we do not subscribe to a claim for a completely new brand of economics, as advocated by several analysts facing the complexities of transformation. Instead, we recommend better use of available knowledge. Modern economic theory does not propose the use of *increments in flow variables* as a measure of overall progress, as was customary 30–35 years ago. Neither does it disregard the structural, quality, sustainability, environmental, wealth and human effects of a given change against one or two very broad macroindicators. The obsession with such ‘real factors’ as output or employment is a heritage of the socialist period, when only ‘production’ really mattered, money was subordinate and the considerations listed above played no role at all. Thus the contention that transformation was in a crisis because industrial production (accounting for 30 per cent of Hungary’s GDP) was in a state of contraction for three years is a biased view, based on a favourable perception of the times when it did grow continuously but the environment was destroyed and output

could not be sold under competitive conditions. There is nothing less self-evident than subscribing to such a bias alone, since gross industrial production is an easily available indicator, so many analysts tend to rely on it.

Economic theory over the past two decades has become increasingly sceptical about the state’s ability to force economic growth, to fine-tune processes and to attain a large number of specific priorities. Instead a conviction has emerged in which *stability and credibility of policies* has begun to weigh heavily. Stabilizing expectation by sending calculable rather than arbitrary signals has become a virtue. The propensity to invest can, however, be *nurtured*, although not *enforced*, by public authorities. The confidence of savers and investors needs to be won through experience, rather than replaced by state activism. In his excellent survey of new developments in growth theory, Romer (1994, especially p.20) warns of the dangers in depicting the installation of new equipment or other physical capital as the major generator of growth. Solow (1994, pp.3–4) also cautions against this view as simplistic. Both authors stress instead the role of knowledge and of a social environment conducive to innovation. None of these can be decreed by governmental action: they can only be supported by the authorities, not generated by them. Thus the scope for specific growth-promotion policies becomes very limited indeed. This change in theory is yet to permeate policy making in transforming countries, where ‘monetarism’ is often confused with stabilizatory or anti-inflationary concerns, whereas a return to an antiquated populist brand of policies (well known from Latin America) is called ‘Keynesian revival’, ‘new economic policies’ or ‘a step towards realism’. But are these not precisely the realities that were to be transformed rather than conserved? To attain that, public authorities may want to focus on those of their functions which others, even in theory, cannot perform in their place, such as instituting banking and social security reforms, or fiscal restructuring.

7. In this broader concept at least two conclusions may be inferred. First, the *speed* of actual transformation seems to be a dependent rather than a freely chosen variable, which may not depend on the priorities of the system’s designers. Thus these cannot be praised or blamed for this particular aspect of change: the resoluteness of their efforts – unlike their competence – may not matter at all. Thus the

debate over shock or gradualist approaches looks truly irrelevant. Secondly, the issue of *property rights* seems to have been inflated and mistakenly seen as the backbone of systemic change. As in Western countries, introducing 'the commercial spirit' and contestable markets is the crux of the matter, and the privatization drive acts as a lubricant rather than being 'the real thing'. Here again, credibility matters more than the number of firms actually sold. What changes the behaviour and performance of management is the threat that his company may become an object of privatization. Thus it is not necessary to have to wait for private property to become dominant in order to attain a competitive market as the basic system.

In fact, it would be misleading to attribute an indifferent or agnostic stance on property rights to this approach. The spread of private property, of course, is a good thing. The difference of this approach from market socialism lies in the *dynamics* of the processes. Market socialism is a theoretically postulated order where public property dominates and it coexists with competitive conditions. This suggestion proved to be untenable and contrary to the facts, both theoretically and practically (Schüller, 1988; Komai, 1992c; Hayek, 1944). In other words, market socialism is a theoretical model, postulating a *dynamic equilibrium* in the coexistence of the two features. Our alternative vision is one in which the private sector *grows steadily in an evolutionary manner, while the state conducts policies which are conducive to a market-conforming pattern of behaviour of economic agents* even prior to the dominance of the private sector. Opening up the economy and maintaining a liberal trade regime, strengthening and applying bankruptcy legislation, and cutting back subsidies can all lead to behaviour changes on the part of all agents, irrespective of their relation to ownership. Under a declared policy of preferring the private sector and nurturing private investment, with a dynamic bottom-up growth of the private sector, the impossibility of selling white elephants may reflect elementary microeconomic rationality considerations rather than a statist ideological concern. Thus the 'mixed economy' in its current shape is *not in a dynamic equilibrium*, since the spread of the private sector is the dominant trend. This conceptual approach is down-to-earth, empirically founded, and thus reflects facing the facts rather than abstract preferences or other postulates. Furthermore it invalidates the

mechanical, quantity-oriented concepts which would see transformation concluded if, say, 50 per cent of firms plus one is in private hands. Evidence from abusing the welfare state in some countries may validate our contention that the *size of state redistribution* counts just as heavily as the share of holdings by private firms. This leads us back to the original framework, in which *transformation does not lend itself easily to quantitative measurement*, and instead a set of soft qualitative indicators has to be relied upon.

This quality makes the subject difficult to approach by direct reliance on methods of mainstream economics, and it does require a certain change in the paradigm which customarily differentiates between hard facts and soft interpretations.

8. Against the conceptual framework developed above, the actual policies in any transforming country today may look inadequate. Indeed, if there is anything to be generalized from the individual histories surveyed here it is that what was shaping the actual results in transforming countries was success or failure in applying *conventional measures of economic policy*, and its interaction with the *inherited endowments*. This, rather than concepts or specific policies aimed at systemic change, is what explains the different empirical developments in various countries. Russia's failure to stabilize may be counterposed to reasonable Czech performance with very limited structural change. A significant potential for improving the efficiency of policy may lie in making better use of the applied economics of transformation.

9. In terms of patterns of development, the concept of *unity in diversity* proved to be quite helpful in orientating policies within emergent new integrational structures, in both the western and the eastern parts of the continent. Our discussion of both the post-Maastricht and the post-Soviet developments pointed towards the possibility and the need for coexistence among fairly different autonomous subsystems within a looser grand structure. This finding is congruous with earlier suggestions (Schneider, 1993) on the applicability of Swiss confederative arrangements to post-Soviet conditions. Indeed, only this, rather than the more straitjacket-like conventional 'coordinative' or 'cooperative' options, seems to be in line with the new reality, in which a large number of states develop according to their own respective pace and preferences, paying little

attention to others. In such a world, *standardization* – the first thought of any bureaucrat – *is the safest way to disruption*, as the uniform rules only amplify dissimilar behaviour.

10. Last but not least, the role of *financing* the process of modernization has to be addressed. On both empirical and theoretical grounds the overwhelming importance of *domestic financial intermediation* has been stressed. Even in countries with sizeable capital inflows, such as the new industrializing countries, over 80 per cent of the funds for modernization had to be saved domestically. If financial intermediation is inadequate or perverse, the more external finance were forthcoming the more of it would be wasted.

In international comparison, the gross investment rates of transforming countries seem not particularly depressed: the problem lies in the inadequate allocation of these funds. We tend to follow Stiglitz (1993, pp.32–3) in seeing the equity market as a side-show, especially at the given level of development of transforming countries, and urging banking reforms under state regulation. Thus the slow and limited emergence of stock markets is not a grave concern, whereas seriously mismanaged bank consolidation, positively fostering morally hazardous lending practices, is.

All in all, what we have offered is a progress report rather than a 'general theory'. Seeing the diversity of ways and means calls for multiplying our efforts, on both the theoretical and the empirical fronts. The interaction of descriptive and theoretical, analytical and policy studies has a vast potential to be stimulated for the process of understanding and for the benefit of nations in the region. Latecomers to the scene, who exist in much larger numbers than the currently transforming countries in Central Europe, may become the prime beneficiaries – this time with a positive peace dividend.

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