TRANSITION FROM SOCIALISM*

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Resumen: Este artículo discute los cambios que los países socialistas, especialmente los de Europa del Este, están actualmente viviendo. También se comenta sobre el declive en todo el mundo de la institución de la nación-estado, particularmente de la disminución en su importancia en la economía.

Abstract: This paper discusses the changes that socialist countries, specially in Eastern Europe, are currently undergoing. It also comments on the decline all over the world of the institution of the nation-state, and, particularly, a decline in its importance in the economy.

I understand El Colegio de México is now celebrating its fiftieth anniversary. I bring you greetings from a sister institution, Stanford University, which is celebrating its one hundredth anniversary. So we can give you some guidance on your next 50 years, the troubles and the joys and successes of university education, and its contributions of students and research to the welfare of the world.

As a preliminary to the discussion of the problems that the socialist countries are facing, I would like to make a general observation. We notice in Eastern Europe the changes from a state-controlled system to, well, we are not sure just to what, actually, but to something which greatly diminishes the power of the State in economic affairs. In Western Europe we are also seeing an evolution, an evolution toward a larger entity than the nation. In short, and I think this is a bold generalization but one that is supported by current trends, we are seeing a decline of the institution of the nation-state and, particularly, of its importance in the economy. The power of the State is necessarily decreasing with these changes; either it is giving way to supranational organizations, or to

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more individual choice, to free enterprises, to market institutions in which the State, per se, wields less power than it did before. I am sure the State will not disappear completely. It will remain a significant enterprise, but it is clear that it no longer has the role it had in earlier periods.

Now, the nation-state is a strange institution from the point of view of world history; it is not by any means the typical institution of the world. In particular, we have had a projection of European nationalities and national rivalries, economic and otherwise, on the rest of the world. In 1756, we find that two Native American groups in what is now the northeastern part of the United States, the Iroquoians and the Algonquins, were fighting with each other. At the same time, two armies in India, from Bengal and from the Carnatic coast, respectively, were at war. And why were they fighting? They were fighting because there was a rivalry between the King of Prussia and the Archduchess of Austria over the control of Silesia. Now, that is a rather striking example of interrelations. In this case, these were allies of the French and of the English, in both India and America. There was a projection, in other words, of national rivalries onto the world scene. I do not think this is one of the most beneficial aspects of European influence in the world.

The development of nation-states in Europe went through several stages. The end of the Middle Ages saw the emergence of some countries in which the central authority was important: first Spain and England and then, slightly later, France, which became much more powerful for a long while than either of the others. These were strong states as opposed to the weak hierarchical states of the Middle Ages, but it took a while before they were in full trade with another spirit, the spirit of the nation. The idea of identifying a political entity with a national entity, with a sense of culture and language and shared history, is a relatively modern invention. To some extent the English and the Spanish, because of their relative geographical isolation, had it. But it took a while, and required a great deal of deliberate effort, to spread to the rest of Europe. Really, it was only with the French Revolution in France, and then its repercussions and imitations throughout Europe, that we saw the true development of the nation-states at the time Germany and Italy became states.

This identification of the nation-state has far from disappeared. In fact, I think that one of the great difficulties in Eastern Europe is likely to be attempts to make national boundaries, in the cultural and linguistic sense, coincide with political and economic boundaries. I foresee a very considerable danger. I do have the optimistic view that over a long period of time this is gradually going to disintegrate, but the period between now and then may be quite painful.

Europe is not particularly wicked, less so than many other parts of the world, but the rise of the European nations happened to coincide with the period in which the European nations were considerably more advanced, from a technological stand point, than the rest of the world. This ability, as was manifested in my country and your country and in Africa at a somewhat later date, has meant that there was a period of several hundred years in which the rivalries of Europe were played out on the world scene. Europe was never a unified place; among the divisions we had France versus Germany, for example. We also have had, in the last forty years, communism versus capitalism. I must say, I do rejoice in thinking that both of these divisions are disappearing and, with them, the capacity of Europe to create mischief for the rest of the world .

In this context, let me turn to some remarks about the changes in the socialist States. I do not claim to be a country expert; rather, I am applying ideas of general economic theory to what I have observed and read in Eastern Europe, and particularly in the Soviet Union. When one talks to Soviet economists and, for that matter, reads the speeches of Soviet statesmen, Gorbachev's or anyone else's, there seems to be repeated agreement, virtual unanimity, as to what the goals of the present transformation are. They want "marketization" (that is an English derivative of the Russian word, whatever it may be) and privatization, and to accompany these, they put forward the ideas of macroeconomic balance and currency convertibility; these are supporting steps towards the two main aims of marketization and privatization.

The official goal of the Soviet Union is to achieve an economy in which the proportion of the economic system that remains in public hands is the same as it is in Italy, 30 percent. Well, this is obviously a change in goals that is utterly fantastic. Seventy years of history had been poured into the effort to create a world in which there was no private ownership or, at best, it was tolerated in exceedingly marginal occupations. There were whole philosophies, there were whole commitments. These have been abandoned and, according to my impression of the Soviet experts, the socialist idea (by socialist idea I mean one in which public ownership is dominant) is dead as an ideal. Of course, if you go to the Soviet Union, you find that everything is still publicly owned. The question is then: How are these goals, about which there seems to be no public dispute, to be accomplished? Or, indeed, will they ever get there? I am not going to attempt to predict, I am just going to try to indicate some of the alternative forks in the road. If you want to be serious about this, we know that history is likely to have some very considerable surprises, and they are not necessarily pleasant ones.

There is a general issue with all these steps, with marketization and privatization, even with convertibility; namely, that it is natural to think of them as taking place over time. If you contemplate the idea of turning over the publicly owned property to the private sector, you wonder how this could be done in a short period of time. Indeed, even under very favorable circumstances, when a country decides to privatize some parts of its national ownership in an economy which is basically privately owned, as in Great

Britain in recent years, that does not take place very quickly. Take any enterprise, like the telephone system; it takes several years of planning, very elaborate procedures for distributing the shares of the company, and so forth. Now we are not only talking about the telephone company, but about the whole economy, the whole steel industry, the entire construction industry, automobiles, whatever you may think of as typical industrial processes.

So it is natural to say, "Look, this cannot happen at once; we want a carefully, time-phased procedure." But there is a serious problem. I think the problem has not yet quite been addressed, and that is the question of credibility. In order to proceed to privatization, you want a situation whereby it is guaranteed that this is a process which will end with a major portion of the industry turned into private hands. You do not want situations in which the process can be reversed in the middle, because purchasers want the assurance that their purchases can not be taken away from them. Otherwise, you will have an enterprise in private hands but with the fear that it will not be in the hands of the present owners. And obviously the owners will not want to make investments, but will try to exploit the existing assets and run them down as quickly as they possibly can. These policies may cause certain increases in the output of the economy for a short period, but in not too long a period will lead to a diminution in national output. So the question of credibility must underlie all of these processes.

Let me now turn to marketization. I take it for granted that a system which uses prices to allocate resources depends on having the prices flexible, responding to market conditions. Prices may be very, very detailed. You will have different varieties of the same good, and the prices should reflect both their costs and their utilities. We all understand the economic case for prices as a way of determining allocation: this means you want a balance between supply and demand, you want prices to more or less reflect costs, you want prices to go up to induce the investment which will create the supply which will meet the unexpected demand, and so forth... All the usual conditions of a free market economy.

You have, at present, a system in which allocations are made more or less in real terms. A system that a lot of work has gone into, in which there is a large apparatus devoted to its performance, and in which prices play, I will not say no role, but a very secondary one. A steel firm says that it needs coal, it sends a request to the Gosplan, and the Gosplan works through the ministries. The Ministry of Steel tells the Gosplan, which tells the Ministry of Coal or the Ministry of Mining what they need, and then instructions are issued from the Ministry of Mining to such and such coal mine to deliver.

Obviously, a lot of things go wrong in that system; the coal mine may not deliver in fact, there are shortages, and all sorts of things can happen. Actually, Soviet firms have always hired expediters, people whose job is to go around and find where there is coal available; so the informal links may supplement, and in some cases very much supplant, the formal ones. But the formal links are very well worked out and do play a decisive role. If the coal mine cannot deliver, there will be great pressure to do so. Well, that is a very different form of system from one with a price system, where the steel company would buy the coal directly, face to face, from the coal company. Obviously, when quality and varieties matter, there is a tremendous inefficiency to roundabout communication. People are not going to know what exactly is required. You get delivery of goods that are not quite right; there are a lot of costs to it. That is at the micro level but, more fundamentally, the fact that they do not have to respond to prices means there is no guarantee that the goods go to the place which can use them the most.

Now the question is: How do you proceed to go from this allocation system in real terms to a price-motivated system? This problem, by the way, is not entirely related to the question of privatization. Indeed, it has been the program advocated by many socialists for a long time. Ideas like these were being circulated, actually, by such Italian economists as Vilfredo Pareto and Enrico Barone before the First World War, more as a theoretical exercise than out of actual interest. Later, after the First World War, when socialism became more of a reality, there was a great deal of discussion, some, like Ludwig von Mises, asserting the impossibility of a socialist system, and others asserting that, yes, the socialist system could do very well by using a price system, that socialist firms would trade with each other. During the period when socialism was dominant in Eastern Europe, some socialist economists repeatedly urged replacing the command system with a price system. It did not happen, and I think the time for market socialism has, as an ideal, irretrievably passed, but I will say I think it is very likely to have a role in the transition.

Now, what do we do with the price system? Even if you have not completely privatized the economy, should you immediately go to a price system? Flexible prices, prices set by the firms themselves, profits retained by the firms, and all the rest of that. How do you manage this? Well, one view is that one day, you simply announce that there are no more price controls; you just have no price controls at all, and let the firms set the prices. Assuming for the moment the markets work well, prices will change and have very little resemblance to present prices. Expectations that have been built up on the basis of previous relationships will be destroyed. Thus, there is a theoretical argument for a time-phased change in prices: leave prices of certain consumer goods alone, and gradually change producer prices, presuming the producers are more sophisticated and can make quicker changes.

It has been assumed that the prices would change to the true equilibrium levels instantaneously. We do know that prices in markets of the free enterprise world are occasionally quite far from any long-run equilibrium.

The price of oil probably varies more on the spot market than can be credibly assigned to any reasonable set of expectations, for example. The stock market similarly shows certain instabilities. In a situation where the change in prices needed is not a small change, not a local change, but a very large one, it can be expected to take quite a while. In this procedure, it may be a very good idea to put some limits on the rate at which prices change, letting them go by steps to their true cost basis, for example.

I think the argument is a very good one, but it is a problem which must be addressed in terms of credibility. If you say we are going to shield these sets of prices, and then you start changing others, perhaps these consumer goods will turn out to be unprofitable or excessively profitable at these fixed sets of prices. Then there will be pressures to change them, but meanwhile there will be vested interests involved. The producers will be strongly interested in maintaining high prices, but not the consumers. If you think of this as a guided process, with somebody controlling the decontrol, you are going to have pressures to change the decontrol, to modify it; and then, of course, if it is known that there are all of these pressures, there will be incentives to play various games, to pretend things are more costly than they really are. There will be pressures of all kinds to make profits by political protection rather than by economic competition.

There is another problem, by the way, in the transition from an allocation system to a price system, namely that the socialist systems have, after all, been organized on the basis of monopolies, as a Ministry of Steel, a Ministry of Construction, or a Ministry of I do not know; and it will be necessary, in the process of transition, to create competition. It will be necessary to break up the units into smaller units able to compete with each other successfully. But this is a non-trivial task. The managers that have worked together in the past will find it very convenient to continue working together. This is one of the dichotomies we have to face. It strongly suggests to me that the Big-Bang approach of free decontrol may be a better one, in spite of some of the difficulties it is going to create.

The problem of prices is, from a theoretical point of view at least, an easier problem than the one of privatization. The first very simple problem of privatization is: Where are the buyers? After all, you have a country in which capital is owned by the State. Not all of it; for example, it is true that private savers hold considerable liquid balances. In fact, these are feared on the grounds that as consumer goods come on the market, and people choose to spend these balances, there will be an inflationary pressure. But, nevertheless, if you think of this as a source of assets to buy the productive equipment of society, it is trivial; it is much too small by an order of magnitude, by factors of a tenth, or probably by factors of a hundredth.

So, who is going to buy the capital? Well, there has been a fair amount of discussion, specially in Poland, whicn is the only country that has actually made some serious steps toward changing the system. All the others are just talking. The first idea of the Poles was to have accounting firms value each existing firm, to set a fair price at which it can be bought. You issue shares, and then individual buyers will buy the shares at a price. In the first place, that turns out to be an impossible situation, because you cannot value firms in any credible way. For the same firm, with different expectations of the future, you can get differences in value of the order of ten times from one estimate to another.

Another proposal to set fair prices is to use an auction procedure. We will now just issue shares and people can buy them. But as I have said, who are the buyers? If you depend on existing assets, a firm will sell at a ludicrously low level, certainly on the assumption that you want to privatize relatively quickly. I think that to privatize in a fairly short period of time, say in a few years, and at the same time proceed to try to achieve something like a fair value for the assets is impossible. That is not a solution; it is virtually a question of mere arithmetic, there is no possible way to achieve it.

One possibility is to sell them very slowly, over a long period of time. The idea then is that you have some part of the economy which is private; capital will be accumulating in that sector, which gradually can be used to buy assets from the State over a long period. That is not an incredible proposition. It does, however, run across the question of credibility; the Government's commitment to privatize gradually has to be very well believed by the people.

There is another idea which, I must say, I thought was not very politically likely, but I now think has some advantages. And that is essentially privatizing by giving the enterprises away. It may sound very funny, but there are ways of doing it that make some sense. One way that has been proposed in both Poland and the Soviet Union is to create a kind of special currency, a voucher system, for buying public enterprises. Shares will be offered in these various firms, and people will bid for these shares; they can use money also, but particularly they can use vouchers. These vouchers, of course, once received by the State, will be retired, because if you alter the money supply you have a terrible problem. It is not illogical because, after all, who owns the enterprises now? You can say the State does, but the State is an abstraction. The State, in a sense, stands for the people. Giving them to the people should, from an ethical or distributional point of view, be as good as giving the proceeds to the State, in fact it may be better. It will tend to preserve equality in income in a better way than giving it to the State, because you do not know what the State will do with it.

I leave aside here the question of foreign buyers. Let me just say that there are two problems with foreign purchases. In the first place, the amount of foreign investment available, under the most favorable circumstances, is not going to be very great when you take it in proportion to something the size of the Soviet Union. Furthermore, you are talking about a very turbulent period with a great deal of uncertainty, and rational foreign investors are going to be reluctant to invest. Of course, you have the international lending agencies that no doubt will play a very useful role, but the aggregate investment from them is not really big, maybe 5% of the total capital value in Eastern Europe and the Soviet Union.

The second thing, of course, is that if foreign investors come into a situation where, let us say, the enterprises are going very cheaply, in terms of their long-run value, after a few years there will be political resentment against an excessive amount of foreign investment; it will be seen as taking advantage of the situation. So I think, for all these reasons, that although foreign investment will play a role, its biggest implication will be the transmission of technology from the West to the East, and that it will not play a large role in terms of the amount of capital.

So the vouchers system is a possibility. Theoretically, it has a lot of good features about it. I was actually with a mission in the Soviet Union for one of the international lending agencies. In our discussions with those economists who were closer to the real decisions, they were quite impatient of any ideas about vouchers. They said: that is gimmickry, that is not a real proposal, it is the sort of thing that armchair economists think about. Now sometimes armchair economists have the last word when it comes to practical ideas, but at the moment I think we have to contemplate the notion that we will not have distributions with the voucher system.

If we do not have a voucher system, then, as I have already suggested, what you have to have is a slow privatization. Start privatizing those industries in which the capital component is small, where essentially human capital, rather than physical capital, is dominant. I am thinking primarily of the service industries and the distribution network. The capital that will accumulate in this sector can eventually buy the more capital-intensive industries that will have been under State ownership for a while.

To get the benefit of a free enterprise system in a socialist context, one has to break up the publicly owned enterprises into self-contained units in which we have a clear-cut sense of property. Enterprises which are on their own can get no subsidies, they can get no help from the State; they can borrow money, but only from banks that are concerned about the repayments. The Hungarian economist János Kornai has emphasized that the overriding failure of the socialist systems is what he calls a soft-budget constraint. The firms are not actually forced to break even; if the firm does badly, it will likely get an allocation of money from the central government to make up for it. What you have to do is harden the budget constraint. The firm has to be on its own, own the property, retain the profits; there may be taxation, of course, but the profits per se belong in the first instance to the company, and if the profits are negative, the company goes out of business after a while. That is the only strategy by means of which the idea of a slow transition to privatization can take place.

Now, there is a problem with both strategies, and that is who is going to handle the transition in particular industries? The natural people are the present managers. A very strong and correct perception exists in the sense that therc is a tremendous amount of inefficiency in the socialist systems. And who is responsible for this inefficiency? Well, to some extent, the present managers. The problem I am talking about here applies to that sector of the industry which is relatively large, that have plants of some considerable size. It does not apply to situations in which management is very closely linked with the work force; when you have a corner grocery store, that is not the kind of problem I am talking about. I am talking about situations where you have a relatively large work force, maybe a hundred or a thousand employees. You must remember, by the way, that socialist firms average many more employees than capitalist firms. That is true not only in the Soviet Union, but in other socialist countries.

So you have a situation in which the ownership is going to be diffused among a significantly large number of stockholders; the firms are too big to have single owners, especially when there are no people with accumulated capital. The result is going to be what we have in large firms in the United States: managerial control. Now, ultimately managers do have to meet the market test. A manager will not stay if he is really losing money conspicuously, but until you get into a bad stage, this is not going to be important. As far as I can see, this argument is true both in the voucher system and in transitory state ownership, because in both cases the managers are not going to have anybody who has effective control over them. In fact, I would be inclined to think that State ownership might be better, because you have a concentrated owner who might really care about the outcome and be prepared to get rid of an inefficient manager. I do not see how managerial inefficiency can be avoided in these situations, because I do not see how you can get rid of the managers.

Another problem, by the way, is that managers will be in an excellent position to benefit from the trade, and I am sure they are doing so right now in quite large amounts. You may say that is a price to be paid for the transition, and there is nothing much to be done about it. From the efficiency point of view this might not be serious; it would be serious from the point of view of the just distribution of income. And maybe that is one of the prices one has to pay. What I mean is this: If the managers are handling how the firms are transferred from part of a State Ministry to a separate self-standing enterprise, they are likely to somehow arrange that to their benefit. They have superiority of inside information, and the chances are that they are going to be able to benefit one way or another: guaranteed positions, higher salaries, having some of the shares issued to them, using various techniques, not all of them unknown in private enterprises, by the way. So I think this is a problem we ought to face.

Now, everybody agrees that one of the problems in developing these steps of privatization and marketization is macroeconomic balance. There is a great fear of inflation in all these countries. Inflation is being held down basically as a result of the controlled economy, and as the liberalization occurs there will be sharply rising prices as now in Poland. There is the view of the monetary overhang, that I have mentioned before. One suggestion is to use the privatization to offset the overhang. It strikes me, and I have not seen it discussed very much, that there is a certain intermediate phase here, when you think of privatizing housing and possibly farming. Especially in the Soviet Union, farming is predominantly socialist. In the other socialist countries there is a considerable fraction of private farms (in Poland most of the farms are private already, in Hungary the situation is mixed). So, just privatizing farmland and housing alone would probably be far more than enough to absorb the monetary overhang. It seems to me that this is an important complementary tool.

You also need reforms of certain basic institutions, institutions so basic that you do not realize you need them, until you see another system. One of them is accounting. It turns out that accounting in the Soviet Union is essentially a way of checking to make sure that people do not steal money, it is cash-flow accounting. For that purpose that is perfectly all right, but in a situation where you really ought to know the economic value of what you are doing, you need to go to a somewhat more sophisticated level of accrual accounting. And this is really more or less unknown, as the Soviet planners will tell you so. There are simply no trained accountants, there is no idea of cost properly interpreted (you do not want to charge all of your capital in the first year you require it, for example). Most economists think that Western accounting methods are very primitive when it comes to allocating costs, that you need much more sophistication than now exists, that cost accounting is too gross. But this is well on the other side of their problem. A movement towards a kind of accounting that we have in the West will be a considerable improvement, and it is interesting that this simple matter has not been defined.

The other thing is property law. If we start creating self-standing firms, we have to have a definition of what they own and what they do not own. In an allocative system, ownership is not that important. If you need something for your firm, you go to your ministry and say, we need this; it is taken away from somebody else and is given to you. It is a coherent system; well, it is a mildly coherent system, it actually breaks down a lot in its own terms, but it is a system that makes some sense in its own terms. That system is being scrapped right now. The new system has not yet been built up, but the old system is being dismantled. With the present feeling that you can disobey laws, the firms do not obey orders.

So you need to move towards defining what is meant by property. You have got to say the firm comes equipped with the ownership over this but not with the ownership of that. If you want the ownership over this other thing, you have to buy it. If you need coal, if you need better lighting, if you need communications, which is a very serious lack in the Soviet Union, you have to pay for it, it is not given to you a priori. That is so elementary that you do not want to discuss it. But the idea that you need a property law was accepted in the Soviet Union five years ago, and nothing has been done about it. The same thing happens in China, by the way, exactly the same discussion of the importance of property laws occurs among Chinese economists. Nobody really denies it; nevertheless, the implementation of it turns out to trod on so many people's toes that it is very difficult.

Also, the tax system has to be completely revised. The basis of the Soviet tax system was theoretically a tax on profits from firms. But it was not really a tax *system*; that is to say, it was not based on rules. If a firm kept on doing well, the central government would increase its taxes. There was never any specification that it would take 30% or 40% or 50% of the profits and no more. It was ordered each time as needed. If a firm was doing badly, a firm would get permission to get its taxes cut. Well, one problem –and this is one of the things that has undermined all previous reform efforts–, has been that there is obviously a tremendous disincentive to do anything. If a firm's efficiency is measured by profits, the profits that they retain, then you would like to know in advance: if you get an extra thousand rubles how much of that is going to stay with you. If you never know in advance, if you have no right to that additional income, let us say for reinvestment or for better conditions for the workers or any other thing you can think of, then there is no incentive. There had been a number of attempts at reforms in the Soviet Union. They never lasted, and one of the reasons was the point about credibility which I mentioned earlier. The statements from the Soviet authorities about what incentives they would provide were not credible; in fact, they violated them all of the time, making them clearly incredible. So the first thing about taxes is that it has to be a system; that is, it has to be rule-based.

A second requirement is that with the potential of inflation you have to arrange for fiscal balance. What they have now is that the tax system, or the lack of system, they had before is beginning to collapse; it is not so easy to collect taxes. The result is that there has been a large increasing deficit in the Soviet Union which has added greatly to liquid balances in the short run. You must have a tax system which is collecting the taxes, deal with the balance, and in fact, I will argue below, maybe a surplus is what is needed. And there is a third criterion, which you may not regard as important, and that is the use of the tax system to achieve equality. I want to expand on it a little later.

Let me state some background to thinking about the future of the socialist economy. One is the theoretical one I have mentioned before –not so much what the theory of a good socialist economy is, but rather why the reforms have not been adopted. There were Soviet economists who were publishing various papers showing how to rationally decide on new investment, for example. Even in the Soviet literature you find that, much more in some of the other socialist countries. Now, those countries did have ups and downs when it came to free political discussion, and it was not always possible to enunciate doctrines. There was a considerable literature in the sixties in Poland on liberalization; in 1968 there was a reaction, and as a result most of the liberal economists were driven abroad. Only in Hungary was there a fairly free discussion. But the interesting question, after all, is that if the decision makers, the communist party leaders, knew about these reforms, why did not they adopt them? I do not really have an answer to that question, but it has relevance to the issue of how the power is going to be transferred today. It is true that communist parties per se are losing all legitimacy, but the bureaucracy is still there, it has not been dismantled. And the question is, assuming as a model that it was bureaucratic interest that prevented reforms from taking place, what can you do with the large bureaucracy that is still there showing no signs of diminution, not only in the Soviet Union, but in Hungary and Czechoslovakia.

Also, there is an interesting question as to why the system was quite as inefficient as it was. For example, managers could have been dismissed or, in the case they did well, promoted to better positions. You would think that some of the inefficiencies which have been revealed now could have been avoided just by prudent management. They were not all under the control of the manager, a great deal had to do with the system, but some of these inefficiencies were at the firm level. From the published data (now published, it was not published until recently), you can calculate some things like incremental capital output ratios. That is to say, you take the additional capital from one year to the next and divide it by the change in output. These run in the Soviet Union, in the order of seven. A figure like that is huge by the standards of any other country; three would be considered a high number in most places. There were several years' inventories on hand. We expect inventories in a reasonably efficient firm to turn over two or three times a year, and that is not by any means the most efficient firms; here they have several years' inventories on hand. Energy usage per unit of output is about double what it is in Western Europe. Now you would think that a management would have some incentive, under any system you can think of, no matter how poor, to cut down its use of energy. Transportation has become a major bottleneck, and the transport per unit of output is very high; those two go together.

Let me say something about the resource structure with which these economies are moving into the new economy. By most measures human capital is very high. The main measure is the degree of education, and if you take the average level of education in the socialist countries, it is high. There has been a consistent emphasis on the importance of education. I must say that among the many pledges of socialism, that seems to be one that was taken seriously. Probably some of you will say, yes, they have a lot of knowledge derived from books or techniques, but they have not learned to think for themselves. There is no entrepreneurial spirit; and so human capital may be misjudged with a measure like that. But still, that is an asset which certainly must be exploited in any change to a new economy. Physical capital, on the other hand, is probably much lower than the figures show, because most of this is ill-adapted. You have to rewrite the capital at its true value. Utilization is rather low in terms of the number of shifts, for example. Transportation, as I have said, is a bottleneck. Though it is possible that as you improve efficiency, say, through a better distribution system, you reduce the demand on transportation, and therefore make the present transportation system more usable. I will say that the quality of the rail system, I am told by the experts, is quite good. Highways, on the other hand, are something of a disaster. They are very poorly maintained, insufficient in quantity, and so forth. There is a very low ratio, by the way, of distribution services to output and this may be a sign of inefficiency.

Now let me turn to few remarks on the role of the State. Basically what I am going to say is that the State role has to be minimized. The biggest problem is micro-management, the tendency of the system through its allocation program to tell individual firms what to do. It is clear that, by any standards you can think of, this is going to be a source of inefficiency. Information in any economic system that has any complexity is distributed unequally. If people were doing something, they have to know more about it than anybody else. For others to acquire that knowledge is very costly and inefficient. For other people to make decisions based on inadequate information, as they do, is even more inefficient. For example, you have this standard of setting output quotas for firms. Well, any firm will produce a great many goods; so you have an index number problem. Consider all those stories about setting quotas for nails. First you decide to set quotas in terms of tonnage. Well, it turns out it is much easier to produce a big nail than a little nail. So to get your tonnage figures up you produce big nails. After a while the ministry realizes the mistake, and it switches to setting the number of nails. But obviously the input per nail is less for a small nail. So you produce a lot of small nails. Either way you do not meet the needs of the market, which after all should be the controlling factor.

Any system of control from above is going to suffer from an excess aggregation. It will never be efficient under the best of circumstances, and the circumstances are certainly not the best. I think it is probably sure that micro-management can not be ended by telling the ministries not to do it. You have to keep this bureaucracy from existing. You cannot really make anything unimportant as long as it is there, and I think you have to make it non-existent. From this point of view, the tendency in the Soviet Union to devolve power into the republics is a good thing. It is a bad thing from a lot of other points of view, but this is one virtue along with its other problems. Presumably, the Russian Socialist Republic (or whatever they will call it, the Russian Republic, the Ukrainian Republic, and so forth) will not take over the old bureaucracies. So that devolution means that the union bureaucracy will have no place to go, and it might automatically wither away, if I may use Lenin's phrase on this occasion.

There are other advantages to weakening the State. If you have a large State, you have a tendency to expect it to do something; politically speaking, if you are voting for people and they have power to do something, you will judge them on their performance. In a transition, and this may sound harsh, I think one of the worst things to do is to retain industries that are decaying. This is a problem in most countries, by the way. Shipbuilding in most of Europe was subsidized for a long period of time, after it was clearly inefficient and other countries were competing. In the same way, the Soviet Union has to allow industries that cannot stand foreign competition to disappear. You may talk about justice and equity and all that, and I think these are very important, but I do not think this is the way to achieve them. One of the reasons for the success of Sweden, which is a country that is very much devoted to egalitarian ideas, is that they did not use their egalitarianism to preserve dying industries. There was a strong tendency to recognize dying industries, and set to meet them by retraining workers and the like in the labor movement. So this is genuine egalitarianism, as opposed to what I think is a false idea of retaining existing jobs.

In the same way, regional policies, policies to protect particular regions, are probably a bad idea at this stage of the game. If you have a weak State you will not be tempted to carry out these ideas. I want to mention a very interesting discussion by Professor Laura Tyson at the University of California at Berkeley, on the Yugoslav movement to self-management about 25 years ago. She says that one of the real reasons for that was not so much to improve efficiency, which was the official argument, but that if each factory was on its own, it was its responsibility to succeed or fail. Now, Yugoslavia is a country with very sharp regional differences in income. There are very prosperous areas (there always have been; this does not have to do with socialist regimes, but rather with the history of the country), and other areas which are very poor. If you go from Slovenia to Macedonia, you will find an extreme variation. Now, how could a socialist state justify inequalities? Their job was to abolish them, but they did not know how to do it and they could not do it. So by transferring the responsibility to the workers, the government was absolved of its blame for income inequality. In the same way, I think a very important thing about weakening the State is that responsibilities of this kind will be given less prominence. In the drive for efficiency and growth, these policies have to be dispensed with. Besides, it is my impression that most regional policies have not been very successful in fact. We had them in the United States, very unsuccessfully; they had them in Great Britain, considerably more extensively, but they have not in fact improved the backward areas.

Let me turn to some specific problems of the economy. One that is very much to be concerned about is transitional unemployment. Essentially, the Soviet Union and other socialist states did have the commitment to full employment. It was maintained, if necessary, by keeping workers on jobs where there was no job. Firms were not free to easily dismiss workers and, of course, the counterpart was that workers did not find it easy to switch jobs; this went both ways. Any system in which you are making each firm responsible for its own activities, along the lines that everybody has been advocating, has to recognize that some firms will do badly and some will do well. And firms that do well, may do well by dismissing half of their work force. They will do well by being more efficient, and efficiency means reducing inputs including, in particular, the labor input, and this process leads to unemployment. We expect it to be transient, we expect this to lead to an expansion in which workers will be reabsorbed with a larger scale of output, but certainly the problem will exist for a period of time. Even in East Germany, which is by far the most favorable possible case, since it has a very wealthy and loving brother, unemployment is expected to rise to 30%. I think one has to have what are sometimes called active unemployment policies, retraining, very good employment exchanges, as methods of improving the transition. There is statistical evidence that, in Western Europe, these have been rather effective. From a cross-country comparison, Sweden, which has a very active policy, keeps unemployment rates low, other things being equal. I think, on the other hand, that while you want an active policy, you also want very generous benefits. As a matter of justice, the people being unemployed are not the ones who are responsible for the inefficiency. It is a matter of justice, it is a matter of preserving social peace. So I think you need both generous unemployment benefits and active policies, but you probably would not want, for example, minimum wages (or at least be very cautious on minimum wages) and certainly, as I said before, no regional policies.

In the Soviet Union, and I believe this is true for the rest of Eastern Europe, service industries need expansion. This is not the characteristic of Third World countries, where there may be too much of the service industries. One of the consequences of Marxism was a bias towards measuring things in terms of material production and ignoring the economic value of services. This is one case where the ideology seems to have a permanent effect. I think that the lack of an adequate distribution system is creating palpable inefficiencies. They hope for some better distribution system to reduce inventories, and I hope that, over a period of time, as the distribution system gets better, they will also have a reduction in the size of the plants. Large plants imply large transportation costs, since production is concentrated in fewer places and you have higher transportation costs. That is one of the reasons why large plants are socially inefficient.

The third problem that people mention is the distribution of income. From the data published in the Eastern bloc on income distribution, particularly in Czechoslovakia and the Soviet Union, one of the things that socialism has achieved is a more equal distribution of income in the Eastern Europe countries than is achieved in Great Britain, for example, or the United States, and probably more than France or Germany; even more than Sweden, as a matter of fact, although it appears to be much closer.

I think in this period of great change there is no reason to assume that this will be maintained. It is true that most historical facts change slowly, and since you start from a highly equal income distribution, you might suppose it will take some time. But what has happened is that this equality was achieved by a compression of the wage scale, doctors' wages are of the order of low-skilled workers' wages, and that sort of thing. We cannot assume that when you move to a competitive world this will be maintained, and probably it should not be maintained for efficiency reasons. There will be wage differentiation, there will be profits earned, there will be the inside managers that I have spoken of before with their special advantages, and so forth.

This is going to be a problem. Income distribution will probably change for the worse. It is possible that the tax system can be used, as in Sweden, to mitigate these changes; but there are a lot of burdens to be put on the brand new tax, and it may not also be able to serve egalitarian functions. So I am a little pessimistic on that one.

Finally, I stressed the problem of where the capital is going to come from to buy an existing plant. But, looking ahead, we have the problem of financing investment; where is the source of investment? There is private savings to be sure, and we do not know what is going to happen as more goods become available. The government has been, after all, a characteristic saver; by taking taxes from the prosperous firms, this has been a source of investment. That has to stop; it is a very inefficient way of generating investment. Of course, there are retained profits. As time goes on, the firms do retain profits and invest in their own activities. Maybe the firms will be very successful in paying dividends, the recipients of the dividends will put their money into the banks

(banks are emerging in the Soviet Union), and the banks will then be the source of investment. But I think that in the beginning you will need more investment, particularly as you write off the old capital goods; remember that I suggested that they were ill-adapted. They need new capital goods, and a lot of investment to improve productivity in the near future, and probably the only way to generate the savings will be through a budgetary surplus, which puts more saving in private hands. I wonder if that may be difficult, since the problem at the moment is thought to be just the opposite, to reduce the deficit, and I am asking for more.

Well, I think I have sketched what I consider some of the main problems in the transition from socialism to some kind of private enterprise economy. There are a lot more. I have not exhausted the topic, I can assure you, but I think this is enough complication for now. Let me just revert to my speculations and broad views at the beginning of the meeting: the future of the nation-state in the economic sphere. What is happening is a phenomenon which I think is not easy to explain, but that certainly is a fact. International trade is really swallowing up national economic sovereignty. For some reason, and I am not sure we have a good theoretical explanation, international trade has become a much more marked feature of the economic world than ever before. The percentage in the United States is two and a half times what it used to be, and in every other country is the same.

I believe that one of the reasons why the socialist world got into its crisis is that it was so linked to the Western world that the slowdown in the economic activity that the Western world has had for the last 15 years (it is beginning to emerge from it now) had its effects on the East. Export opportunities for the East diminished, as the growing days of the 1960s were replaced by the rather stagnant days after 1973. This showed up, by the way, specially in the debt crises for Poland and Hungary.

In the days of Stalin these problems did not exist. There was a limited amount of trade with the Western world. It was done not by the firms involved, but through a special trading company. They were selling natural resources, which tended to have demands that would depend on the business conditions, and they would expand the exports if the price fell. There was no real economic calculation. But as the economy became more complex, as the need for interaction with the West became greater, they could not avoid becoming so much more dependent on the West. That is a major factor in the negative judgement of socialism by the people. So even some of the autarkic Eastern bloc could not really escape the influence of world trade.

Part of the reason is that technological transmission seems to be closely associated with foreign trade. A way of learning about newer technologies is to import them for a while, get the engineers and so forth, and this leads to a transmission of technical knowledge. So the countries could not cut themselves off from the West. And I think they have found, as the Western countries have found, that their autonomy in economic affairs has greatly diminished.

We see this, for example, in fiscal policy. In the early post-war period, fiscal policy, under Keynesian influence, was devoted to stabilizing the economy; and the record of the 1960s looks very good by the way. But now it does not work nearly as well, because the economies are more open. Spending at home may lead to a much bigger leakage, you may remember the old Keynesian terminology; that is to say, more would go abroad, and would not in fact help the country as much. That is why the idea developed of global Keynesianism, called the locomotive theory of coordination, where the leading Western states will agree on their fiscal policies. Well, they never managed to do it; it never worked in practice. The argument was to replace the country with the world as a unit of analysis, but that is not possible.

So it looks as though countries have a much weaker ability to administer their own affairs. This raises a deep question: Given a world in which international trade plays a controlling role, is there any system, other than free enterprise, which is compatible with that fact? This is not even a question of what is desirable. Is it possible to have strong, nationally-run economies in the world of international trade? Thank you.