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Reform Economics and Western Economic Theory: Unexploited Opportunities*

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Abstract

The theory of economic reforms in Soviet Union and Eastern Europe did not follow the development of western economic theory. Although the fundamental economic issues are different in the West and in the East (employment and inflation versus shortages and lack of technological progress) the reform economics is concerned with the optimal mix of centralisation and decentralisation, of market and hierarchy, of autonomy and control, and – more recently – of public and private. All these issues have been extensively treated in western economic literature.

This paper overviews those fields in contemporary economics which could offer the East European reformers an enlightening perspective and useful tools in their search for a new institutional solution. Four such fields are presented: comparative economic systems, theory of incentives, literature stressing relative costs and benefits of different institutional solutions and comparing market and nonmarket failures, and the theory of property rights.

1. Introduction

A western economist looking at the literature on the economic reforms in the Centrally Planned Economies (CPEs) would have some trouble to find familiar currents and references. It is indeed striking how isolated the reform thinking is from western economic theory. Of course, the repeated attempts at transforming the economic system were not based on a fundamental choice of institutions in conformity with some theoretical considerations but were rather determined by a continuous stream of *ad hoc* policies under the pressure of actual political constraints. However, East European economists and policy makers do refer to 'economic theory' and, particularly in the recent period, complain that the supply of the theory does not follow the demand of the practice quickly enough.

Until now the economists in the East and in the West work separately

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using their own languages and terminology. The East European economists stress the specificity of their problems and experience and do not try to fit them into the general framework of western economics. Surely there are good reasons for it and we can imagine a rationale behind such an attitude: the scale of their problems is different (western economists were never confronted with the challenge of designing the whole economic system); the separation of political and economic spheres is more difficult; many of the theorems of the traditional economic analysis are based on assumptions facilitating the formalization procedure that make the theory irrelevant for empirical problems; until the 1960s the economic literature was dominated by the general equilibrium approach on the one hand, and by the theory of market failure on the other – neither of these two currents could attract the attention of East European reformers.

However, it seems that the reformers did not notice the evolution of classical economics to a more socially and politically relevant political economy. They often dismiss economic theory as it if were still limited to the case of perfect competition. The origin of this misperception was probably ideological but with time this kind of resistance disappeared. The inability to recognize that the extensions of the economic analysis and dynamically developing new fields were concerned with similar problems and might have been usefully exploited by reformers seems to be due in a large extent to the specific training of East European economists and their lack of interest in western economic science. It is also a linguistic problem. As long as they are convinced about the particularities of the issues they face and, consequently, use specific language and terminology, the perception of common themes and questions remains difficult.

The fundamental economic issues are certainly different in the West and in the East (employment and inflation versus shortages and lack of technological progress). But the reform economics is concerned with the optimal mix of centralisation and decentralisation, of market and hierarchy, of autonomy and control, and – more recently – of public and private. All these issues have been extensively treated in western economic literature.

Since the 1970s some western authors[1] have argued that the concepts and tools of conventional macroeconomics may be applied to study particular problems of the CPEs; that systematic differences notwithstanding, the issues of economic policy in the CPEs may be comparable (with some modifications) to equivalent issues in mixed economics. Although on a macroeconomic level this view is defendable (but it has never been accepted by the East European economists), we shall adopt here a different perspective, that of the reform economists who look for a new institutional order, and not only for adequate policy instruments.

In what follows we shall try to indicate those fields in contemporary economics which could offer the East European reformers an enlightening pespective and useful tools for their particularly challenging enterprise. We shall also suggest incidentally some developments in economic theory for which observing the East European experience more closely might have been stimulating and instructive for western economists. This will be a very tentative list of themes which should be developed in further research.[2] Also references to the literature will be necessarily incomplete and given for illustrative purposes.

The question of unexploited opportunities is not only of an historical value. It is also of an immediate importance and interest. We are witnessing a new and unusually far reaching wave of redesigning the economic system, indeed a search for a new paradigm, in the Soviet Union, Eastern Europe and China. More thorough understanding of the real possibilities and limits of western economic theory is probably now more urgent than ever.

2. Market failures and nonmarket failures

For long economists have been divided roughly between two schools of thought: there were those who believed that markets work best if left to themselves and that the function of the state should be limited to the establishment of a legal framework ensuring that markets work properly, and those who believed that the government should be an active agent concerned with the maximization of some social welfare function which can significantly improve the operation of the economy. Since the Keynesian revolution in the 30s and for the next 30 years the second trend remained the mainstream of macroeconomic theory and largely dominated the literature. To remedy the unquestionable market failures (externalities and public goods, increasing returns, informational imperfections) two solutions have been envisaged and applied: first, government intervention in the allocation of resources through regulation and taxes, and secondly, nationalization. The existence of any market inadequacies was considered as necessary and sufficient condition for the government's intervention as if it involved no social costs.

Welfare economics – which contributed to rapid growth of the public sector – was not interesting for central planners and reformers. They knew only too well the arguments for central planning but also its dysfunctions. Their experience could be rather enlightening for those western economists who for long remained fascinated by the idealistic vision of the welfare state. Since the mid 1960s, however, the nonmarket (government and bureaucracy) failures have been carefully examined. It becomes largely accepted, following Demsetz (1969) that it would be a fallacy ('a Nirvana form of analysis') to suppose that perfect government can replace an imperfect market, and, consequently, to compare an unrealistic optimal system with a real nonoptimal one.

A huge literature has been devoted to the unintended and unexpected consequences of government intervention and to the social costs that it implies. Several critiques of the involvement of public authorities in economic life have been formulated, underlining different aspects of the problem: the public choice school and the economic theory of bureaucracy, political business cycles literature, the theory of property rights, and the theory of incentives.

Public choice school and the economic theory of bureaucracy[3] study the performance shortfalls of different nonmarket organizations, including governments. They stress the fact that public organizations, developed in order to guarantee the law, to provide public goods, to stabilize and control the economy, fail in several respects to fulfill their original task. Bureaucrats are not disinterested men totally devoted to the public interest, they are ordinary men trading off (at best) between their own private interests (defined as the three 'p's: more pay, power and prestige) and the public interest. Moreover, because they are not submitted to budgetary constraints and systematically checked by 'hard facts' in the same way as market firms, the correction of the distorted information (and action) may be long in coming. The resulting inefficiency of the public sector has been studied extensively.[4] This large literature, considered often as weak from the theoretical point of view, marked an important breakthrough; it pointed out that the respect of optimal rules cannot be taken for granted and that the actual implementation should be carefully scrutinized; it also stimulated the development of rigorous models of behavior of public firms.

The economics of public enterprises providing private goods, first more normatively oriented and looking for the optimal behavior rules, switched to positive studies of bureaucratic behavior, analyzing allocative inefficiencies due not only to government objectives but also to difficulty of control, incorporating the dimensions of imperfect and asymmetric information (e.g. on unobservable productivity parameter), and the question of incentives. The key issue became the distortion of information by the self-interest seeking behavior of different groups. Then came the theory of property rights, the theory of agency and the theory of incentives (which will be treated in Sections 4 and 5).

Constitutional economics is another extension – a strongly normative one – of the public choice school. It underlines the importance of political and economic institutions and of the long-term constitutional constraints on government. It goes beyond the usual concern of economic analysis (efficiency) and looks for such institutional design that will allow for social improvement (in terms of increased individual freedom).[5]

Both the public choice school and the constitutional economics approaches seem to be particularly close to the reform economists' preoccupations. Critiques of government involvement in economy and the search for viable political and economic reforms are indeed the very essence of their endeavour.

An important qualification is, however, in order. The positive theory of public enterprises supposes that the system of control of public enterprises operates within a market framework; that public enterprise is subject to constraints arising out of market conditions (and technology and government control). This is obviously different from the CPE context in which market sanctions do not exist.

Also political business cycles literature stresses the unintended consequences of government intervention. It is based on the observation that politicians are driven by short-term electoral considerations and their policies can destabilize the economy. Indeed in democratic systems there is an incentive to policymakers running for re-election to use stabilization policies to win popular support. Before elections, democratic governments are inclined to adopt expansionary policy actions with immediate visible benefits and hidden, delayed costs.[6] Although in the CPEs there is no real electoral checks, social discontent can manifest itself through decline in productivity, withdrawal from the labor market, visible accumulation of frustrations, or even revolt. In several East European countries planners proved to be sensitive to this kind of 'vote' and reacted to consumer dissatisfaction by stopping investment expansion. Therefore, instead of western democratic government destabilizing *ex ante*, before elections (applying popular measures), and stabilizing *ex post*, we can expect East European planners' investment policy to overheat the economy *ex ante* (using unpopular measures), and to equilibrate *ex post*, when a growing dissatisfaction of the population forces them to adjust.[7]

Since the end of the 1970s, a sketchy reconciliation and synthesis of these two opposite traditions in economic policy thinking – enthusiasm of welfare economics and scepticism of public choice school – emerges in several works stressing the necessity of comparing relative costs and advantages of different institutions. Between public economics (assuming perfect control of public firms by the government) and the economic theory of bureaucracy (fundamentally distrustful of public intervention), it comes to be more and more accepted that, in terms of allocative Pareto efficiency, the theory of market failure has to be confronted with the theory of nonmarket failure[8]; that the economy can be moved by the policymakers only along the frontier of the social opportunity set, trading off one good for another (for instance externalities for more costly administrative structure, or employment for real wages); that dynamic efficiency and the incentive for technological innovation may remain in conflict with the static, allocative Pareto efficiency (for instance patent regulations restricting access to technological information in the interest of long run efficiency reduce competitive pressure and the short run efficiency).

This way of looking at economic issues may be extremely useful for reform economists. Their search for a new system combining central planning with some elements of the market was usually based on one of two presumptions: some viewed central coordination of the economic life as basically beneficial and were looking for a limited injection of a market mechanism, others were convinced that 'the market was a marvel' and would like to graft as much of it as possible into the 'real socialism' (the second tendency has been particularly alive for the last few years). Pragmatic evaluation of the actual working of different institutions was rarely undertaken.[9]

Transaction cost economics adopts this comparative institutional approach, views each organization as a package of distinctive strengths and distinctive weaknesses, and examines the choice between market and nonmarket organization in terms of assessing comparative advantages of different institutions.[10] It is based on the presumption: 'in the beginning there were markets' and tries to explain why and when transactions are removed from markets and organized internally. Contrary to the common sense explanation according to which vertical integration has technological origins,[11] transaction cost economics attributes it basically to the opportunity of economizing on the 'costs of running the system', equivalent to friction in a physical system. However, the gains offered by a hierarchy may be offset by the monitoring costs: for instance, in a firm, the costs of negotiating separate contracts for each exchange are reduced, but the control loss may exceed this gain. Therefore, transaction cost economics is concerned with the reasons for which firms exist but also with the limits on their growth. It favors the vertical integration as long as the marginal costs of transaction are smaller than those of completing transactions through the market.

If we think of the CPEs' institutions in terms of transactions cost economics, the point of departure is 'in the beginning there was a big organization' but the internally organized transactions broke down and have to be shifted to the market. If in the case of the market economy the main question is when a hierarchy can be expected to internalize successfully a part of the market,[12] in a CPE it will probably be: how far should the hierarchy (the national economy) be transformed into the market? To answer the first question the experience of the planned economy may be relevant, and *vice versa*, the operation of the market economy gives some arguments in favor of not overly reducing the size of the firm.

The concept of transaction costs, stressing the importance of the contract execution stage, is quite appealing for the analysis of the centrally planned, shortage economy. For example, in the course of exchange between firms specific informal costs should be taken into account: formal monetary costs are not of primary importance for the enterprise (cost-based prices allow the incorporation of the cost into the higher price for the product and money hoards are relatively useless); what counts most are goods and services in short supply which are at the firm's disposal and which have to be exchanged for other goods and services, necessary but in short supply (a 'vector price' for each deficitary good might be established for such a barter exchange). Other informal transaction costs should include bribing the supplier, sending him employees of the firm as workers, accepting his demand for credit.[13]

3. Comparative economic systems

Reform economists are familiar with concepts of comparative economic system analysis and sometimes use them. However, the deep sense of the systemic approach does not seem to be widely assimilated or applied. Beyond a meticulous description of various aspects of economic systems and an attempt to create a common conceptual framework allowing for the comparison of different systems, the systematic approach is a way of seeing different elements of an economic system as necessarily and inevitably interrelated. If we agree – as most of us do – that any economic system can be characterized by its decision-making structure, information structure and incentive structure, the normative conclusion of comparative economic systems is that any change in one part of the system necessitates adequate adjustment in other elements. The neglect of this principle may render futile or even harmful any apparently rational measure aiming at overcoming some imperfections of a given system. For example, it is useless to create strong incentives encouraging economic agents to make some decisions that, according to the authority structure, will not be in the area of their competence.

The history of economic reforms in Eastern Europe gives several examples of the incompatibility of reform proposals with this basic tenet of comparative economic systems. Since 1956 most of the successive reform proposals touched upon all three subsystems: decision-making had to be decentralized to lower entities; the number of plan indicators had to be reduced and financial indicators had to replace direct physical allocation of resources (information structure); incentives had to be associated with the performance of the enterprises. However, the lack of coherence of different blueprints was notorious: failure to take into account conflict between any incentive system and basically unstable rules of the game (the limits of the Center's decision-making power being ill-defined, some theoretically good incentive systems proved to be inefficient because of the enterprises' expectation of change); contradictions between the incentive systems at different levels of the economic hierarchy (modifications of the success indicators on the level of the enterprise without adequate changes on the level of intermediary units, e.g. industrial association); inadaptation of the information structure and incentive structure (the search for an increased autonomy of the enterprises did not bring about consequent substitution of orders by financial parameters); incompatibility between the decision-making structure and the incentive structure (incentives have been often changed to make managers more sensitive to efficient use of resources and to stimulate innovations, but this has not been accompanied by adequate modifications of the decision-making structure, giving them, for instance, the right to buy and sell the capital of the firm).

Related, although somehow different, is the problem of the relationship between the economic policy and the economic system. The economic policy is different from and external to the economic system, although it influences in a significant way its performance (for instance, the policy of full employment or of a strong progressive taxation inevitably weakens any incentive system). Given strong interdependence between the two, it is admitted that they should be carefully adjusted one to the other: a particular economic policy may be compatible only with a limited set of organisational solutions and, conversely, a particular economic system imposes some constraints on the set of policies which may be implemented without challenging the logic of the system.

In writings about the CPEs, the awareness of these subtle relationships is not always present (but for example Kornai (1986) distinguishes carefully between the two). In practice there is often a tendency to consider the economic policy as a substitute for institutional changes (e.g. Gierek's period in Poland). Another confusion, more characteristic of the Western perception, is to speak about reforms when what we have to deal with is merely change in the economic policy (there are several exceptions, e.g. Hewett (1988) stressed forcefully this distinction). In situations of profound disequilibria, the problem of priorities between the economic policy and the economic system is discussed: some argue that if there is strong excess demand, an appropriate macroeconomic policy should be the precondition of the reform; others say that it is only a deep reform which can bring about the equilibrium. Empirical evidence suggests that as long as disequilibria are relatively weak and the economic system relatively coherent (even if inefficient), adequate economic policy can be successful; but beyond some threshold of decomposition of the economy (Poland), profound systemic changes seem for many economists to be the necessary preliminary step (with adequately adjusted economic policy measures).

Looking back at over 30 years' experience of reforming the CPEs, it appears that this misperception had a harmful effect on the reform process. As soon as the conflict appears between the goals of the economic policy and the (temporary?) effects of the reformed system, the new rules of the game are abandoned: if, for instance, the profit-oriented incentive scheme creates differences of revenues incompatible with a wage policy expressing distributional preferences, the former is sacrificed to the advantage of the latter.[14] Because of this substitution effect and the fundamental instability of the rules of the game it is often difficult to disentangle the impact of the system itself and of the economic policy on the performance of the CPE. This can probably explain some contradictory theoretical statements about the CPEs. For instance, according to Granick (1987), many malfunctions in the CPEs, which have been commonly attributed to the existence of a central planning system, can be attributed to the Center's preference for a Job Rights Overfull Employment objective. Granick argues that this has the highest priority in the planners'/government's eyes and that the choice of policies and institutions is subordinated to it. This contradicts Kornai's conviction that overfull employment is the *result* of the distinctive systemic features of the CPEs: permanent disequilibrium, overheating and soft-budget constraint. Needless to say, the choice of one hypothesis or another will strongly influence the reform economics and policy thinking.

4. Theory of incentives and theory of principal-agent

Comparative system analysis puts an accent on the informational, incentive and decision-making properties of an economic system and stresses the complex and delicate relations between these three subsystems. There is, however, a normative extension of this approach that studies feasibility, implementability and efficiency of different organizational solutions.

Decentralized procedures for planning may be considered as the first works in this field. Their focus on the *ex ante* contracting stage and the informational aspect of an allocation mechanism probably discouraged CPE economists and planners from considering them as a serious alternative solution to the CPE problems. The neglect of the motivational side and of the implementation stage was one of the reasons for the distrust of Lange type schemes.

However, since the beginning of the 70s, there has been a boom in the literature stressing the strategic aspects of the economic agents' behavior which have come to be considered by many economists as the key problem of economic organization.[15] It appears in different forms: theory of agency, principal-agent problem, or theory of incentives.

The problem of incentive is formulated as follows: the principal, who engages agents and delegates to them some decision-making authority, has his own objectives which do not coincide with those of the agents. Moreover, some of the agents' private information is not known to the principal (which may lead to adverse selection) and/or the principal cannot observe the agents' actions perfectly (moral hazard). So the principal must choose an incentive scheme which specifies in advance how he will react to the agents' information and action (i.e. what will be the agents' reward for each possible observed outcome), and which induces the agent to reveal truthfully its characteristics and to behave as if he were maximizing the principal's welfare (or at least which limits a divergence from his interest). The principal-agent theory has several applications: to the relationships between government and managers of public firms,[16] between shareholders and managers of privately owned firms, between employer and workers, between insurer and insured.

The theory proposes several procedures (transfer functions) possessing desirable incentive properties in different frameworks – static or dynamic, under moral hazard and/or adverse selection, with or without commitment – and with a variety of behavioral assumptions: firms maximize profits, or value-added per worker (Ward, 1958), or a combination of 'effort' and money, or some more complex objectives. These transfer functions, composed usually of a fixed transfer (higher for low-cost agents than for high cost agents) and a bonus (or penalty) which depends on the difference between expected and observed outcomes (Picard, 1987), assure that the truthful revelation (of endowments or of a marginal rate of substitution) and the optimal effort are a dominant strategy.[17]

The problem which reformers face in the CPEs may be also formulated in terms of the incentives theory: is it possible to design a contract between the planner and the state enterprises which will guarantee that the firms do not use their informational power and that will induce them to work hard? It is a particularly complex problem of a dynamic incentive scheme, combining adverse selection (hidden information) during the working out of the plan (the planner does not know the firms' production functions) and moral hazard (hidden actions) during the carrying out of the state plans (the planner cannot observe how far the firms' choices are guided by the search of a maximum input/output ratio and of a quiet-life). The complexity of the problem is increased by the fact that there is no credible warranty that the planners will respect the agreement (an incentive scheme without commitment). As far as we know, no incentive scheme has been proposed until now allowing for such a complexity.

So, very abstract and mathematically sophisticated, the theory of incentives may not be applicable directly to the real CPE's world. Besides the extreme complexity of the CPE's principal-agent problem, there is the question of a basically nonmarket environment for the state firms in a

CPE. The distinguishing mark of any firm is that it supersedes the price mechanism, but in a market economy (or in a mixed economy) the firm remains related to an outside network of relative costs and prices. The implicit hypothesis of the theory of incentives is the presence of this strongly motivating factor. The firms in the CPEs are free from this constraint. The second objection concerns the lack of commitment. Without a minimal guarantee that planners will respect the terms of contract, the whole incentive problem is meaningless.[18] The firms will not reveal information if it may be used against them. Constant modifications of the regulation system of enterprises make problematic even the assumption of short-term commitment. The 'success indicators' and the bonus system of a CPE enterprise change very often and the prediction of this change is part of the firms' rational expectations.[19] This shows the limits of the possible utilisation of the principal-agent as a positive theory of the CPEs. But, at the same time, it suggests that the stabilization of the rules of the game and the building up of trust are necessary preliminary conditions for any efficient incentive scheme. This is another way of arguing the importance of constitutional economics. However, even at a positive level the theory of incentives may provide some instruments allowing to assess different incentive schemes actually used or proposed in the CPEs.

5. Theory of property rights and theory of agency

If the incentive theory takes the organizational structure of the economy as given and tries to design an optimal incentive scheme, the theory of property rights goes another way around and studies the impact of the distribution of property rights on the economic agents' performance.

In a broad definition, property means not only 'ownership' but also various rights (regulation) enforced by legal means.[20] Ownership is defined as the right to use the assets (*usus*), the right to appropriate returns from the assets (*usus fructus*), and the right to bear the consequences (positive or negative) of the changes in the values of those assets (*abusus*).[21]

The property rights approach maintains that private property is the best institutional arrangement creating incentives to channel individual economic effort into activities that bring the private benefits (or costs) close to the social benefits (or costs). It claims that in order to use economic resources in the most productive way, it is necessary to develop property rights completely: they should be individual, exclusive and freely transferable. In all nonprivate institutions, like public firms, different nonprofit institutions, mutual associations, cooperatives, the discrepancies can be expected between private and social rates of return. The argument is based on the absence of capitalizable, saleable property rights and, consequently, the lack of incentives for the 'owners' to move resources from a less productive to a more productive use and to exercize adequate pressure on X-inefficient management.[22]

This is obviously directly relevant to the CPEs. It came to be widely acknowledged by reform economists that the enterprises should have the right to participate in profits from current use of assets (*usus fructus*) and all reform projects were sensitive to this issue. In recent years the problem of ownership has been openly discussed in Hungary, Yugoslavia, Poland and China. The long-term lease of land to peasants has been decided in China and in the USSR. In Hungary several proposals have been made to redefine property rights in order to create incentives in accordance with those of an owner. Looking for the personification of the state ownership, Tardos (1986), for instance, proposed the creation of special bodies – state holding companies – to supervise the enterprise management, as stockholders do in a modern corporation. However, the role of *abusus* seems to be undervalued. And still the possibility for the owner to split up, merge and sell the firm by capturing its market value provides a stimulus of primary importance. Although the utility function of a manager of a private firm in a market environment and that of a manager of a state enterprise in a CPE may be similar (i.e. a combination of income, effort level, growth rate of the firm and the level of discretionary managerial expenditure), the first one is constrained in the pursuit of his own objectives by the fact that, ultimately, the shares of his firm are marketable (every shareholder can transfer his property rights to another investor). The empirical evidence suggests, and particularly the analysis of the Yugoslav experience, that the absence of transferable property rights is a powerful disincentive for enterprises to care about the net worth of assets.

The property rights school also studies extensively the consequences of what is called the separation of ownership and control in a privately owned corporation:[23] managers who are not the firm's security holders can be expected to appropriate perquisites out of the firm's resources for their own consumption and to devote a smaller effort to creative activities (learning about new technologies, and so on) than in the case of an owner-managed firm. The problem of control is however limited, according to the economics of property rights, by the fact that the price of a share in the capital market reflects the expectations about the firm's prospects (it rises if the performance of a manager is good and *vice versa*) and shares can be bought and sold: every shareholder can transfer his property rights to another investor.

So the property rights literature attributes to the entrepreneur (the risk bearer) a central role in disciplining managers. The threat of outside takeover is considered as providing a discipline of the last resort.[24]

The theory of agency, related to the property rights school, is also concerned with the incentive problem in a modern corporation in which the decision makers (managers) do not bear a major share of the wealth effects of their decisions, but its approach is different: if the theory of property rights suggests how to make *ex ante* evaluations of the impact of alternative institutional structures on economic behavior, the theory of agency views the separation of ownership security and control as an efficient form of economic organization and tries to explain *ex post* the survival of organizations in which shareholders cannot exercise real power to oversee managerial performance.[25] It dispels the notion of ownership and the key role of the entrepreneur in monitoring the managers for two reasons: 1. security holders diversify their portfolio between the securities of many firms and, consequently, are less sensitive to the information about inefficient managerial decisions and less interested in overseeing any of the firms, and 2. managers do care about the performance of the corporation; although they do not suffer immediate gain or loss from current performance, it influences the value of their managerial services on the labor market. So management and risk bearing are treated as naturally separate factors of production, the first being constrained by the managerial labor market, the second by the capital market and the possibility of takeover.[26]

Therefore, the theory of agency does not argue that ownership is unimportant, but that the agency costs resulting from the separation of ownership and control are limited by the existence of three markets: the capital market, the market for corporate control, and the managerial labor market. If these markets do not exist the agency costs increase significantly. They will be higher – all else being equal – in publicly owned firms than in private firms: in the public sector the lack of a capital market and of a market for corporate control weakens the managerial incentive system.

This presumption must be however qualified: it depends strongly on the market structure (degree of competition) and regulation in the market. This shows the limits of the theoretical arguments and the need for empirical evidence about the impact of ownership arrangements on performance.

The empirical studies comparing the actual performance of private and public firms are still very few. The basic reason for this is probably the difficulty in finding comparable firms in the same product area.[27] The recent wave of privatization offers, however, an opportunity to assess the performance of nationalized versus privatized firms. Some conclusions are already available.

Several authors[28] studying the experience of privatization (particularly in Great Britain) agree that the implications of changes in the structure of ownership depend heavily on the effectiveness of regulatory policy and the degree of product market competition. In other words, privatization and deregulation proved to be satisfactory cures to the inefficiency of public enterprises if there were no important market failures. In the case of firms with important market power subject to regulation the arguments *pro* and *contra* privatization should be carefully scrutinized: unless competition is expanded and/or adequate regulatory policy applied, privatization of a monopoly may not produce expected results.[29] The role of competition appears to be particularly important both as a powerful incentive system and as a mechanism for the discovery, revelation and diffusion of information.

The relevance of all this for the CPEs is not straightforward. In a socialist economy there is no capital market, no managerial labor market and no market for corporate control (no threat of takeover). Managers are free from the market pressure; they are monitored by direct control. But all reform projects attempt to increase the independence of managers and limit the scope of central control. The theory of property rights and the theory of agency suggest, however, that without a competitive market environment, this can only increase the agency cost: with the relaxation of the 'principal''s control and without the discipline of the market, the agents' (directors of state enterprises) behavior may be supposed to diverge still more from an 'optimal' one.

6. Conclusions

What can reform economists learn from western economics? Is their scepticism justified as far as the utility of economic theory for reform thinking is concerned, or do they miss something important?

It is true that in looking carefully through different branches of economic theory, a reform economist may feel embarassed. On the one side, there is an overwhelming empirical evidence of the bankruptcy of central planning and of state ownership, on the other, economic theory seems to be unable to provide clear-cut, well founded arguments in favor of private enterprise. It says rather that there is no perfect solution; that there are market failures and nonmarket failures which have to be compared; that a particular institutional set up does not determine univocally the results because tacit knowledge is important. Economic theory can merely suggest what are the possible trade-offs (e.g. between increasing returns to scale and diminishing returns to management, or between uncertainty due to strategic behavior and uncertainty due to the lack of communication) and where to look for the comparison of costs and benefits. In western thinking about the economy, such an approach seems to be more and more accepted and takes the place of ideal models. Everyday experience shows the ubiquity of intermediary solutions, the coexistence of markets and hierarchies, the eclectic use of advantages of organisation and of individual entrepreneurship.

However, crucial for this analysis and for the operation of various organizations in the West is that they operate in the framework of a market system with private property of the means of production. This assumption, self-evident in the West and unrealistic in the East, seems to be the key obstacle in making the economic theory relevant to the CPEs.

The role of a market environment is strongly underlined by the theory of economic evolution and economic selection (which may be considered as an extension of the theory of property rights). They also give the most powerful argument in favor of private enterprise. The evolutionary theory of economic change accepts private enterprise because of its sensitivity and responsiveness to unforeseen changes and its capacity to stimulate technological innovation.[30] The theory of economic selection views the pluralistic market economy as favoring the selection of organisations which have the best combination of error-elimination and trial-generation capacities.[31] Both put an accent not on the resource allocation mechanism (including incentives for truthful information) but on the dynamic aspect of the search for efficient organization, including incentives for entrepreneurship. So the argument is different from the orthodox claim for superior static efficiency. Without a pluralistic market environment, a sophisticated comparison of markets and hierarchies, or of private enterprise and central planning, becomes a totally different problem, both theoretically and empirically.

In a socialist economy with state ownership of the means of production, like in a public economy, selection and evolution do not operate in the same way as in a market economy. Bureaucracies struggle for accommodation with superiors, not for survival. 'Hard facts', such as a budget bottom line, do not play a discriminatory role. Subtle strategies against selection develop; uncorrected errors accumulate.[32]

In the reformed CPEs it is more and more recognized that a kind of market pressure is necessary for the market oriented reforms to produce expected results. Consequently, several interesting institutional proposals have been formulated in the attempt to reproduce market pressure in the framework of a basically state-owned economy.[33] The question remains whether it is possible to create a market environment with all of its blessings maintaining state property of the means of production. In other words, is it possible to *simulate* the market?

If we agree that the market must be *real* in at least a large part of the economy, the question is, of course, how large should it be to make its logic spill over onto the nonmarket sector? The question is common to contemporary market economics and to socialist economies. In mixed economies the question is: how far can we go in enlarging the public sector without losing the main advantages of a private economy; what deviations are acceptable before the system becomes unworkable? In the East the question is: is it possible to get an 'optimal mix' of private and public, coming from a centrally planned economy with state property of the means of production; can it be done by partial privatization in a 'hostile' (nonmarket) environment, or is a full switch to the free private economy necessary? (In the first case the positive results may be too long in coming, in the second the social costs and resistance may be prohibitive).

This points out the fundamental problem that the reform economists face today – the problem of transition. To this economic theory has no answer. It is a political question. The limited tolerance of the population for a radical, painful change may be an argument for the progressive experimentation with different property rights set-ups, institutional frameworks, etc.

In any case, '*the theory of economics does not furnish a body of settled conclusions immediately applicable to policy. It is a method rather than a doctrine, a technique of thinking, which helps its possessor to draw correct conclusions*' (John Maynard Keynes).

Notes

1. Particularly Richard Portes in his several articles.
2. The positive examples of the application of western economic theory, and particularly of the incentive system, to the study of the Soviet-type economies, do exist but we shall not present them here. The authors of such works are western economists. See for example Loeb and Magat (1978), Mougeot (1988).
3. Standard references are Buchanan and Tullock (1962), Niskanen (1971).
4. Some stress the fact that the behavior of public managers is influenced by political pressure (e.g., Fiorina and Noll, 1978); others concentrate their attention on bureaucrats' use of informational monopoly to influence the government (Niskanen, 1971).
5. Cf. for instance McKenzie (1984), Buchanan (1987).
6. Cf. for example Lundberg (1968), Nordhaus (1975), Lindbeck (1976), Frey (1978). Recent empirical evidence is mixed. For interpretation of CPEs' fluctuations and adjustment in terms of political business cycle see Grosfeld (1986).
7. In a threshold model of planners' investment behavior the planners' sensitivity to the evolution of real wages has been confirmed. Cf. Grosfeld (1987).
8. Wolf (1979) proposes a typology of nonmarket failures analogous to that which exists for market failures: internalities and private goods (due to internal structure of rewards and penalties unrelated to external prices system), redundant and rising costs ('X-inefficiency'), derived externalities (unintended side effects of nonmarket intervention) and distributional inequity (in terms of influence and power as compared to income and wealth in the case of market 'failure').
9. Kornai (1983) stresses the inevitability of trade-offs between different economic 'diseases' but not between different organisational structures.
10. The fundamental reference is Williamson (1975).
11. Cf. Alchian and Demsetz (1972) who view technological nonseparability as primarily responsible for the appearance of the 'classical capitalist firm'.
12. The question has been first asked already by Coase (1936): why is not all production carried on in one big firm?

13. To regulate the flow of capital the central bank in a CPE applies lower rate of interest for trade enterprises than for industrial enterprises. However, in the situation of shortages, the position of the latter is so strong that it can and does impose conditions on deliveries to the former. Credit (with the low interest rate) is one of these conditions. (*Zycie Gospodarcze*, No. 4, 1988).
14. Recent developments in China are a good example of this phenomenon: After a decade long period of economic restructuring and market-oriented reforms, the Chinese government found growing inflation, inequalities and corruption to be unbearable. It decided (as is the typical reflex for a CPE's government) to sharply reduce the role of the free market: the control of the prices of many goods will be reimposed, the number of private firms will be limited, and the capital spending by local authorities will be scaled down (*International Herald Tribune*, 18.10.1988).
15. Cf. seminal paper by Groves (1973).
16. In fact, in democratic countries there is a double principal-agent relationship: the government acts as a principal in its relations with managers, but as an agent in its relations with citizens (voters). (Cf. for instance Caillaud *et al.* (1988)). The political business cycle phenomenon may be explained in these terms.
17. A dominant strategy is the best strategy for the enterprise independently of other enterprises' choices. Some authors develop the Bayesian solution defined in terms of an agent's beliefs about others' behavior.
18. See Guesnerie (1988).
19. For the analysis of a dynamic game with a ratchet effect between the Government and the firm see Freixas, Guesnerie and Tirole (1985).
20. Cf. for instance Pryor (1973).
21. *Abusus* implies of course the ability to sell or exchange the share of rights.
22. See Alchian (1969), Demsetz (1967), Furubotn and Pejovich (1972, 1974), Alchian and Demsetz (1972). Of course, private property rights are never absolute: they are always restricted by the political order of the society. See Warren Nutter (1974).
23. The issue has been stated first by Berle and Means (1932). One of the most illuminating contributions is Jensen and Meckling (1976).
24. See Manne (1975).
25. Such an approach is similar to Hirschman's search for hidden rationalities. Studying the Colombian reality, instead of stressing various disequilibria and deviations from the path followed by industrial countries, Hirschman looked for possible rational uses of shortages, bottlenecks, unbalanced growth, and so on. He looked for processes that did work although in an unfamiliar way. See Hirschman (1986).
26. See Fama (1980).
27. Cf. M. Marchand, P. Pestieau and H. Tulkien (eds.), 1984.
28. For instance Yarrow (1986), Vickers and Yarrow (1988).
29. See Vickers and Yarrow (1988).
30. This goes back to Schumpeter's idea of creative destruction. See also Alchian (1950), Nelson (1981).
31. For an excellent presentation see Pelikan (1985).
32. See Forte (1982).
33. See Nuti (1987), Tardos (1986).

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