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# **Political Economy of Reform and Change**

**A Case of Eastern Europe**

**Jan Winiecki**



## Political Economy of Reform and Change

First published in 1997, this collection of articles and essays analyses the political economy of reform and change in Eastern Europe during the years of Gorbachev's *perestroika* and the years immediately following the fall of the Berlin wall and the collapse of the Soviet Union.

Written by Polish economist Jan Winiecki, between 1984 and 1996, this work explores the issue of the feasibility of reform and change during the period of decline and collapse of communist economic order and, later, the emergence of the capitalist economic order in the post-communist Eastern Europe. Split into three parts, the work considers firstly the failures of Gorbachev's political economy of reform, secondly the determining factors in the collapse of the Soviet system, and finally the feasibility of the systematic change which began in the wake of its collapse.

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# **POLITICAL ECONOMY OF REFORM AND CHANGE**

**A CASE OF EASTERN EUROPE**

**JAN WINIECKI**



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*Printed in the United States of America*

To my Mother who taught me  
To see the difference  
Between good and evil  
- and between good economics  
and bad economics

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## INTRODUCTION

This book aims at offering the Reader a kind of intellectual guide through the collection of articles and papers that make up **'Political Economy of Reform and Change'** - and, in this manner, through the general issue of the *f e a s i b i l i t y* of reform and change. They were written by the present writer over the period of 12 years (1984-1996) and, therefore, should be perceived in the context of both time and place, that is the period of decline and collapse of communist economic order and, later, the emergence of the capitalist economic order in the post-communist Eastern Europe.

To exemplify the idea, it is a different story to have written in 1987 (as this author did) that there is strong probability that Gorbachev's economic *perestroika* is going to be carried much further than both its proponents and opponents (i.e. in the East communist *apparatchiki* - J.W.) perceive at the moment than to have written it in, say, 1990. In the former case the author thought it necessary to substantiate the prediction with references to the logic of decline of the Soviet economic system; in the latter the decline would have been clear for all to see.

The intended guide should start with the title. There exists an intellectual muddle in the literature on the subjects in question, where the terms: 'reform' and 'change' are used interchangeably. However, **equating reform and change is an error of a large magnitude**. One 'reforms' something that already exists and is in need of more or less substantial modifications to make it work better. On the other hand 'change' suggests shift from one state of affairs to another. Thus, one reforms an economic system but one changes from one system to another.

In the relevant context 'reforms' mean near-continuous attempts to improve the performance of the communist centrally planned (centrally administered, Soviet-type) economy. These reforms usually tinkered with the structure of incentives, administration of planning and plan implementation, etc., but without breaking decisively with fundamental institutions of the economic system, let alone questioning the fundamentals of communist political system.

By contrast 'change' signifies a shift from the communist centrally planned to a capitalist market economy. **Such shift must, however, entail both political and economic change - and in this order.** As political change destroys the symbiotic relationship between political and economic system under communism, it opens up the possibility (but in no way the certainty!) of successful economic change. Without such a decisive break with the political past the economic change is well-nigh impossible. A substantial part of the pre-collapse and post-collapse writings of this author, collected in this book, consistently stress the point.

Furthermore, **there is no necessary continuity between earlier tinkering and later systemic change.** The successful quasi-liberalizations accomplished under the banner of 'reform' were not always beneficial in terms of their contribution to later systemic changes. For among the countries that are widely regarded as success stories there are both perennial tinkers under communism as well as those that remained close to the Soviet economic orthodoxy.

A 'political economy' term raises fewer questions. Thus, this collection concerns itself not so much with the question how badly the Soviet system performed and how successive modifications failed to improve it but rather with the question why, although badly needed, reforms, let alone fundamental institutional changes, were not implemented. In other words it concerns itself not with 'hows' but with 'whys', or with **the political feasibility of reform.**

The same applies to systemic change. It is not the efficiency and coherence of stabilization, liberalization, and institutional change-related measures that are a prime consideration here but rather political feasibility of their elaboration and implementation. Also, the role of coalition-

building in support of transition from plan to market is repeatedly stressed by this author.

The term 'Eastern Europe' requires some comments as well. Many a Reader would be surprised to learn that it is of a rather recent vintage. It, in fact, came into being after the World-War-II to stress the division of Europe, with 'Eastern Europe' understood as the part under the Soviet communist domination. But in the somewhat more distant past, various parts of what used to be later called 'Eastern Europe' were called 'Northern Europe', and more recently 'Central' or 'East-Central Europe'.

These differences are of interest not only to historians or geographers, though. They have also important connotations for the subjects covered in this book because **'Eastern Europe' covers countries with sharply differing political histories and these differences may, in turn, strongly affect the systemic change.** The 'East-Central Europe' is, thus, a narrower term covering most often the countries historically belonging to the Western Christendom. A look at the map of Eastern Europe and the dividing line between the East-Central Europe and the rest may also look like a dividing line between success and failure of systemic change [see Winiecki, 1996].

But let us turn to the reform failure, first, as it makes up the first part of this book. The Soviet economic system could be characterized as one, where initiative was limited by and large to the center (central planners and their political masters), thus missing the benefits of entrepreneurship and innovation of autonomous economic agents. System's ability to utilize information available throughout the economy was by its centralized nature extremely poor. Finally, incentives to perform well were either non-existent or heavily distorted. The system was also unstable over time. As economic structure became increasingly distorted and complexity increased [see, *i.a.*, Winiecki, 1987a, 1988, and Winiecki & Winiecki, 1992], as external shocks began to exert growing influence on performance, the initially low capacity of the system to perform began to decline, slowly at first and precipitously at some point.

The foregoing has given an impulse to the search for performance-improving measures - the search that began already in mid-1950s [see, *i.a.* Kornai, 1959, and Berend, 1990] and continued throughout the system's

existence, until its collapse at the threshold of 1990s. These **continuous attempts at economic reforms were unsuccessful, marginal improvements notwithstanding**. Therefore, over time, the literature on the subject of reform began to be increasingly interspersed with questions concerning not the *economics* of Soviet system's reform but the *political economy* of reform.

The present writer began asking **the question: 'why reform fail in the Soviet economic system?'** in terms of political economy, rather than economics from mid-1980s [see i.a. Winiecki 1984, 1986, and 1987b]. He pointed at the apparent irrationality of the resistance to performance-enhancing reforms. After all, as Mancur Olson once remarked, 'even in dictatorial systems, the dictator has an incentive to make an economy of the country he controls work better, since this will generate more tax receipts he can use as he pleases and usually also reduces dissent' [1984, p.637].

The 'New Economic History' school, led by Douglass North, underlines the benefits from the institutional arrangements, primarily the existing property rights' structure as a reason why high-cost institutions survive. **If the shift to low-cost institutions is detrimental to powerful elites who draw benefits from the existing arrangements, such shift will be abandoned, distorted, or reversed** [North, 1979].

Following this property rights-based approach, this author identified **fundamental system-specific forms of rent-seeking** that exist only under the particular political-economic system of communism *cum* centrally planned economy. Also, he identified **those who were primarily interested in maintaining institutional *status quo*** and, given their position in the ruling stratum, were able successfully to block the shift to low-cost institutions.

Of the two system-specific forms, the principle of *nomenklatura* is a better known one. It entails the privilege of the communist party apparatus to recommend (read: nominate) candidates to all high and middle level managerial positions in the economy and in state administration. These appointments were made primarily on the basis of loyalty to a given *coterie* rather than competence. Unsurprisingly, *apparatchiki* appointed to

these best paid positions their card-carrying cronies from the party organizations and bureaucracy.

Another form was benefits from the privileged, non-market access to goods and services in short supply at below market clearing prices - a very important feature in shortage-plagued economies. These came often in the form of kickbacks from the very same managers appointed to *nomenklatura*-covered positions, supplying those who appointed them, as well as other superiors and colleagues (who could help them in their careers).

**These peculiar methods of rent-seeking could be maintained only thanks to the existence of the communist political system.** The domination of the communist party apparatus and the bureaucracy, that is main beneficiaries of system-specific appropriation of income and wealth, insured that no change took place in the economic system that would eliminate these opportunities for enrichment.

It was abundantly clear that *apparatchiki* and bureaucrats were keen not to allow the economic system to be transformed into the private property-based market economy. For in the latter there would be no *nomenklatura*. Moreover, a 'normal' capitalist market economy tends toward equilibrium, and at equilibrium it is market prices that allocate goods. Thus, there would be no apartments, cars, TV-sets, etc. to be distributed at below market prices to the privileged minority.

**The whole Part One is devoted to answering the basic: 'why reforms fail?' question.** The texts contained therein point to options available to the ruling stratum in communist countries at the time of decline, explain why some segments of that stratum resist the performance-enhancing reforms and change, describe *techniques* of resistance, dispel ambiguities concerning the attitudes of enterprise managers toward reforms and change and even consider how much it would cost to 'buy out' the resisting *apparatchiki* and bureaucrats so as to remove the obstacles to institutional change.

Although all these texts were written *before* the communist system's collapse, *i.e.* before the verdict of history was delivered, the present writer regarded the prospects for reforms, *i.e.* of successful performance-enhancing modifications *within* the system, as non-existent. Therefore, I stressed that 'until those pillars of the system that benefit most [...]

withdraw their opposition, are forced to withdraw it, or are forced out of power, things will get from bad to worse' and warned that 'things will get worse, may be much worse,' before systemic change may take place [Winiecki, 1984 and 1987b]. Incidentally, this author's predictions as to the probable timing of such a change were not very wide off the mark since he did not expect 'such fundamental economic change to come about earlier than in the next five to ten years' [*ibid.*]. And the first, *mimeo-graphed* version of the 1987 book quoted above had been written in 1984.

The **t i m i n g** of successful systemic change inevitably raises the question as to **why the communist system's collapse happened when it did** - and not earlier or later. As an answer to the question, **the determinants of the collapse, are dealt with in the Part Two of this book**. This author thought it advisable to include his earlier considerations on the issue since there has been a lot of misunderstanding - or even outright nonsense - surrounding the issue. Sometimes one might have surmised from reading the pundits that it was Mr. Gorbachev who, singlehandedly, accomplished the change (one is tempted to add: including his own political demise).

The 'Spring of Nations' that came in the autumn of 1989 to East-Central Europe, as well as the disappearance of the Soviet Union in 1991, were the **phenomena to which Mr. Gorbachev contributed mightily, although for the most part inadvertently**. Except for the apparent abandonment of the doctrine of intervention in the 'outer empire' (i.e. East-Central Europe), whatever Mr. Gorbachev did, it turned out into something contrary to what he intended to do. He tried to improve, not to dismantle the system, both political and economic, but by trying **s i m u l t a n e o u s l y** *perestroika* (restructuring) and *uskorennye* (acceleration) he pushed the already declining Soviet economy over the brink. He tried to install in East Berlin and Prague more reformist (but communist) regimes but his inefficient fumbblings accelerated the political change and brought communism to an end in both countries more quickly than would have happened otherwise.

The texts in the Part Two try to explain precisely **w h y it would have happened otherwise, Gorbachev or no Gorbachev**. The major contribution to Part Two is an essay that lists major economic determi-



nants of Soviet economic system's decline, underlines that they were inherent in the economic system in question, and tries to establish the period, when the Soviet-type economies passed the point of no return on the path to terminal decline [*text no.6*]. The text was published in 1991, i.e. *ex post*, but the story has already been told in greater detail in earlier publications of this author [1984, 1986, 1987b]

One learns from the text that **most of the determinants of decline became, for internal or external reasons, more painful in the 1970s**. This is revealed also in the analysis of performance indicators of the countries in question. Thus, *Mane, Thekel, Fares* has been on the walls of the communist edifice for quite some time before system's collapse. **The collapse has been the outcome of 'long processes rather than spasmodic events'**, as it often seemed to outsiders [see, the the text in question].

One more acknowledgement should be made here, when the timing of system's collapse is considered, namely that for Mr. Reagan. Reagan's policy has been well-thought-of and based on better perception of Soviet reality than that of Mr. Gorbachev. Consequently, the Soviet response to the new U.S. technological challenge was an, already quoted, 'acceleration' program that, indeed, accelerated but only the process of unraveling of the Soviet economy and, consequently, of the communist system .

As the Soviet communist system collapsed in East Central-Europe, and two years later in the Soviet Union itself, the political change became a fact - and, with it, the o p p o r t u n i t i e s for the decisive shift to a capitalist market economy. **The political economy of the shift, or transition, or transformation**, as the systemic change is often called, **forms the core of Part Three of this book**.

To begin with, almost everywhere standard IMF/World Bank 'package' of measures have been accepted (even if not always consistently followed, while in some cases not followed at all). Again, almost everywhere, the knowledge of the Soviet-type economy has been largely neglected [see, specifically Winiecki, 1993, 1995]. Therefore, **a higher economic price was paid than if decision makers were prepared for what was to happen, given the legacy of the past**. This, in turn, made the p o l i t i c a l price of systemic change higher, because the usual disillusionment (or the

'reform fatigue', as the phenomenon was called by Michael Bruno [1992]) set in earlier.

Nonetheless, economic fundamentals of the 'package' have been sufficiently sound to ensure that countries staying on course progressed toward stability faster than those doing it hesitantly and with zig-zags (let alone those doing little or nothing). Liberalization has been even more successful than stabilization. Usually a greater degree of stabilization discipline went together with a greater degree of liberalization - and both went together with the already stressed decisiveness of the preceding political change.

Underappreciated in all cases - more and less successful alike - was, however, the fact that **costs of systemic change are front-loaded**, *i.e.* borne in the early transition period, while benefits begin to be felt with a considerable time lag. As this author wrote in 1989, at the start of transition, 'Polish economy is abandoning the Soviet-type economy, a creation of historically unparalleled wastefulness. **The costs of bidding utopia farewell are less than the costs of forty years of utopia, but unfortunately they are still high** [Beksiak, Gruszecki, Jedraszczyk, Winiecki, 1989 and 1990]

Indeed, output fell steeply in the early transition, when Soviet system-specific sources of demand (excessive inventories, overinvestment, etc.) disappear, while new demands for old output of state enterprises are not yet found and new output from the emerging private sector is not sufficiently large to compensate for the fall in output of state enterprises [see Winiecki, 1990 and 1991].

Moreover, the large gap between the demand for and supply of market-type institutions makes the performance of the emerging market economies inevitably unsatisfactory. The institution-building and its political economy-type implications take a lot of space in two important texts included in Part Three [*see texts no. 9 and 10*].

The first stresses the priorities forced upon the politicians by the need to create the institutional rudiments of stabilization policies. It also points to the role of **the time factor**. For regardless of policy makers' performance the supply of institutions will be for the time being insufficient to create a platform for healthy economic growth.

The second tries to approach the issue of **policy responses to the build-up of disillusionment and pressure to slow down the process of systemic change**. It addresses the issue of rapid change (called sometime a 'big bang') *versus* gradualism, as well as the tactics of change in the face of strong political resistance, *i.e.* Hirschman's [1963] 'roundabout strategy'. With respect to the latter it suggests measures strengthening the constituencies in favour of change rather than tackling head-on powerful interest groups benefiting most from the inefficient past institutional arrangements.

A next batch of texts deals with the privatization issues. Among the many hotly debated - and politically sensitive - issues, two in particular seem crucial from the political economy vantage point. The first is the way policy makers deal with the privatization. It is, of course, first of all an *e c o n o m i c* phenomenon stemming from the need to transform state ownership into private ownership because private economic agents on the whole act in a more efficient manner.

However, as there is no clear-cut path of 'getting from here to there', it may be pursued in a manner that *p o l i t i c a l l y* enhances or, on the contrary, handicaps the overall process of systemic change. **If privatization is seen as a 'fair deal', then the political capital spills over beyond privatization itself; if it is not, then it may become an albatross around the transition's neck** (a contrasting experience of the Czech Republic and Poland is most telling in this respect [*see text no. 14*]).

The point has repeatedly been stressed by this author since the start of transition, as the excerpts from the program of stabilization and systemic change written in August-September 1989, at the time of creating the first non-communist government in Poland (and *f o r* that government) testify. His later articles and papers included in Part Three also underline the political economy aspects of privatization.

The second issue concerns **the difference between the privatization of state enterprises and that of the national economy**. For in the latter case, the private sector emerges from both 'privatization from above', *i.e.* ownership transformation or privatization proper, and 'privatization from below', *i.e.* the creation and expansion of the generic private sector [on this point see Gruszecki and Winiecki, 1991, Winiecki 1992]. The latter is no less important, as underlined by the present writer in the text concerning

the superiority of eliminating barriers to entrepreneurship *vis-a-vis* the privatization activism of the state [*text no.13*].

The elimination of barriers to initiative, entrepreneurship, and innovation may be more rewarding than privatization in economic terms, as **the resultant expansion of the generic private sector creates firms where the structure of incentives and employers-employees relations are geared from the start to the competitive conditions of the market economy.** On the other hand, privatized firms largely carry over the distorted employers-employees relations from the communist past. Furthermore, the impact of the structure of incentives is weakened by the legacy of corroded work ethics, more harmful in the, largely unchanged, personal setting in the long established firms. Herein, *nota bene*, lies an explanation of a superior growth performance of the Polish economy, where the generic private sector is larger than in other countries of the region under consideration

The foregoing development has, additionally, an important longer term political economy advantage. As the number of people working in the generic private sector increase, so does, over time, the number of those who understand the linkage between individual effort and reward, between firms success and reward, and - through the latter - between the environment conducive for business (inclusive of the regulatory regime of the economy) and reward.

**Capitalism and the role of a capitalist are better understood in private firms, and even more in relatively small private firms.** After having worked in such a firm for some years, few would declare, as Lenin did, that a management of a firm is 'within reach of anybody who can read and write and knows the first four rules of arithmetic', a view that Mises rightly dubbed 'the mentality of the filing clerk' [Mises, 1972, pp. 24-25].

**With better understanding of the 'rules of the game' comes greater acceptance of the system based upon those rules, and, consequently, political support for the parties standing for the capitalist market economy.** Thus, the proportions of those in favour of systemic change to those *de facto* against it will be changing in post-communist so-

cieties in the longer run, increasing the numbers of the former and, therefore, reinforcing the emerging system.

Last two texts in Part Three tackle the underpinnings of the strong support - unexpected for many pundits - for the political forces of the communist past. The earlier stresses **moral degradation** resulting from communist ideology and, even more, from its actual 'rules of the game'. The latter links that up with the respective political influence of the state sector *vis-a-vis* the emerging private sector. Also, the text in question pinpoints **two major social groupings that are definitely hostile to systemic change**.

The first, the present writer calls *industrial lumpenproletariat*, underlining the fact that what in capitalist societies lingered on the margins of society, under socialism could be found in large, industrial state enterprises, where economic performance was the worst, waste was staggering, while rewards were at their highest. The outcome was the greatest extent of demoralization among the labour force. Now, as the inefficient socialist mastodons are threatened with extinction in competitive market conditions, or at least require a major downsizing [see Winiecki and Winiecki, 1992] , their labour force is in the forefront of resistance to change.

In the same camp, however, one finds educated people, largely from what is called in the West: 'public services'. They got their education, including university education, in communist times, often being the first in their families to do so. Under more normal circumstances they would adapt to professional and moral codes of their peers and respective professional associations. But under communism middle class, or *bourgeois*, morality was most viciously attacked, as well as adherence to it penalized, and all independence of professional (and all other) associations was almost completely destroyed. Consequently, these people, once employed, entered the moral and professional void - and increasingly so, as the older generations retired and passed away. The outcome was the emergence of the class of semi-professional, shifty, immoral (or amoral) *lumpenintelligentsia*. Although dissatisfied with their pay, they are against any rise in the professional and any other standards of their work. **They, too, like workers from large state enterprises are happy to have capitalist**

plenty in the shops, but prefer to keep sloppy socialist work practices in factories, schools, hospitals, etc.

The influence of these two groups upon the course of the transition process is all the greater as they work in the best organized segments of the economy. **'Big battalions' of large state enterprises and public sector trade unions are strongly overrepresented politically, vis-a-vis the thriving, but fragmented generic private sector.** Although, the last text in this collection concerns the situation in Poland, the situation, apart from some Poland-specific developments, is not drastically different elsewhere. Both the existence of the two social groups described here as *industrial lumpenproletariat* and *lumpenintelligentsia* are present everywhere, in greater or smaller numbers, and their political overrepresentation through labour unions are characteristic of all post-communist societies.

Now,, a plea of understanding seems in order here. The Readers are asked for understanding that some of the texts presented in this book may lack the necessary distance to the subject of reform and change. However, **the articles and papers are not concerned with a subject of historical interest only.** Nor the present writer has been an ivory-tower type of an academic. A dissident economist at first, an adviser and critic later, he has been more than present at the demise of the old system and the creation of a new one. Some texts were written in the heat of debates that had more than only intellectual issues to settle. A *sine irae et studio* approach has been sometimes all but impossible.

Next, acknowledgements are in order here. The author would like to thank editors and publishers of various texts included in this collection. Thus, the thanks go, in the order of the texts, to editors and publishers of *Soviet Studies*, *Intereconomics*, *Economic Inquiry*, Routledge, *International Journal of Law and Economics & Elsevier Science Publishers*, Springer Verlag, *The World Today* and Royal Institute of International Affairs, London, *Banca Nazionale del Lavoro Quarterly Review*, Centre for Research into Communist Economies, London, Basil Blackwell, *Communist Economies and Economic Transformation*, and, finally, Adam Smith Research Centre, Warsaw. Of course, proper references are found at the bottom of the first page of each text.

Finally, some technicalities in the presentation of the collection should be indicated. Thus, a sign: '(...)' marks each abbreviation made in the texts. Often, these abbreviations eliminate repetitions. In such cases references are made of other texts where the issue has been considered. Texts are presented in the original form, except for corrections of discovered linguistic errors. Wherever earlier abbreviations required additional word(s) to be added later on, such additions were clearly marked '[ ]'. There were only two types of changes *vis-a-vis* original texts. First, the present writer stressed some parts of texts differently to suit the new context within which they were presented. Second, references in the text were changed where necessary to ensure the same format of references throughout the whole book.

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## **PART I**

### **POLITICAL ECONOMY OF REFORM: FAILURES AND THEIR CAUSES**