

Towards a New Theory of Reform

By Victor Polterovich *

There is little doubt that the use of neoliberal recipes failed to deliver their intended results in many economies in transition. This happened for several reasons. The neoliberals ignored the massive costs of institutional transformation. They believed that the creation of a legal framework for markets was sufficient for the formation of efficient institutions. They disregarded the possibility of "institutional conflicts" when institutions are transplanted from one culture to another, and they neglected the need for an effective state. Understanding these failures does not imply an attempt to return to older views. Work still remains before we understand what should and could be done in the future.

Up to the 1970's it was customary to think that the state should play an important role in the economy. A radical socialist theory of transition from capitalism was based on a simple and seemingly obvious recipe: "Set up a good plan and enforce it". Practice showed that this recipe could not be implemented since nobody knew what a good plan was and how to enforce it. Theories of rent seeking and corruption were developed to explain the roots of government failures. Instead of the old slogan, a new one, as simple and obvious, was widely embraced as a recipe for reforming developing and centrally managed economies: "Create market institutions and enforce their efficient functioning". This was misleading again since nobody knew what market institutions were and how they should be designed to be efficient. More specifically, there were five main mistakes.

First, the size and distribution of transformation costs were forgotten. In practice, these costs turned out to be huge. Most former Soviet republics suffered drops in GDP of around 40 per cent, and welfare differentials surged. There are three basic sources of transformation costs. Resources have to be diverted from traditional objects of investment to the riskier business of building up new institutions. Disorganization prevails while the old system is dismantled before the new one can function efficiently. Economic agents need to learn a lot, and the learning processes are expensive.

The transition from the old systemic equilibrium to a new one takes years, and many mistaken decisions are made before a new balance is found. Of necessity, many barriers to free movement of resources exist, and each offers somebody the possibility of earning rent revenue. Under central management, the crucial sources of rents were differences between wholesale and retail prices as well as domestic and world market prices. Such rents should disappear in transition, but in fact the process of liberalization offers huge possibilities of earning income just by being "in the right place at the right time". This process creates a class of newly rich, but it also imposes losses on most of population.

Second, it was not understood that creating the legal framework for markets - through privatization, in particular - did not guarantee the spontaneous formation of efficient market institutions. A given legal system can give rise both to good and bad institutions. Among the latter, barter, arrears, corruption and tax avoidance developed on a huge scale in Russia. Once in place, such institutions become well entrenched, culturally sanctioned and self-reinforcing. Price liberalization and standard stabilization measures taken under unstable transitional institution structure may provoke the formation of these bad behavioral norms. Not understanding this was the third neoliberal mistake.

Fourth, it seems often to be reasonable to transplant institutions; there is no need to reinvent the wheel. When such transplantation occurs across cultural boundaries, however, "institutional conflicts" easily arise, either leading to the death of some institutions or to the formation of strange mutations: stable, but inefficient, institutional traps. The typical post-privatization Russian industrial firm, the joint-stock company dominated by the employees, is a prime example of this kind of development.

Fifth, the role of the state was undervalued. The World Bank, in particular, has recently raised this issue. This is not the issue of the "strength" of the state, as most Russian debates put it. A strong state may serve just narrow elite interests. What is needed is an effective state that can coordinate different social preferences and work towards social goals, also by delegating power to those that can best use them. By reallocating rights through liberalization, privatization and deregulation the state automatically takes over an enhanced role. Therefore, the government effectiveness has greater importance at times of change than under stable conditions. The experience of effective governments in France, Japan, Korea after the Second World War showed that industrial policies and indicative planning could also find their places in the governmental toolbox.

Russia is tired of reforms but needs them perhaps more than ever. The task now is to reform the state, including the political institutions. Russia also needs a programme for getting out of the four basic institutional traps: barter, arrears, tax avoidance and corruption. A reasonable balance among the interests of different groups within and around enterprises has to be found. The financial system has to be reformed. All of this needs much work, including serious theoretical consideration, before new guidelines for reformers are available. Perhaps the Washington Consensus will be followed by a Moscow Consensus - at least it is exactly the Russian case that offers the most food for thought here.

**The author is a visiting researcher at BOFIT.*

RUSSIAN ECONOMY, The Month in Review
5 January 1999 ISSN 1455-7355

Bank of Finland
Institute for Economies in Transition
P.O. Box 160 FIN-00101 Helsinki
phone +358 9 183 2268
email bofit@bof.fi
Web <http://www.bof.fi/botit>

Editor-in-Chief Jouko Rautava

Information herein is compiled and edited from a variety of sources. The Bank of Finland assumes no responsibility for the completeness or accuracy of the information.