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Dieter Lösch\*

# The Road to a Market Economy

## Elements of a Normative Theory of System Transformation

*The ongoing conversion of the economies of former socialist countries into market economies has so far suffered from the lack of a theory of system transformation (policy) which indicates the means of achieving the desired objectives and makes it possible to evaluate the transformation policies of individual countries. The following article outlines the essential aspects of such a theory.*

Since almost all the former socialist countries and most of the states that became independent as a result of the collapse of communism began their efforts to introduce a market economy, the lack of a "theory of system transformation" has often been bemoaned. What is generally meant by this is a theory of transformation policy, in other words a concept or blueprint for the conversion of socialist economic systems into market economies. The replacement of command economies by western-style market economies calls for conceptually based economic policy action, in other words a theory of transformation policy. Such a theory should indicate the means of achieving the desired objectives and should also make it possible to evaluate the transformation policies of individual countries.

To do that, it is first necessary to define the objective of the transformation process in more concrete terms and to determine when the process begins and ends. Neither task is particularly easy, as the transition at each end of the process tends to be fluid. It is therefore difficult to distinguish the beginning of the transformation to a market economy from previous attempts to reform the planned economy, which were intensified in all the former communist countries in the eighties.

In theory, the end of the transformation process can be pinpointed precisely, but in practice it is difficult to recognise, as the objective is not just to introduce a market economy but also to eliminate the misallocation of resources and production factors due to the old system and

to correct the structural distortions caused by isolation from the world economy outside Comecon. The transformation process can therefore be considered complete only when the adjustment requirements caused by the old inefficient system and revealed by the new economic system have been fulfilled, not simply when the changeover to a new organisational model, new patterns of behaviour and new procedures – in other words, the introduction of resource allocation regulated by market forces – has been made.

### Main Phases of the Transformation Process

Taking this objective and temporal definition as a basis, the following tasks to be performed in the course of system transformation can be distinguished:

- the period-related task of creating a new legal and institutional framework,
- the date-specific task or tasks of implementing new legislation (such as the freeing of prices) and bringing organisations into operation (such as the inauguration of new authorities), and
- the period-related tasks of consolidating and restructuring the economy, including social measures to offset the adverse distribution and welfare effects of the transformation process. Given the inherent logic of these tasks, at first sight there is much to be said for tackling them in the order just indicated. In other words, once the legal and institutional framework of a market economy has been created, market-related resource allocation can be set in train on all markets simultaneously; from then onwards

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there would be a market-related basis for policy intervention aimed at achieving macro-economic equilibrium in a socially acceptable manner in as short a time as possible.

Accordingly, the transformation process can be divided into three phases:

I The preparatory phase, in other words the time-consuming phase during which the legal framework and the organisational and institutional basis for the market economy are laid down.

II The start-up or liberalisation phase, during which market-related resource allocation is brought into operation (simultaneously or spaced over a number of dates).

III The adjustment phase, that is to say the period in which policy is called upon to make market mechanisms work, to end the acute economic crisis and to guide the rehabilitation of the economy (adjustments in levels and structures).

### Alternative Sequence of Events

According to the basic model of the process at the heart of the shock therapy concept, the preparatory phase should be as short as possible, after which the market economy comes into effect all at once and the adjustment phase begins.

If the liberalisation measures establishing (or further liberalising) markets are not introduced simultaneously but at different times, one can speak of a gradualist approach. The individual liberalisation measures remain date-specific, but as they are taken at intervals the start-up phase is spread over a period of time.

A third possibility is to begin the start-up phase at the same time as the preparatory phase, with liberalisation being carried out in a series of small steps, accompanied by ad hoc stabilisation, adjustment and social measures from the outset. This variant describes fairly well the sequence of the system transformation in Hungary between 1968 and 1989 and in China since about 1978. Clearly, it is only feasible, if at all, in countries where the old system is still workable at the beginning of the reform process and political conditions are fairly stable.

### Timing and Pacing

The above differentiation between date-specific and period-related tasks or phases of system transformation shows very clearly that the so-called shock therapy and the gradualist conceptions of system transformation differ primarily in their recommendations for phase II. If date-

specific liberalisation is carried out at a stroke, this is shock therapy *par excellence*. On the other hand, if liberalisation measures are introduced over a period of time, with intervals between the various stages, this is a gradualist approach, although here more minor shocks are spread over the period involved. The length of the preparatory phase and, where appropriate, that of the intervals between the various liberalisation shocks is quite another question.

Clearly, rather than speaking of shock therapy or gradualist concepts, it is more useful to distinguish between the timing and pacing of the transformation process and to examine the period that concrete transformation concepts envisage for individual period-related tasks or for the entire process and to ascertain what they say about the implementation of date-specific measures. Timing therefore means determining the point or points in time at which date-specific policy measures (in particular liberalisation measures) should be implemented or at which period-related action should commence. Pacing, by contrast, consists in laying down the length of time required for measures that take effect over a period.

### The Process Model

An outline application-related timetable for the transformation process can be sketched in the light of the above considerations regarding the beginning and end of the transformation process, the phases into which it is divided and the sequence, timing and pacing of the individual phases.

□ Phase I is period-related; the sequence and timing of the process are determined largely by internal logic, so that there is relatively little scope for conceptual variants. As to pacing, the question is whether the time allowed for phase I should be kept as short as possible or should be extended beyond the technical minimum for political or social reasons.

□ The measures in phase II, on the other hand, are essentially date-specific. Logically, it would seem advisable to liberalise all markets completely on the same date, since market allocation can operate without distortion only if all markets have been liberalised and deregulated. There would have to be convincing grounds for any departure from this principle.

□ Phase III is again period-related, but it differs from phase I in that here transformation policy is subordinate to general economic policy. The sequence of individual measures and their timing is determined by the diagnosis of the imbalances in the economy and by economic policy

priorities. Above all, the extent to which the adjustment process is to be influenced politically – channelled in particular directions, restrained or accelerated – must be decided politically.

### The Problem of Optimisation

A normative theory of system transformation calls for optimality criteria to be defined and operationalised. If two or more transformation strategies are appropriate, it is obvious that preference should be given to the one that

- achieves the objective in the shortest times (the time criterion),
- causes the least net social cost (the cost criterion) and
- is likely to be the most acceptable to the public (acceptance criterion).

Although each of these criteria is clear in itself, their strong mutual interdependence (competition between objectives) makes it very difficult to state categorically that one concept is preferable to another, particularly as this requires assumptions to be made whose empirical validity is uncertain.

For example, a shorter transformation process could entail higher net costs than a longer one. It would therefore be sub-optimal according to the cost criterion. The effect this would have on public acceptance is unclear, if it is assumed that acceptance is correlated negatively with higher costs but positively with a shorter time-span for the transformation process. In addition, acceptance may be affected decisively not only by the level of costs but also by their distribution over time.

Alternative strategies for the entire process or for individual stages and measures must therefore be formulated in such a way that the time-span and costs of the transition are minimised and public acceptance maximised. This forms the normative basis for the following considerations regarding an optimum transformation strategy.

### Optimising the Preparatory Phase

Phase I, the preparatory phase to the introduction of market mechanisms, during which the legal and institutional framework of the market economy must be created, breaks down into three distinct sub-phases, which logically should follow one another:

1. First come *legislative activities*. Here a distinction must be made between the creation of the legal framework for market mechanisms on the one hand and the enactment of legislation to establish specific

organisations that are needed for the new system to operate and any institutions needed only temporarily to perform tasks during the transformation process.

2. Accordingly, the second task to be performed during the preparatory phase is the *creation of organisations*, economic and financial authorities, a central bank, commercial banks, capital market institutions and a privatisation authority.

3. As soon as these organisations are ready to operate, the third step can be taken, in which concrete *reforms* are introduced to create the institutional framework for the start of resource allocation by the market: reform of the tax system, creation of competitive structures at the micro level by means of decentralisation and privatisation, and possibly a currency reform.

Viable markets require a corresponding micro-economic structure (competitive market forms, stringent budget restrictions). The creation of such institutions in turn calls for action on the part of organisations, as players in transformation policy. These organisations must first be developed, which can only be done if the necessary legal prerequisites are in place. This determines the sequence of tasks to be performed during phase I. Timing is dictated by the seemingly trivial rule that each successive step can begin only when the one before has been completed. As the time needed for different measures will not be the same, law-making should begin in those areas where the creation of organisations or the implementation of measures by these organisations is likely to take longest.

In view of the differences in the initial situation of the reforming countries, it is obviously not possible to define every detail of an optimum strategy for the preparatory phase. However, a number of propositions can be made about the way in which transformation policy should proceed, given the problems described above:

1. In view of the political situation in the reforming countries, there is much to be said for keeping the preparatory phase as short as possible. The legal framework should therefore not be constructed systematically from constitutional law upwards; instead, priority should be given to commercial law, and especially to the creation of the legal basis for the necessary institutional reforms in the monetary field and the establishment of a privatisation authority, because these are the organisational tasks that take most time.

2. Decentralisation, in other words the dissolution of industrial ministries inherited from the previous system and measures to deconcentrate enterprises and give them their independence, can begin by administrative means even without a legal foundation. The so-called "small-

scale privatisation", which is relatively unproblematic, can also begin immediately. Some "major privatisation" projects may also be undertaken at this stage, although most privatisation methods require markets to be created first, so that privatisation on a grand scale must wait until the adjustment phase. For this reason, special legal and organisational measures need to be taken in the preparatory phase in order to make state enterprises more "commercial", in other words to transform them into relatively independent enterprises subject to stringent budget restrictions.

3. In conjunction with this, the foundations of a tax system should be laid as early as possible; the many works that have been written on the subject of rational tax systems should be used as a guide, rather than copying the often irrational tax systems of existing market economies. As the time needed to create a fully functioning tax administration should not be underestimated, this should be given priority over the creation of other institutions, such as a competition authority.

It is essential to adopt the approach outlined here for social reasons, but also on grounds of public acceptance, for the longer this phase lasts, the greater the danger that the inevitably continuing crisis will be blamed on the

market economy, even though it still does not exist. This could cause the transformation process to break down even at this early stage.

Qualitative or quantitative criteria for judging that the preparatory phase has been completed can only be outlined in broad terms. As a general principle, it must be guaranteed that market forces come into play once liberalisation has begun even if they do not immediately operate ideally in all areas, in other words if competitive markets do not yet exist. As the commencement of phase III, the adjustment phase, coincides with the inauguration of markets, the creation of the instruments for influencing the economy should be completed during the preparatory phase. Tax legislation must therefore be well advanced and the tax administration sufficiently developed to ensure that tax collection functions reasonably well. In the monetary sphere, the central bank must be able to operate and commercial banks must be independent, free of debt, open to competition and able to carry out banking operations correctly. The monetary institutions also include an effective banking supervisory body and an efficient system of communication between the banks and the central bank. It is particularly important that the restructuring of the banks should have already been completed.

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**INSTITUTIONAL ASPECTS OF ECONOMIC  
INTEGRATION OF TURKEY  
INTO THE EUROPEAN COMMUNITY**

In October 1989 a symposium on "Institutional Aspects of the Economic Integration of Turkey into the European Community" took place at the HWWA-Institute. The symposium was conducted in cooperation with the Technical University of Darmstadt and promoted by the Volkswagen Foundation. At the centre of the discussion were the questions of how to strengthen the Turkish institutions responsible for integration and how to make them more efficient, how to evaluate the efforts made by both sides to improve economic relations, and what consequences are to be expected for economic and social policy. This volume contains selected contributions to the symposium and summarizes its results. (Only available in English.)

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### Timing and Pacing in the Start-up Phase

Theoretically, resource allocation by the market, in other words phase II, should not begin until phase I has been completed, but this is not possible, partly for practical reasons owing to the time required for privatisation and partly because most privatisation procedures cannot succeed until market forces are in operation. However, if the start of resource allocation by the market must be preceded by privatisation and the success of privatisation in turn depends upon the operation of market forces, we have a "catch 22" situation, a logical contradiction in the procedural model. This contradiction can be resolved only by forgoing privatisation before the introduction of market forces or by using privatisation methods that do not require the existence of functioning markets. The best solution is clearly to make enterprises independent during phase I and to subject them to as stringent budget restrictions as possible so that privatisation can then be tackled swiftly after the start-up phase.

This militates in favour of the *instantaneous liberalisation* of all prices on a given date, flanked by the liberalisation of foreign trade and the establishment of currency convertibility (or possibly the introduction of a new currency on the same date). However, a number of arguments are raised against this approach and in favour of *liberalisation in stages*. Nevertheless, liberalisation in stages can clearly mean any of three things:

- the step-by-step liberalisation of markets in such a way that initially only a few prices are freed while others continue to be controlled;
- the complete but sequential liberalisation of different markets (for example, first product markets and then markets in production factors);
- the liberalisation of the internal market before the liberalisation of foreign trade and the establishment of currency convertibility.

The first method – whereby prices are freed in batches at set intervals, foreign trade is partially liberalised and the exchange rate is gradually adjusted towards an equilibrium rate – is favoured primarily on grounds of public acceptance. Economic agents, both consumers and enterprises, are not to be subjected to excessive shocks.

The main argument in favour of this method is clearly that it allows the adjustment costs to be spread over time, thus perhaps making them less noticeable. In addition, it is also clearly assumed that the costs of liberalisation will be less with a gradualist approach than with instantaneous

complete liberalisation. It is obviously hoped that in this way the expected inflation can be kept under better control, a severe fall in output avoided and employment sustained at a higher level.

The main arguments put forward in favour of the sequential liberalisation of different markets are primarily technical, such as the different time needed to create the necessary conditions, different regulatory requirements, and so forth.

Deliberately postponing the liberalisation of foreign trade and the establishment of currency convertibility until after liberalisation of the internal markets is intended to ensure that enterprises are not immediately exposed to the full force of competition in the world market. This is a form of protection that is to be reduced only in stages in order to give enterprises time to get fit to compete internationally. It is intended to avoid de-industrialisation of the former socialist countries, which would have enormous social costs in terms of unemployment, and the devaluation of production plant and which would reduce the countries concerned to the level of developing countries.

These arguments are not entirely convincing, in view of obvious objections that cannot be discussed here for lack of space. Consequently, the recommendations for optimising the liberalisation phase are as follows:

1. The inception of markets through the liberalisation of prices should be carried out over a very short period of time. There are no sound economic reasons for stretching this phase over a longer period. Solely on social grounds, and hence for reasons of public acceptance, the liberalisation of certain highly sensitive consumer good markets could be postponed, but these would be isolated exceptions to the general rule.

2. If the institutional prerequisites for the operation of particular markets are not yet met, the markets in question can be liberalised after the liberalisation of prices in product markets. However, this concession also does not mean a fundamental departure from the rule that market liberalisation is a procedure that should apply equally to all markets. Only when this condition is met will undistorted resource allocation begin.

3. There is no reason for a systematic postponement of the liberalisation of foreign trade and hence the introduction of current-account convertibility. In this context liberalisation does not mean the complete abandonment of regulatory control over foreign trade, which is also commonly regulated in market economies. However, an approach whereby foreign trade remains more closely controlled than is normal in market

economies and current-account convertibility is not introduced until the domestic market has become competitive should be rejected.

### Problems during the Adjustment Phase

The tasks that transformation policy has to tackle in phase III are of a procedural nature, apart from the major organisational task of privatisation. What is required is an economic policy that corresponds to the economic policy pursued in established market economies, but differs in that during the adjustment phase it is being implemented under specific conditions. These specific conditions prevailing during the adjustment phase are characterised by the instability of the political system, the incompleteness of the legal and organisational framework, deficiencies in the system of administration, a micro-economic system in its infancy and socio-psychological problems due to the fact that the population has no practical experience of a market economy, knows little of its functional requirements and social impact and is impatient for an improvement in the economic situation. The special conditions under which economic policy must operate also include the amount of catching up and the scale of structural adjustment that are needed, which are so great that the economic policy concepts developed to deal with structural crises in market economies may not be adequate.

The consolidation and adjustment processes proceed in parallel during phase III. This does not mean that economic priorities do not have to be set. There is much to be said for giving priority to the establishment of monetary stability, which is a precondition for undistorted resource allocation by market forces. However, a policy aimed at stabilising prices runs into a series of conflicts between objectives, which are no less important in the transformation process than in crises in established market economies. For that reason, economic policy in phase III must be formulated with extreme care. The choice, timing and dosage of interventions must be dictated by the situation prevailing at the time. Rules for an optimum approach during this phase can therefore be formulated only in very broad terms.

1. As stated above, stability policy has priority insofar as it is necessary to avoid or curb inflationary developments, since a system based on market forces requires a functioning currency. This does not mean, however, that the objective should be absolute price stability; during this first phase of the transformation process only relative stability can be achieved, in view of inadequate competition in the markets for goods and services, insufficiently stringent budget restrictions

(which above all cause employers to be too compliant in wage negotiations), difficulties in consolidating the government budget owing to uncertain and initially inadequate tax revenues and the growing need for social measures, and not least deficiencies in the management of money supply growth by the central bank, which often still does not have the necessary intervention instruments or sufficient experience in their use.

2. Stabilisation policy is flanked by policies on economic growth and employment. A multitude of instruments is available for this, ranging from tax measures to investment subsidies, export promotion measures, and so forth. Measures to encourage foreign direct and equity investment are particularly important, but so too are special measures to create and foster an indigenous middle class.

3. In view of the scale of the structural adjustment required, economic policy measures are needed to facilitate the structural transformation. An active industrial policy aimed at preserving particular industries and/or production sites should be avoided, however. The very purpose of introducing the market economy is to achieve maximum economic efficiency, one of the implications of which is that the signals for structural change come from the market, thereby avoiding welfare-reducing subsidies. Nevertheless, the argument that the former state enterprises must be given the opportunity to adapt to changed circumstances should be taken seriously, as otherwise there is a danger that they will disappear from the market, despite the possibility that they would become competitive over the longer term. This argument suggests that economic policy should initially give all enterprises an equal chance to prove themselves in the market economy. It is therefore particularly important to resolve the problem of enterprises' past debts, either by the state taking them over or by means of debt-equity swaps. After a certain time, state aid should be swiftly withdrawn from those enterprises that show no prospect of surviving and the enterprises closed. The state should therefore encourage structural change by providing adjustment subsidies on a decreasing scale over a predetermined period of time.

Social policy plays a particularly important role during the adjustment phase. A distinction has to be made between the creation of a social security system such as those existing in market economies and emergency social measures needed temporarily but all the more urgently as a consequence of the specific adjustment processes occurring during phase III. The construction of the welfare state can and should be left until later. Instead, it is essential that an adequate level of social assistance be provided as a matter of urgency for the masses afflicted by unemployment as a result of structural change.