

# WIDER

RESEARCH  
FOR  
ACTION

THE AFFINITY BETWEEN OWNERSHIP  
AND COORDINATION MECHANISMS

THE COMMON EXPERIENCE  
OF REFORM IN SOCIALIST  
COUNTRIES

JANOS KORNAI

WORLD INSTITUTE FOR DEVELOPMENT ECONOMICS RESEARCH  
OF THE  
UNITED NATIONS UNIVERSITY

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and Coordination Mechanisms**  
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Reform in Socialist Countries**

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## PREFACE

WIDER has within its work programme a research project on Economic Reform in Socialist Economies. In the first phase of this project, which has been completed, the emphasis has been on the varied accomplishments of the reform process so far in a selection of socialist countries, namely, China, Hungary, Poland and the USSR.<sup>1</sup> The second phase of the work which is under way, looks to possible future directions of change in the light of what has been accomplished so far. Among the central issues that will be considered by the project is the question of an appropriate balance between central planning and the market mechanism. The project will also attempt to explore new forms of property ownership within socialist economies and new mechanisms for economic coordination distinct from planning and the market.

Professor Kornai's paper is a significant contribution to the debate on possible future paths of evolution for socialist economies. Corresponding to each of the principal forms of ownership that exist within socialist economies, namely, state ownership and private ownership, there are two forms of coordination, bureaucratic coordination, and coordination by means of the market mechanism. Whenever a system based on state ownership experiments with market coordination, the system tends to relapse into one of bureaucratic coordination. Similarly, whenever a system based on private ownership attempts to coordinate its activities bureaucratically, the system moves back towards a reliance on the market mechanism. In other words, state ownership is strongly associated with bureaucratic coordination, and private ownership with market coordination.

The question that Professor Kornai poses is whether there could be a third way, involving both a different form of ownership and a different coordination mechanism. The possibility he explores is that of a cooperative form of ownership which is both non-private and non-bureaucratic in character and which can have linked with it what he terms 'associative mechanisms' for coordination. In Professor Kornai's

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<sup>1</sup> The Research Adviser for the project is Dr. Marian Ostrowski, Director, Institute of National Economy, Warsaw, Poland. The research output of the project is available in the following WIDER Working Papers: 'Reform, Stabilization Policies, and Economic Adjustment in Poland', No. 51, January 1989; 'Adjustment through Opening of Socialist Economies', No. 52, January 1989; 'Reforming Process and Consolidation in the Soviet Economy', No.53, January 1989; 'Stabilization and Reform in the Hungarian Economy of the late 1980s', No. 54, March 1989; 'Economic System Reform in China', No. 55, March 1989.

words, “It is probably easiest to define the set [of associative mechanisms] in a negative way, as any mechanism of coordination which operates neither through the bureaucracy nor through the market, but which is based on self-governance, on free associations, on reciprocity, on altruism, or on mutual voluntary adjustment.”

Professor Kornai must not, however, be misunderstood as advocating this third way. Unfortunately these associative mechanisms are, in his view, too weak to bear the main burden of coordination, as weak as a market socialism based on a combination of state ownership and market coordination. Such weak linkages may play a useful auxiliary role but are unable to serve as the main coordinating levers of society. Thus whatever one’s sympathies for such mechanisms, primary reliance must be placed on one of the two strong forms of linkage, private ownership cum market or state ownership cum bureaucracy. The difficult political choice that has to be made concerns precisely which set of the strong linkages identified by Professor Kornai is to drive the economic system.

On this view of the matter, the key political choice concerns the dominant form of ownership in society, whether it ought to be private ownership or state ownership. In posing the choice this way, Professor Kornai has, indeed, enlivened the current debate on the future course of socialism. His general line of argument has to be followed up by a more detailed investigation. Professor Kornai is pursuing this important theme further in the work he is presently undertaking on the ‘Political Economy of Socialism’ as a Distinguished McDonnell Fellow at WIDER. The present paper gives us a foretaste of that major contribution.

Lal Jayawardena  
Director

# The Affinity Between Ownership and Coordination Mechanisms

## The Common Experience of Reform in Socialist Countries

### 1. Introduction<sup>2</sup>

The title of our session, “The Theory of Markets in a Planned Economy”, suggests two alternative approaches. One is that of a normative theory, that is the elaboration of a theoretical blueprint for an economy, relying upon both the plan and the market. Whatever might be the significance of such an approach, this paper takes as its basic themes the other approach, namely positive analysis. A reform process is under way in several socialist countries. The course of thought applied in the paper is based on the hypothesis that in all reform countries it is possible to identify certain common tendencies. Of course, each reforming country constitutes a unique case, and one must look hard to find suitable ways of discerning common patterns of reform in countries as diverse as Yugoslavia, Hungary, China, Poland and the USSR. One must accomplish another equally difficult task as well, that is the task of properly evaluating the cases of failed reform such as the one which was attempted in 1968 in Czechoslovakia. Nevertheless, there exist many common lessons, and in this paper we will attempt to delineate some of them.

The reader is urged, however, not to take these lessons at face-value, and to be very cautious before he accepts and applies them. Clearly, the small number of reforming countries which we have mentioned, do not add up to a statistically significant sample, and the period of observation is, in most cases, much too brief to provide a basis for a well-founded positive theory of reform. What can be attempted is much more modest and is nothing more than an outline of a few preliminary conjectures which will have to be tested against future historical development.

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<sup>2</sup> Earlier versions of the paper were presented at the New School for Social Research (New York), at Harvard University (Cambridge, Mass.), at the European University Institute (Firenze), at WIDER, the World Institute for Development Economics Research (Helsinki). The paper was presented at the Round-Table Conference on “Market Forces in a Planned Economy” organised by the International Economic Association jointly with the USSR Academy of Sciences in Moscow on March 28–30, 1989. The paper will be included in the volume containing the IEA Round-Table papers. I should like to express my thanks to the participants of the seminars at these institutions for valuable comments and to Mária Kovács, to Carla Krüger and to Shailendra Raj Mehta for assistance in the transcription and editing of the lecture. The support of the Hungarian Academy of Sciences, of Harvard University, of WIDER and of the Sloan Foundation is gratefully acknowledged.

Since the objective of the analysis is to offer a few general observations, here we will not attempt to support the conjectures with empirical evidence.<sup>3</sup> In other words the emphasis is less on a purely factual description and more on the outlining of a specific approach to the analysis of these well-known facts.

One more reservation must be stated in advance. The issues to be discussed in the paper have many political ramifications. Decisions concerning ownership and coordination mechanisms are, of course, strongly linked to the questions concerning power, political institutions and ideology. Apart from a few short hints, this paper does not elaborate on the political aspects of the topics.<sup>4</sup>

## 2. Transformation without a Strategy

If we look at the history of the countries mentioned, we find that without exception, reform blueprints or programmes were in circulation before the actual period of the reform. In many cases, these blueprints were prepared by scholars. As a matter of fact, for the first example of such an academic proposal for transformation within socialism one can go back as far as Oscar Lange's famous proposal for market socialism and to the debate to which his idea gave rise in the 1930s. Some blueprints were also prepared by the leadership in charge, that is to say by party and government officials in Yugoslavia, in Hungary, in China, in the USSR and in other countries. Finally, there have also been instances of programmes published illegally or semi-legally by dissident politicians, such as those by the authors close to the unofficial trade union Solidarity in Poland, as well as by opposition intellectuals in Hungary and in the Soviet Union.

While all these reform proposals are interesting historical documents, and while some of them have exercised a certain influence on the course of events, the reality of the reforming countries, never did and does not today correspond to any of the blueprints. In fact, even the officially publicised intentions of the party and of the government were usually not consistently realized, and the deviations from the

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<sup>3</sup> There is a voluminous literature concerning the description and the analysis of reform processes in the various socialist countries. To mention only a few examples: J.P. Burkett (1989) on Yugoslavia, J. Kornai (1986a) and L. Antal et al (1987) on Hungary, D.H. Perkins (1988) on China, Iu. N. Afanas'ev (ed.) (1988), E.A. Hewett (1988), G.E. Schroeder (1987) and N. Shmelev (1987) on the USSR.

<sup>4</sup> The author is working on a new book entitled: "The Political Economy of Socialism" where the relationship between political structure, ideology, ownership forms and coordination mechanisms is explored in detail.

original programme were sometimes so large that they bore no resemblance to the initial guidelines. Of course, history stands witness to other cases of discrepancies between intent and outcome: the fate of the French Revolution reflected little of the ideas which the Encyclopédists along with Rousseau had been discussing in their works, and the Soviet Union in the 1930s turned out to be a country quite different from the one which Marx or the participants of the revolutions of 1917 had imagined.

It is ironic to note, nevertheless, that major transformations in centrally planned economies go on without being based on a central plan. There is a Chinese adage which talks of “crossing the river by touching the stone”. The reform process in socialist economies conforms exactly to this image: whole societies have proceeded to cross the deep water without accurate knowledge about the final direction by a process of moving from one stone to another. Because of this lack of strategy, the reality of reform in socialist countries is characterised by historical compromises, by movements backwards as well as by movements forwards, by periods of euphoria and of optimism alternating with periods of lost illusions and of frustrations. It also often turns out that, in spite of the best efforts some changes cannot be preserved. At times, people learn the limits of reformability by, figuratively speaking, running against a stone wall. In any case, the limits of transformability of a society can only be accurately gauged once one begins to transform it.

Under such circumstances it becomes extremely important to observe what evolves spontaneously in the transformation process. Marx used the German term “naturwüchsig” (as grown in nature) to characterise spontaneous historical processes. These are phenomena which appear not as a consequence of governmental orders or of administrative pressure but follow the free will of certain social groups.

The study of “naturally grown” changes is all the more important since individual freedom of choice typically increases as a consequence of reform. True, certain restrictions imposed by unchangeable taboos remain. Nevertheless, spontaneous changes reflect to some extent the voluntary decisions and revealed preferences of various social groups.

Exactly this approach distinguishes the present paper from many other studies. Most of the work on reform in socialist systems deals with the normative issues, and even in the realm of positive analysis, the intentions and actions of the leadership and the apparatus are discussed. This paper would like to draw attention to another, not less important point of view: what is going on spontaneously, not at the orders of the leading groups or even in spite of their orders.

### 3. The Evolution of a Private Sector

In this endeavour, our first focus should be on the evolution of a private sector. Let us remind ourselves briefly of the period in which the first reform proposals were elaborated. When, for example, the author began to participate in the Eastern European thinking on reform in the years 1954, 1955, and 1956, all of the scholars who took part in the debate, were almost exclusively concerned with the questions of reform as it applied to the state-owned sector.<sup>5</sup> Discussions turned around the issues of how to give stronger autonomy and more profit-based incentives to the state-owned firms, of how to decentralise economic administration while, at the same time, maintaining state ownership in all but the most marginal sectors of the economy. These were the views of the radical reformers of those days.

Taking a thirty year leap in history, it turns out that, quite in accordance with the previous section of this paper, history has taken quite a different course from the one outlined in the original blueprints written by academic economists. In the author's opinion, in all the socialist economies in which reforms have had time to develop, and especially in Hungary, in China and in Poland, the emergence of a significant private sector is the most important result of the reform in the economy.

The most important inroad of private activity in socialist economies occurs through private farming. There exists a variety of forms. Either the land has been reprivatised de facto as for example under the Chinese "family responsibility system", or private farming has never been abolished and survives all kinds of political changes, as for example in Yugoslavia or in Poland. In Hungary, the role of the household plot and of private farming has also increased in the wake of the reform. In addition, typically there also exists some kind of family subcontracting within the agricultural cooperative.

In addition to these private and semiprivate agricultural businesses, we find legal, tax-paying private businesses in various other sectors. A significant private sector has emerged in various branches of the service, transport and construction industry; to a lesser

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<sup>5</sup> See for example, the following sample of the earliest papers advocating a decentralisation based reform in Eastern Europe: B. Kidric (see his papers from the fifties in the (1985) volume) for Yugoslavia, Gy. Péter (1954a,b, 1956) and J. Kornai [1957] (1959) for Hungary, and W. Brus [1961] (1972) for Poland, E. Liberman [1962] (1972) for the USSR and Sun Yefang [1958–1961] (1982) for China.

extent private business operates in manufacturing as well.<sup>6</sup> There appear different forms of income derived from private property, for example, from the renting out of private homes in cities or from privately owned second homes in recreational areas.

In addition to the formal private sector, various types of informal “moonlighting” often appear; unlicensed, and perhaps illegal, but none the less tolerated activities proliferate in the service, commerce, transport and construction sectors. Reform economies also experience a significant increase in elaborate do-it-yourself activities, such as the building of one’s own house with the help of one or two professionals and that of some friends.

In some countries, and in some sectors, such as housing and agriculture, it even happens that property owned by the state or by some other social organisation is sold or leased to individuals. The idea of genuine reprivatisation in the British way, that is to say, the idea of the sale of the stock of state-owned companies to the public, came up, for instance in the Hungarian and Chinese discussions of reform. In practice, however, the larger part of the growth of the private sector takes place as a result of entrepreneurial initiative sometimes based on private savings but sometimes almost exclusively on the labour input of the individual.<sup>7</sup>

It must be stressed that the government typically does not have to convince its citizens to enter the private sector by a propaganda campaign. Usually, after certain prohibitions on private activity are lifted, the private sector begins to grow quite spontaneously with individual enterprises sprouting up like mushrooms in a forest after rainfall. The explosion of private activity is all the more notable as it often follows a period of brutal repression of any form of private ventures. As soon as the repression against private activity is terminated in the reform countries, the private sector immediately begins to expand in a genuinely spontaneous manner. People do not have to be cajoled or coerced in order to choose this way of life.<sup>8</sup> In fact, they are immediately attracted by the higher earnings, by the more direct linkage

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<sup>6</sup> Private business partnerships, owned and operated by a group of people belong to the private sector, along with business owned and operated by single individuals or by a family. In the Soviet Union such partnerships are called “cooperative”, although everybody knows that they are in fact private business partnerships.

<sup>7</sup> About the formal and informal private sector see G. Grossman (1977), I. R. Gabor (1985), C. M. Davis (1988), S. Pomorski (1988) and B. Dallago (1989).

<sup>8</sup> Perhaps the USSR, and especially the Soviet agricultural sector is an exception. Here the memory of the terror which accompanied mass collectivisation

between effort and reward, and by the greater autonomy which the private sector offers. The third reason, namely the prospect of greater autonomy in private activity, in particular should not be underestimated.<sup>9</sup>

Private activities generate relatively high income because they are able to meet demand left unsatisfied by the state-owned sector. A craftsman, or the owner of a corner grocery store or indeed of a small restaurant is typically in the middle income group in a private enterprise economy. But here, in the environment of a chronic shortage economy the same activities catapult these people into the highest income group, not because they are particularly smart or greedy, but because of the rarity of the service that they provide. The price which they get for their output is just the market clearing price in the small segment of the economy, where a genuine market operates. They can be grateful to the state-owned sector and to the fiscal and monetary systems which create supply and demand conditions leading to free market prices significantly higher than the official prices in the state-owned sector.

The dimensions of this growth of private economic activity are even more remarkable, if one takes into account the fact that the private sector must adjust to the hostile environment of the half-heartedly reforming socialist economy. Despite some improvements, the daily life of private businesses is still characterised by a multitude of bureaucratic interventions and restrictions. The private sector has limited access to material supply, and almost no access to credits and to foreign exchange. Material, credit and foreign exchange is often acquired in illegal or semi-legal ways.

A further sign of hostility is the jealousy of people who are suspicious of growing income differentials. This envy of individuals who suddenly come to earn more than others, while it occurs in all systems, is likely to be all the more divisive in a society in which people have been brought up to consider equality to be a major social desideratum. Finally, further difficulties are caused by the absence of legal institutions for the consistent protection of private property and for the enforcement of private contracts, as well as the lack of political movements and associations devoted to the articulation of the private sector's interests.

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and the "liquidation of kulaks" is so deeply imprinted on the collective conscience that it has been passed on from generation to generation and many individuals are still diffident about starting individual farming or any other kind of private business.

<sup>9</sup> On Hungarian television, the author once watched a programme about a man who had been a lawyer in a state-owned enterprise, but who had decided to leave his job to open a small private restaurant – just so as to no longer have a boss tell him what to do. The same reason was given by former members of an agricultural cooperative who had chosen to quit and had opened a small regional food-processing plant.

Even dissident groups are, so to say, reluctant to step forward and advocate the interests of private business and private property. And that leads to the ideological aspects of the issue.

Can one justifiably assume that this small-scale-private activity inevitably leads to capitalism? It is very tempting to simply answer “no”. Thus, if we were now in a meeting called upon to decide on the pragmatic question of how many licenses to give to private taxi cab owners, this author would not at all object to the argument that private taxi cabs are not genuine capitalist ventures, and that Hungarian, Soviet and Chinese socialism will not be endangered if a few more such cabs are allowed on the road. Nevertheless, if we want to be objective, it is not possible to dismiss the above question so easily.

Using now the terminology of Marxian political economy, we may classify the overwhelming part of private sector activities in socialist economies as small commodity production. Roughly speaking, the decisive distinction between small commodity production and genuine capitalism in the Marxian sense is that the former uses only the labour input of one individual, together perhaps with that of his family members, whereas the latter uses hired labour regularly and thus becomes exploitative as it seeks to extract the surplus from the employee. In this context, the ideology and practice of socialist countries has been very much influenced by Lenin’s frequently quoted dictum that “... small production engenders capitalism and the bourgeoisie continuously, daily, hourly, spontaneously, and on a mass scale” (Lenin [1920], (1966), p. 8). In the author’s opinion, Lenin was absolutely right. If a society allows for the existence of a large number of small commodity producers, and if it permits them to accumulate capital and to grow over time, a genuine group of capitalists will sooner or later emerge. To appreciate this fact, the reader is asked to imagine for a moment what would happen if private producers had the same access to credit and to all kinds of inputs as the state-owned enterprise in a socialist economy and, moreover, were to be treated equally by the tax and subsidy system. Without any doubt, the more successful private businesses would begin to accumulate and grow. Thus, the negative answer to the question as to whether small commodity production breeds capitalism in pragmatic discussions of particular cases, is already predicated on the assumption that the government will not allow private business to grow beyond a certain critical threshold. In other words, the growth of the private sector in a socialist economy is not only hampered by the excessive red tape of an ubiquitous and omnipotent bureaucracy; the sustained growth of private businesses also runs counter to the ideological premises of the system, and will therefore be held in check by the ruling party and by the government which are not willing to tolerate a significant capitalist sector.

There are different ways of imposing constraints on the private sector's ability to grow. Sometimes, these constraints simply take the form of legal restrictions such as, for example, the form of an upper bound on the number of people which may be employed in a legal private enterprise, or of a limit on the amount of capital which may be invested in private businesses. Obstacles to growth may also be incorporated in the tax system. The extent of taxation of a particular activity at a given point in time can vary quite substantially, thus providing the authorities with an additional tool for keeping the private sector under control. The author has talked to Hungarian private craftsmen who pointed out to him the exact level of taxation up to which they would be able to uphold the private venture, and beyond which they would have to abandon it and return to work in the state-owned sector. Of course, these critical reservation thresholds may vary from sector to sector, from period to period, and from business to business. But it is important to note that they exist and that they impose institutional limits on the survival of a private firm. The most powerful upper limit on accumulation is uncertainty and the fear of future nationalisation and confiscation. Memories of past repression are alive, and the individual might be scared that he and his children might one day be stigmatised as "bourgeois" or "kulak".

As a consequence of this situation, economies of scale cannot be enjoyed due to the limits on capital accumulation. It might be socially more reasonable in the given political and ideological climate to waste one's profits rather than to put them to productive use. In historical accounts of capitalist economies, we are used to reading about the parsimony of the founders of family businesses who endeavour to bequeath their wealth to future generations. In accordance with the picture painted in Thomas Mann's novel "Buddenbrooks", we begin to associate wastefulness only with the second and subsequent generations of a family line of capitalists. By contrast, waste in family businesses in socialist countries often begins on the very first day of their existence, given that it is quite uncertain whether the venture will have a prolonged existence even within the individual founder's own life-time.

The social environment of the private sector also results in a myopic behavior. The private firm is typically not interested in building up a solid good will with its customers for its products or services, because its owners feel that they might not even be in business the following year. Thus, in the extreme, given the overall environment of the sellers' market, private firms may be quite dishonest with their customers so as to reap the largest possible amount of one-time profit. To the extent that consumers are used to the queues and to the shortages in the state-owned sector, it is generally easy for the private firm to keep its customers, even though its employees might hardly be more forthcoming and polite than the employees of its counterpart in the state-owned

sector, if there is one. Instead of raising the overall standards of service of the sellers' under state ownership in the direction of those of a buyers' market, the standards of a new small private venture drop downward to those of sellers in a chronic shortage economy.

Private ventures have to adapt to the use of bribery too in the acquisition of the necessary inputs. Cheating is needed not only to acquire inputs, but also to defend the business against the state. Many individuals joining the private sector are not entrepreneurs, but adventurers. Such is the natural process of selection under the given conditions.

These circumstances set the trap for the social position of the private sector. Daily experience supplies arguments for “anti-capitalist” demagoguery and for popular slogans against profiteering, greediness and cheating.<sup>10</sup> Such propaganda fuels further restrictions and interventions which lead to further deterioration: to capitalism at its worst. We, therefore, face a vicious cycle. It is reminiscent of a marriage between an anti-Semite and a Jewess, or between a racist and a black woman. Husband and wife irritate each other, even may hate each other but they know they must live together because of strong common economic interests. The contemporary socialist system needs the active contribution of a private sector, otherwise it is not able to deliver the goods to the people. Socialism has apparently arrived at a stage in history when it is unable to survive in its pure, strictly non-capitalist fashion and must co-exist with its self-acknowledged arch-enemy not only world-wide but within its own borders as well. In other words, the system is heading towards a mixed economy where various forms of public and private ownership will operate side-by-side. The formulation of the problem makes it clear, that this is an issue of extreme political importance, but in keeping with the brief compass of this paper we will not discuss it any further.

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<sup>10</sup> It is ironic that some politicians and journalists in the reforming socialist countries, (sometimes even in the “new left” circles within oppositional groups) argue against high prices and profiteering on moral grounds. It is not recognised that it is inconsistent to declare the desirability of a market and at the same time to refuse the legitimacy of a price generated by the very same market mechanism.

#### 4. The Persistence of Bureaucracy

The state-owned sector remains the dominant sector of the economy in Eastern Europe and in the Soviet Union, and in China as well, though not to the same extent. As China proceeds on the road to industrialisation, however, the role of state-owned enterprises is likely to increase.

The central idea of the original reform blueprints had been the abolition of the command economy, that is the elimination of mandatory output targets and mandatory input quotas. At this time, Yugoslavia and Hungary are the only countries which have more or less consistently implemented these proposals. In China, USSR and Poland they have been realized only partially.

The initial expectation of the reformers had been that, once the administrative system had been abolished, there would be a momentary vacuum which would then be filled by the market mechanism. In other words, bureaucratic commands would be instantaneously replaced by market signals. The underlying assumption of this position was that of a simple complementarity between the two mechanisms of coordination, namely bureaucratic and market coordination.<sup>11</sup> However, this expectation, which was shared by the author in the 1950s, has turned out to be naive. What actually happened was that the vacuum left by the elimination of administrative commands, and thus by the elimination of direct bureaucratic coordination, was filled not by the market, but by other, indirect tools of bureaucratic coordination.

The role of the market, which had not been completely eliminated even under the classical socialist planning system, has of course increased in the wake of the reform. However, the role of the bureaucracy continues to remain pervasive, and is asserted in many different ways.<sup>12</sup> To summarise in a nutshell, the role of the bureaucracy remains

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<sup>11</sup> The term "bureaucratic coordination", here as in other works of the author is used in a value-free sense, without any negative connotation as in many Eastern European writings and speeches. It refers to certain types of controlling and coordinating activities. The main characteristics of this mechanism include the *multi-level hierarchical organisation of control*, the dependence of the subordinate on the superior and the mandatory or even coercive character of the instructions of the superior.

<sup>12</sup> In the spirit of footnote 11, a word of explanation is needed concerning the term "bureaucracy". This notion is also used in a value-free way, without implying any negative judgement whatsoever. It denotes the hierarchical apparatus in control of all social and economic affairs and includes not only government officials and managers, but the functionaries of the party and of the mass organisations as well.

paramount in the selection and in the promotion of managers, and in the decision-making power with regard to the entry and the exit of firms. And while the bureaucracy has reduced or completely relinquished direct administrative control over the quantities of output and input of state-owned firms, it can still control them through informal interventions, through formal state orders and informal requests, and also through administrative price setting and through the extremely strong financial dependence of the firm on its superior organs. Thus, the state-owned firm has remained strongly dependent on the various branches of the bureaucracy, on the ministries in charge of production, on foreign-trade authorities, on the price control office, on financial bodies, on the police and so on. The party organisations also intervene frequently in the affairs of the firms. A change has taken place in the form, but not in the intensity of dependence.

In our description of the private sector, we have used the terms “spontaneous” or “naturally grown”. Here, we shall emphasise that the persistence of the bureaucracy is a spontaneous and natural outgrowth of the system as well.<sup>13</sup> The Central Committee or the Politburo does not have to decide to maintain as much of the bureaucracy as possible during the process of reform. On the contrary, the bureaucracy may grow despite sincere attempts to reduce it, and in the face of dramatic campaigns to get rid of it, such as the one which took place during the cultural revolution in China. The current Soviet Perestroika (restructuring) again sets out as its goal the reduction of the size of the bureaucracy; yet, the experience up to now does not allow us to place a lot of confidence in the possibility of checking the natural growth of the bureaucracy, even if drastic methods are employed. A self-reproduction of bureaucracy can be observed in the sense that, if it is eliminated at some place, in one particular form, it will reappear at another place in some other form. This permanent restoration of bureaucratic control is explained by many factors. One is, of course, all the material advantage associated with bureaucratic positions, namely financial benefits, privileges and access to goods and services in short supply.

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In other words “bureaucracy” refers to a certain social group different from other groups in society, and “bureaucratic coordination” refers to a certain coordination mechanism, different from other mechanisms, such as, for example market coordination. Conceptual distinctions notwithstanding there is, of course, close linkage between these two phenomena: the bureaucracy applies bureaucratic coordination methods to govern those who are subject to its power.

<sup>13</sup> As before, the term “natural” is not used here in the sense of American advertising, where it is a synonym of words such as good, wholesome and non-artificial. Rather we use it to denote a phenomenon which reproduces without government support, and sometimes even in spite of policies designed to oppose it, simply as a consequence of the social situation.

Even more important is the attraction of power. And here we arrive at a highly political issue again. The relative shares of the role played by bureaucratic and market coordination are not simply a matter of finding the most efficient division of labour between two neutral forms of control. The bureaucracy rules the socialist economy. Allowing the genuine functioning of the market, means the voluntary surrender of an important part of its power.

The most important consequences of this situation are the limits imposed on the reformability of the state-owned sector by the systemic tendency of self-reproduction of the bureaucracy. We might be able to appreciate this point more clearly by considering the question of the constituency for reform. In the case of greater state tolerance for private economic activity, this constituency is large and well-defined. It consists of all citizens of a socialist country who choose to or at least would like to be able to have the option to work in the private sector, as entrepreneurs or as employees.

On the other hand, nobody is an unqualified winner in the decentralisation of the state-owned sector. Every person involved with the state-owned sector gains as well as loses as a result of genuine decentralisation. Each member of the bureaucratic apparatus may gain autonomy *vis-a-vis* his superiors, but at the same time may lose power over his subordinates. A reduction in paternalism and a concomitant hardening of the budget constraint<sup>14</sup> entails advantages as well as disadvantages for the managers as well as for the workers of a state-owned firm. They gain in autonomy, but at the same time lose in protection. While it is typically true that people are not in favour of or are at best indifferent with regard to the protection of others, they usually like to be protected themselves. In a capitalist economy, this ambivalent feeling towards protection is best reflected in the complex attitude towards free trade being evaluated favourably when it allows a company to market its own products in foreign markets with only minimal tariffs, but being less eagerly welcomed when it results in foreign competitors entering the company's domestic markets. In a socialist economy, every individual working in the state-owned sector has these schizophrenic feelings with respect to the soft budget constraint, to paternalism, and to protection. While high taxes are disliked, subsidies, even if the firm is not now receiving them, may come in handy in the future, and can therefore not be opposed quite firmly. Shortages, while they inconvenience the firm as a buyer, suit it as a seller. Thus, it turns out that neither the bureaucrats, nor the managers, nor indeed the workers are enthusiastic adherents of competition or of the marketisation of the

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<sup>14</sup> The terms "soft" and "hard budget constraint" are discussed in the author's works (1980, 1986b).

state-owned sector. Some enlightened government officials and intellectuals may come to the conclusion that a hardening of the budget constraint and a decrease in paternalism is needed so as to improve the performance of the economy. However, there are no strikes or street demonstrations in favour of increasing economic efficiency at the expense of state protection. As a result, there does not exist a grass-roots movement for the decentralisation of the state-owned sector.

Since on the one hand there is strong inducement to maintain the bureaucratic positions, and on the other hand there is no unambiguous constituency against their maintenance, the final result is the permanent reproduction of bureaucratic coordination.

## 5. Alternative Forms of Social Organisation

After this discussion of the private sector and of the state-owned sector and of the role of the bureaucracy and of the market in a prototype reforming socialist economy, let us now approach the theme of this paper from a somewhat more general point of view. Consider the Figure on the next page.

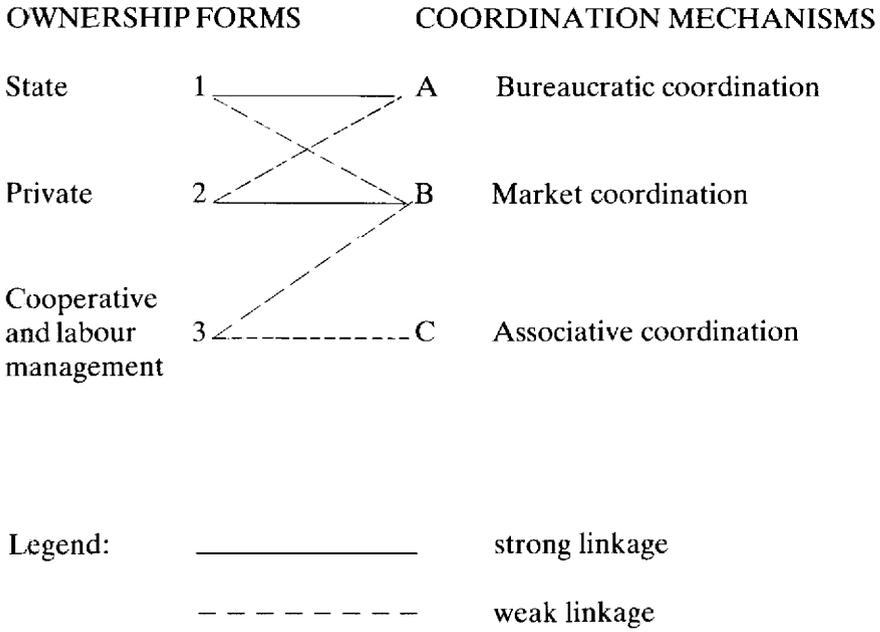
When referring to state ownership 1, we have in mind the classical case of bureaucratic centralised state ownership, 2 is private ownership, while A and B refer respectively to bureaucratic and to market coordination.

Two strong linkages exist between the ownership form and the coordination mechanism. Thus, it is common to encounter classical, pre-reform socialist economies which combine state ownership with bureaucratic control and classical capitalist economies which combine private ownership with market control. These two simple cases might be looked upon as historical benchmark models. It seems quite natural, that when economic units based on private ownership operate in the market both as sellers and as buyers, that they would be motivated by the incentives of financial gain and would be highly responsive to costs and to prices. Similarly economic units under state control are operated by the bureaucracy, using bureaucratic instruments.

By contrast, we can observe that in the reforming socialist economies, the private sector, while mainly controlled by the market, is also subject to bureaucratic control, as symbolised by the dotted line from 2 to A. Yet this attempt to impose bureaucratic control on private activities does not and cannot work smoothly due to the basic incongruity of this pair.

# Figure

## Strong and weak linkages



In addition, there exist other, generally also inconsistent attempts to coordinate the state-owned sector via market coordination (the dotted line from 1 to B). This idea was of course at the center of the blueprint of market socialism. However, it turned out not to be possible to decrease the dominant influence of the bureaucracy. The influence of the market on the coordination of state-owned firms is full of frictions, as we have already seen in the earlier sections of this paper. In spite of the efforts of reformers to strengthen the linkage of 1 to B, there is an inclination to restore the linkage of 1 to A: bureaucratic coordination penetrates and pushes out the influence of the market.

To sum up: the relationships between the latter two pairs, namely the relationship between 1 and B, and between 2 and A can be characterised as weak linkages.

The notions “strong” and “weak” linkages do not imply a value judgement and do not indicate any preference on the part of the author. These are descriptive categories. In accordance with the general philosophy of the paper, a linkage between an ownership form and a type of coordination is strong if it emerges spontaneously and prevails in spite of resistance and countermeasures. It is based on a natural affinity and a cohesion between certain types of ownership and certain types of coordination mechanisms respectively. The adjective “weak” refers to linkages, which are to some extent artificial and not sufficiently strong to resist the impact of the stronger linkage. Weak linkages are pushed aside by the strong ones time and again, whether the intellectual and political leaders of the reform like it or not.<sup>15</sup>

## 6. The Weakness of “Third Forms”

Is there a “third way”? First, let us turn to the issue of ownership. In row 3, where the Figure refers to cooperatives and labour management, we must emphasise the non-private, but also the non-bureaucratic character of social ownership, such as that found in genuine communes or in instances of genuine worker’s management.<sup>16</sup> The idea of cooperative socialism has long been part of socialist thinking. As for coordination of type C, the term “associative mechanisms”

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<sup>15</sup> There are many other combinations of 1, 2, A and B worth considering. For example, if in an economy the private sector is strong and stable, and the linkage of 2 to B is the dominant one, a certain segment of the economy can be successfully subjected to the linkage of 1 to B. In other words, in a basically private market economy the state-owned can adjust to the rules of the market.

<sup>16</sup> In accordance with the definitions used in the present paper, private business partnerships in the Soviet Union cannot be regarded as genuine cooperatives. They belong to Form 2 and not to Form 3.

is the collective name of a set of potential mechanisms. It is probably easiest to define the set in a negative way, as any mechanism of coordination which operates neither through the bureaucracy nor through the market, but which is based on self-governance, on free associations, on reciprocity, on altruism or on mutual voluntary adjustment.

The literature on socialism is rich in proposals which suggest that socialist society be based on cooperative ownership, and on non-market, non-bureaucratic associative coordination. In referring to this tradition of thought Marx coined the somewhat derogatory term "Utopian Socialism". Early representatives of this line of thinking have been Proudhon, Fourier (to an extent), Owen, and others.

The literature does not always couple 3 and C. Some authors place the emphasis on 3, others on C, while in some cases, the two are considered together. Ideas of this kind come up frequently in the context of the reform discussions in socialist countries.<sup>17</sup> The whole Yugoslav experience constitutes an attempt, albeit a highly imperfect one, to move in the direction of this third way to socialism away from the exclusive reliance on state or private ownership and on the bureaucracy or on the market. The Chinese cultural revolution may be looked upon as an attempt to smash the bureaucracy and to proceed to a non-bureaucratic kind of socialism without the introduction of market elements. But neither of these two great historical experiments leads to conclusive results. In both cases the transformation was forced upon society by the political leadership and although at the beginning the initiative from the top had enthusiastic support among at least a part of the population, it was subsequently institutionalised and forced through, without countenancing any deviation from the central party line. Therefore, the fact that something resembling ownership form 3 was and still is the dominant form in Yugoslavia or that the rhetoric of Mao's Cultural Revolution re-asserted principles similar to coordination mechanism C does not allow us to reach any conclusions concerning the true strength of these forms.

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<sup>17</sup> Of course, cooperative ownership can be linked not only to coordination mechanisms of type C, but to the market mechanism as well. For example Yugoslavia experimented with a coupling of ownership form 3 (labour management) with both coordination mechanisms B and with mechanism C (market and "associative" coordination). Large segments of the economy were coordinated in the usual way by the market mechanism. At the same time, so-called "social compacts" were arranged to establish direct contacts between the representatives of producers and of consumers; they were expected to voluntarily make mutual adjustments. While the official policy alternated in the emphasis given to mechanisms B and C, in fact bureaucratic coordination mechanism A was prevailing all the time, and was in a latent fashion the dominant force.

Let us apply instead the criterion proposed previously and look at whether cooperative ownership and associative coordination grow spontaneously and naturally during the reform process of socialist systems. This question is meaningful, because the establishment of genuine voluntary cooperatives, voluntary adjustments and other forms of associative coordination are not prohibited in these countries. Small cooperatives are far better tolerated by the system than private economic activities. And altruism and non-commercialised reciprocity are of course legal in any system.

However, we can observe that, while 3 and C exist and did exist even at the peak of bureaucratic centralisation, these forms have not experienced a spectacular growth after the command system had been abolished. When beside centralised state-ownership other forms were permitted, private ownership gained ground rapidly. While the elimination of direct bureaucratic control left a momentary vacuum, this vacuum has been filled mainly by indirect bureaucratic control, as well as with some form of market coordination. Cooperative ownership and associative coordination play only an auxiliary role at most.<sup>18</sup>

Let us sum up our theoretical conjectures concerning the strengths or weaknesses of the forms of social organisation. While ownership forms 1 and 2 are robust, 3 has few followers. Similarly, while coordination forms A and B are widely applied, C operates only in a rather restricted area of affairs. And in contrast to the strong linkages between 1 and A, and between 2 and B, all other potential linkages from 1, 2 and 3 on the ownership side to A, B and C on the coordination mechanism side are weak. (The Figure shows with dotted lines only four of the potential weak linkages. There are, of course, others.)

The validity of conjectures concerning the strength or weakness of certain ownership forms, of coordination mechanisms and of linkages between ownership and coordination mechanism is an empirical matter. As indicated in the Introduction, the present paper does not provide empirical evidence. Yet these conjectures can be accepted, modified or rejected by inference from empirical studies reported in the available literature or conducted in the future. In any case, the issue of the validity of empirically testable conjectures must be strictly separated from the normative issue: political and moral preferences over the set of alternative forms of ownership and coordination mechanisms.

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<sup>18</sup> Ownership form 3 and coordination mechanism C are associated in many writings and certain political ideas such as administrative decentralisation of government activities, the increased role of local governments, participatory democracy and self-governance, corporative ideas of various sorts and so on. Again the discussion of these aspects is beyond the limits of the present paper.

It must be admitted that the observations concerning the weakness of third forms, drawn from a small sample observed over a brief period. Perhaps twenty or thirty years from now, researchers might be able to observe that this tendency was stopped and that history took an alternative route. History is always unpredictable. But as long as no contrary evidence is provided by experience, it is worth while to keep in mind the observations concerning the strength or weakness of the alternative ownership forms and coordination mechanisms.

It is fully understandable that various social groups and intellectual currents advocate a wider role for third forms. These efforts may have beneficial effects, provided that those who make such suggestions do not nourish false hopes and do not strive for the dominance of non-state and non-private ownership, and of the non-bureaucratic and non-marketised coordination. It would be intellectually dishonest to hide the weakness of third forms.

## 7. About Normative Implications

No search for a third form of ownership and/or for a third form of coordination mechanism allows one to evade the real tough choices. Hence, we really need to decide what the relative importance of the two robust forms of ownership – state versus private – will be. Closely allied to this will be the choice concerning the relative shares of the two robust coordination mechanisms: that is, bureaucratic versus market coordination.

Here a caveat is needed. In the discussion of reform ideas it has not infrequently been observed that critical propositions generated as the positive (descriptive) analysis of an existing socialist system acquired a normative twist. The logical structure of this normative twist is as follows: “If you say that the phenomenon A has harmful effects, then it implies a value judgement and a prescriptive suggestion as well: the elimination of phenomenon A eliminates the harmful effects. Therefore phenomenon A should be eliminated.” This train of thought is logically false and also dangerous. Even if one can prove that phenomenon A has harmful effects, it does not follow from this proposition, that (i) the elimination of phenomenon A is at all feasible under the given conditions, and (ii) that the elimination of phenomenon A is a sufficient condition for the elimination of the harmful consequences.

And now we can return to the ideas elaborated upon in the present paper. The author would like to avoid normative twists to his own positive analysis. The positive (descriptive) statements to the effect that both state and private ownership are robust forms, and that each

of them has a strong linkage either to bureaucratic or to market coordination does not imply the proposal that society must give up state ownership and shift to private ownership. The paper does not suggest that we are faced with an “either-or” type of binary choice between mutually exclusive forms: either state ownership cum bureaucratic coordination, or private ownership cum market coordination. The ideas presented in the paper can, however, be construed to entail the following:

- i) State and private ownership can coexist within the same society. Yet in the present political, social and ideological environment this is an uneasy symbiosis, loaded with many dysfunctional features.
  
- ii) The decision concerning the actual shares of state and private ownership, and the associated decision concerning the combination of bureaucratic and market coordination are both dependent on the ultimate value judgements of those participating in the choice. The paper does not comment on these value judgements, nor on the political and ethical criteria underlying the choice. Consequently, it cannot offer unambiguous suggestions. What it tries to do is much more modest: it offers conditional predictions based on the theoretical conjectures about the strengths and weaknesses of various possible linkages between ownership and coordination mechanisms. This paper merely warns: let us not have illusions and false expectations. Once one arrives at a large share for state ownership, one gets a “package deal”, and the package then inevitably contains a large dose of bureaucratic coordination. Another warning is also needed: if one really wants a larger share for market coordination, one must ipso facto, accept a larger share for private ownership and for individual activities. But a desired coordination mechanism, (say market) does not come about without a significant backing of the appropriate ownership form (say private ownership). Likewise, one cannot get the desired ownership form (say public) without getting its associated form of coordination (say bureaucratic coordination). Such is the Realpolitik of reforms.

The usual slogans demanding state–ownership cum market entail a misunderstanding or engender a naive, false expectation which will certainly be disproved by the bitter track record of experimentation with half-reforms. We might even say that some economists and policy-makers have used this catch-phrase as a tool of mass-manipulation, or, to apply a less perjorative formulation, as an educational instrument. (“After a long period of telling  $2 \times 2 = 8$ , it is reasonable to say at first  $2 \times 2 = 6$ . Declaring immediately that  $2 \times 2 = 4$  causes too much of a shock.”) But then, must every socialist country tread the painful path of gradual disenchantment? Is it really hopeless to expect that the latecomers to the reform process might learn from the disappointments of those who have gone before them?

- iii) Those who sincerely want a larger role for the market, must allow more room for formal and informal private activities, for free entry and for exit, for competition, for individual entrepreneurship and for private property. Only a radical extension of the private sector creates favourable conditions for the marketisation of the whole economy, including more effective market signals and more powerful profit incentives for state-owned firms. Movement in that direction, namely in the direction of the extension of the private sector, is the most important yardstick of economic reform. Without such movement reform slogans are only a lip-service to decentralisation and market-coordination.

How far can a socialist system go in the uneasy symbiosis with private ownership and individual activities? The answer to this question is more a political or an ideological issue, than a question of economics – and the analysis of these aspects goes far beyond the theme of the present paper.

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