AN ANTIDOTE TO SHOCK THERAPY: AN EVOLUTIONARY APPROACH TO THE EAST EUROPEAN ECONOMIC TRANSITION

Peter Murrell

INTRODUCTION

During 1989, as the East European revolutions proceeded one after another and the economics profession became increasingly engaged in the reform process, there was almost a consensus amongst economists about the way in which reform should proceed. First, there would have to be liberalization--the freeing of all economic actors from the administrative controls of the central government. That liberalization would necessarily be accompanied by a drastic, market-style stabilization based on tight money and the hardening of budget constraints. The guiding light in the first steps of reform would that all economic agents, whether state or private, would participate in the market under the same set of conditions. Given the immediate reliance on the market mechanism, the old institutions of traditional control--especially the planners and the supply organizations--would be destroyed. Existing formal and informal property rights in the state sector would be eradicated in order to give the central government the right of disposal of state assets. This measure would occur as preparation for privatization, which would be pursued as soon and as fast as possible.

The 1989 consensus view of economic reform, I will call the radical approach. It emphasizes speed, the destruction of the old, and the quick conversion of organizations to the arrangements of developed capitalist economies (Lipton and Sachs 1990).

The train of events over the last two years in Eastern Europe has not been kind to the radical model. There are now signs that the former consensus is breaking down. One constantly hears pronouncements from officials and academics that reform is more difficult than expected, more costly than expected, and slower than expected. But disappointed expectations are not the prime factor in cracking the academic consensus. Rather, the radical model is coming into question because of the manner in which expectations have been disappointed. In this introduction, I list a few facts that seem pertinent in this respect. As I do so, I hint at the way in which these facts undermine the radical program of reform and serve to justify a different approach. The two papers accompanying this introduction serve to outline an alternative approach, an evolutionary reform program.

No normative model is ever implemented cleanly, but in East Germany the radical model came as close to complete implementation as one is likely to see. East Germany seemed to have everything--a big brother to hold the currency firm and to ensure credibility of the reform process, a structure of laws and institutions that were accepted immediately, and immediate entry into the world's largest trading bloc. In addition, the whole package could be implemented overnight. That implementation resulted in the largest economic disaster in Europe in the postwar period.

The economic reform that conformed least to the radical pattern was that of China. In that country, there were the worst initial conditions, including communist leaders who would not let go and a large urban, state-owned industrial sector with much influence. From the radical perspective, the reform was implemented in the most chaotic manner, with distortions of immense magnitude, with initially opaque property rights, and with large barriers to competition. Nevertheless, there can be no doubt that the reforms in China are as successful as have been seen. The contrast between the Chinese experience and the East German experience should surely give pause to those confident in the radical model.

It is now clear that the radical reform model faces large implementation problems in the East European countries. These problems damage the coherence that is the most important economic property of the model. Consider the following statement by that most radical of all reformers, Václav Klaus, the minister of finance of Czechoslovakia: "I agree that the opinion claiming that cooperatives will cease to be a significant entity in our agriculture within my lifetime is nonsense and stupid ideological propaganda".[1] Similarly, Polish government officials have made grand statements about radical implementation of a capitalist economy by swift privatization, refusing to countenance the third way of employee ownership. Nonetheless, the major step toward privatization in Poland so far has been employee buyouts--a method that had been greatly denigrated by the radicals.[2] The inability to implement major aspects of the radical reform program surely argues that there are problems in its conception, particularly the supposed coherence that is at its heart.[3]

The tenacity of the old appears not only in the inability to destroy existing institutions. The organizations that were expected to change their behavior in response to the new conditions have failed to do so. This is particularly the case for the large state enterprises that still dominate the East European economies. The press reports, the observations of politicians, and the performance of enterprises now speak in one voice on

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[1] Foreign Broadcast Information Service-Eastern Europe (henceforth FBIS-EEU), 91-112, 11 June 1991.

[2] Jacek Bukowski of the ministry of ownership transformation reported in Seattle on 8 June 1991 that six state companies had been privatized by favored methods, whereas 100 enterprises were privatized by employee buyouts.

[3] One particularly challenging way to state this point is that if liberalization is implemented and privatization is slowed, then the radicals are in the position of advocating a market socialist economy. But this is just what the radicals have argued against (Lipton and Sachs 1990).

this issue.[4] The lack of organizational response calls into question the notion that austerity and liberalization will rapidly change the behavior of existing organizations. It is now clear that the hope for Eastern Europe lies primarily in the new organizations that are created in the private sector and then selected and shaped by market forces.

Where destruction of the old framework of institutions has been accomplished, the results have hardly been fortunate. The single best example of this is the demise of the CMEA in early 1991. The precipitate dropping of the old CMEA arrangements is now widely recognized to have caused enormous problems in East European trade, which in turn caused large domestic economic crises. Many fewer economists now than one year ago subscribe to the notion that a long-established bureaucratic procedure can be quickly replaced by the market.

While most economists agree that bureaucratic procedure must be replaced by normal monetary transactions in the long run, there is increasing sympathy with the idea that the phasing out of old institutions must be smooth and gradual. This realization, prompted by the effects of the destruction of the CMEA, is now becoming an important factor in present discussions concerning the economic arrangements between the countries that have replaced the Soviet Union. There are many advocates of the notion that elements of the old system must be protected for a while in order to prevent economic collapse. This is hardly the type of analysis that one would have expected from economists only one or two years ago. It is certainly not consistent with the radical models of reform that were promulgated in those blissful early days of 1990.

Beyond a rise in sympathy for policies that temporarily protect the old system, there is in some instances a movement toward recreation of previously destroyed parts of that system. Barter deals are now being forged between countries that suffered greatly from the precipitate destruction of the old CMEA barter system.[5] Consider also the fact that the Polish government is now reactivating its interventionist policies of the past, for example as a credit manager for the state sector. "After so many years of a state-steered economy, it is impossible to have no intervention at all. In our situation, we cannot assume that the market is going to be the only regulator," according to Henryka Bochniarz, the head of Poland's newly created ministry of industry and trade.[6]

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[4] For a sampling, see a report on Prime Minister Bielecki's visit to some of his factories (New York Times, 3 June 1991) and the comments of Finance Minister Balcerowicz reported in FBIS-EEU-90-093, May 14, 1991. Similar statements from elsewhere could fill a further paper.

[5] See for example the details of a Soviet-Hungarian deal swapping $100 million of food and buses for raw materials (FBIS EEU-91-107, 4 June 1991). Similar types of arrangements are being reconstructed across the countries of the old CMEA.

[6] Washington Post, 5 August 1991.

In summary, little in the economic record of the past two years suggests that the radical program of reform is successful. The old institutions cannot be simply destroyed, and therefore the radical reform plans have serious problems of coherence. Furthermore, it is now becoming increasingly accepted that sudden destruction of the old institutions can be economically inadvisable. The economic pressures associated with this realization are so great that some of the past institutions are being recreated--a recreation that is far more costly than keeping the old institutions in grudging acceptance of the fact that they cannot be replaced overnight. All these points tend to suggest that an alternative model of reform is necessary--one that has more sensitivity to the difficulty of changing socio-economic arrangements than the radical model.

The two papers that follow provide some theoretical underpinnings for that alternative--evolutionary--approach to reform.[7] Such an approach places little emphasis on reforming old organizations, but instead pins its hopes on the growth of a nascent private sector. An evolutionary policy, therefore, combines a policy of the gradual phasing out of the old institutional framework, an active program to promote new private sector activity and the institutions that this sector requires, and gradual privatization using market processes.

The impetus for pursuing an evolutionary approach came from Murrell (1990), which provided an analysis of the causes of the problems of the pre-reform economies of Eastern Europe. The concluding chapter of that book provided some brief ideas on the processes of reform, which were later expanded into a policy paper (Murrell 1990). The two papers presented here are a continuation of that work, exploring the intellectual underpinnings and the policy prescriptions of evolutionary reforms. The papers are self-contained and thus need no further introduction. Despite the fact that the lessons in each of these papers derive from very different sources, their prescriptions are very consistent. This is simply because the separate theories that underpin each paper can be seen to be parts of wider world view, using similar assumptions about the nature of human activity and placing emphasis on similar aspects of socio-economic processes.

[7] For works that have some elements in common with the approach offered here, see Kornai (1990) and McKinnon (1991).

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EVOLUTION IN ECONOMICS AND IN THE ECONOMIC REFORM OF THE CENTRALLY PLANNED ECONOMIES[1]

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> The science of constructing a commonwealth, or renovating it, or reforming it, is like every other experimental science, not to be taught a priori. Nor is it a short experience that can instruct in that practical science; because the real effects of moral causes are not always immediate...The science of government being therefore so practical in itself, and intended for such practical purposes, a matter which requires experience, and even more experience than any person can gain in his whole life, however sagacious and observing he may be, it is with infinite caution that any man ought to venture upon pulling down an edifice which has answered in any tolerable degree for ages the common purposes of society, or on building it up again, without having models and patterns of approved utility before his eyes.
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> Edmund Burke, Reflections on the Revolution in France, 1789.

INTRODUCTION

The transformation of the centrally planned systems into market economies is an immensely complicated task for which economic theories can only provide loose metaphors, rather than precise lessons. Economists are not as fortunate as engineers assigned to build a bridge, armed with a simple goal and with hard and fast, and tested, scientific principles. Rather, economists must rely upon sets of theoretical propositions known to be true only in highly stylized circumstances and empirical results often connected to the basic theories by tenuous additional assumptions. Thus, in deliberating on economy-wide economic reforms, economists should remind themselves that their theories are incomplete metaphors, rather than precise instruction manuals laying out the path to progress in a clear and definite way.

[1] The author would like to thank the Center for Institutional Reform and the Informal Sector (IRIS) at the University of Maryland for financial support in the writing of this paper. For helpful comments on this paper and related ideas, he would like to thank Josef Brada, Chris Clague, Jacques Cremer, Ed Hewett, Norbert Hornstein, Michael Marrese, Richard Nelson, Mancur Olson, Randi Ryterman, Jan Svejnar, and economists and economic policy-makers in Czechoslovakia, Hungary, Poland, Mongolia, and the Soviet Union who freely discussed with him their ideas about their own countries' reforms.

The purpose of the present paper is to present the lessons of one such economic metaphor: to examine an evolutionary approach to economic reform. When the word "evolutionary" is used in common parlance, it usually conjures up two images. The first is of slow and gradual change, rather than of a revolutionary leap. In the second there is the connotation of the theory of natural systems central in biology. I hope to show in this paper that the conjunction of these two images is no simple matter of coincidence. The economic theories that are related to the theory of evolution do, on balance, suggest that the process of economic reform should be gradual. Perhaps more important, these theories suggest that economists should be wary of emphasizing the benefits of privatization and instead should focus on the positive effects of building a market economy by encouraging the growth of a nascent private sector.

The ideas comprising the "evolutionary paradigm" derive from a number of sources. The early impetus was from Schumpeter (1950). At the simplest level, the theory also draws some insights by analogy with biological evolution. As Nelson and Winter (1982) make clear, however, the underlying basis of the evolutionary paradigm rests securely on a systematic articulation of theories of individual and organizational behavior, particularly focusing on informational problems. This fact implies that there are many links to be made between the evolutionary paradigm and that part of current economic theory focusing on informational processes--for example, investigations of the informational limitations of markets, the role of institutions in informational transmittal, the game theory approach to economic organizations, and so on.[2] Of pertinence in the present context, Murrell (1990) argues that the evolutionary paradigm identities those systemic features most responsible for the differences in the economic performance of capitalist and centrally planned economies. These are the features of centrally planned economies that must be most urgently changed in the process of reform.

The second section that follows presents a summary of those elements of evolutionary theory that seem most pertinent to any deliberation on the process of economic reform. The third section considers the connection between the speed of imposition of reform and the level of economic performance in the immediate post-reform phase. The fourth section examines the hopes for privatization and considers whether the process of privatization itself might impede the attainment of other worthwhile objectives of reform. The nature of stabilization programs is considered in the fifth section, particularly the extent to which those programs should rely solely on market-based measures. Using the view of organizations emanating from the evolutionary paradigm, the sixth section considers whether the existing organizations of the pre-reform economy should have any role in the transition process.

THE EVOLUTIONARY PARADIGM FROM THE PERSPECTIVE OF REFORM

[2] Stiglitz (1989) and Murrell (1991), although not addressing this point directly, show connections between some recent theoretical results and evolutionary views.

The evolutionary paradigm begins with two premises.[3] First, in order to understand the success of capitalism, one must primarily focus upon mechanisms that produce growth and change, not on equilibrating processes. Second, one must begin one's economic theorizing with a satisfactory description of the behavior of economic agents, especially one that takes full account of problems of decision-making and organization in the face of severe limits on information-processing abilities. Then, the description of economic processes must follow directly from this view of the nature of agents.

At the center of the evolutionary emphasis on growth and change is the notion that innovation has been the driving force behind the immense increases in wealth occurring since the industrial revolution. One must be careful, however, not to attach too narrow a meaning to the notion of innovation. Progress has come not only from new technologies, but also from organizational and institutional innovation. Thus, the notion of innovation should conjure up not only the invention of the blast furnace or the semiconductor, but also the development of the multi-divisional corporation and fast-food franchising.

In emphasizing growth and change, and thus innovation, the evolutionary perspective implicitly accords relatively less importance to the property of allocative efficiency. According to this perspective, the neoclassical paradigm's primary focus upon allocative efficiency and competition within an equilibrium framework is misleading. Rather, as Schumpeter (1950, pp. 84-85) stated most forcefully, these features are of secondary importance compared to capitalism's mechanisms for change and innovation:

> [I]t is...competition within a rigid pattern of invariant conditions, methods of production and forms of organization in particular, that practically monopolizes attention. But in capitalist reality as distinguished from its textbook picture, it is not that kind of competition that counts but the competition from the new commodity, the new technology, the new source of supply, the new type of organization.... This kind of competition is much more effective than the other as a bombardment is in comparison with forcing a door, and so much more important that it becomes a matter of comparative indifference whether competition in the ordinary sense functions more or less promptly.

A direct implication of this quote--and the evolutionary approach--is the notion that proposals for economic reform concentrating on the pursuit of allocative efficiency will not address the main problems of socialist economies.[4]

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[3] Nelson and Winter (1982) provide the most complete modern exposition of evolutionary theory. The present discussion closely follows their approach, emphasizing elements most critical to reforms.

[4] This is the conclusion reached by Murrell (1990) in a comparative analysis of socialist and capitalist economies.

In modelling processes of growth and change, the evolutionary approach begins by acknowledging the effects on behavior of rampant uncertainty and the consequent demands on information resources.[5] Thus, agents are constrained not only financially and physically, but also by limits on information processing capabilities and by the difficulties of exercising control in complex organizations. The latter constraints have profound consequences for the construction of effective organization.

A complex system organizing the interaction of many individuals must be able to coordinate the actions of those individuals and to process the information that flows between them. The exercise of routine operations is an efficient means of handling such coordination. Through the repetition of tasks varying only over a narrow range, an organization is able to economize on the scarce information-processing resources of each member. Then, each member can clearly interpret the flow of messages that provides the coordination that is the essence of large-scale organization. Hence, organizational efficiency is intimately tied to the exercise of a particular "routine" or narrow range of routines.

With this view of organizations, it is important to realize exactly where information, or technology, resides. That information should not be viewed as being held by individuals, but rather as maintained in the continuing interactions between individuals. Information and skills, then, have value largely through interactions taken in the context of the exercise of a particular organizational routine. The productivity of an organization (and the individuals within that organization) depends to no small degree on the ability of that organization to continue its operations within some small neighborhood of its past behavior.

As well as solving the coordination problem, routines are also an element in the solution to organizational incentive and income distribution. A routine is essentially one equilibrium of the complex non-cooperative game that is at the heart of efficient organizational design. There are usually many equilibria of such games, of widely varying efficiency. Hence, the process of reaching efficient solutions could entail a long search. Thus, the perpetuation of a routine is itself protection against the creation of conflict that would arise in any attempt to find an alternative solution to the organizational game. During such conflict the efficiency, and indeed the existence, of the organization would be under great threat.

Of course, organizations are not totally inflexible. They do change routines. But the search for alternatives is constrained by an existing stock of information. Since that information is intimately bound to the exercise of an existing routine, the search is highly prescribed. Hence, the search for alternatives should be characterized not as wide-ranging choice over a universe of alternatives, but rather as a history-bound process of discovery within a neighborhood of existing operations. Moreover, when such a search takes place, the existing routine is itself threatened,

[5] The justification for the view of organizational behavior taken in the evolutionary paradigm is provided in detail in Nelson and Winter (1982). Here, I follow these authors in emphasizing the importance of organizational routines. One could reach essentially the same conclusions using the concept of corporate culture, as developed by Cremer (1987).

jeopardizing the stability of the organization by calling into question the existing division of organizational income.

Given the reliance on routines and the constraints on search, societies that succeed in a changing world must have a mechanism freeing them from the inertia inherent in the operations of an existing set of organizations. Capitalism provides such a mechanism in several ways. First, there is the automatic way in which markets reallocate the control over resources from inefficient organizations to efficient ones. Second, bankruptcy and, to some extent, takeovers and mergers remove inefficient organizations. Third, there is the process of entry--the creation of a variety of new organizations, some of which will find an effective organizational structure in the new circumstances. Then, in a process that marks the evolutionary approach to economic change, according to Nelson and Winter (1982, p. 9): "Patterns of differential survival and growth in a population can produce change in economic aggregates characterizing that population, even if the corresponding characteristics of firms remain constant."

We are now in a position to summarize the elements of the evolutionary paradigm that must be kept most firmly in mind when deliberating upon economic reform:

1. The use of routines and the fact that search reflects the historical experience of an organization mean that much persistence in organizational behavior should be expected.

2. The evolutionary approach forces us to focus on the concept of the economic environment, the set of external influences that affect an organization's performance, including the set of other organizations in society. Given a stable environment for a long enough period, the types of routines and behaviors that are present in any society will be conditioned by the environment in which society's organizations have survived and adapted.[6] Hence, in an initial period after a change in environment, the types of behaviors observed will be to a large extent a reflection of the past environment.

3. The evolutionary approach emphasizes the importance of selection processes, or entry and exit, in accomplishing change. Changes within organizations are de-emphasized in favor of a focus on shifts in economic resources from inefficient (or technologically obsolete) to efficient (technologically progressive) organizations or to new organizations better suited to the new economic environment.

[6] This does not, of course, mean that the society will necessarily become progressively more productive over time. Increasing fitness of organizations to the conditions of a social system will be certain to result in improved productivity only when a social system encourages only productive behavior. However, I do assume in this paper that socially productive behavior was encouraged to some degree by the old systems, but not to the degree that such behavior is encouraged in market economies, of course. Thus, at the beginning of transition the socialist economies have a stock of enterprises whose productivity, within the old system, is certainly better than that of a random set of organizational arrangements and whose productivity, within a market environment, cannot be assumed to be better than this random set of organizational arrangements.

4. To aid in the efficacy of the selection process, there is a need to generate variety in the types of organizations that are present in society. This is especially the case when a radical change in environment is considered and society's stock of organizations has been honed in a different environment. Moreover, it must also be emphasized that a variety of organizational forms is characteristic of modern capitalist societies (Nelson 1990).

5. The uncertainty and the limits on information processing that are emphasized in the evolutionary approach to organizations must also be acknowledged as elements in the policy-making process. Policy-makers' knowledge of the behavior of the economy outside a narrow domain close to their experience will be highly inaccurate.

Let us now turn to a discussion of the importance of these points for understanding the process of reform and for deliberation on the types of policies that should be implemented during reform.

REFORM, ORGANIZATIONAL RESPONSE TO ADVERSITY, AND ECONOMIC PERFORMANCE

Comprehensive economic reform means first and foremost a radical change in the economic environment. The existing stock of organizational routines and information, however, is a product of the old environment. In the case of most East European countries, this past environment is the centralized, bureaucratic system of administrative allocation and control. Given that this system survived for a number of decades in a number of countries, it is reasonable to suppose that organizational routines were selected according to the needs of the unreformed environment and are largely suited to that environment.[7] Moreover, the allocation of personnel to positions has occurred within that bureaucratic system. Thus, the centrally planned systems will have an allocation of human capital and of management styles that matches the dictates of a non-market environment.[8]

Because the stock of existing routines, behavioral patterns, and expectations--organizational structure for short--is suited to the existing environment, it is unlikely to be suitable for a new market environment. A radical change in the economic system requires large changes in organizational structure, which will induce much poorer economic performance during the lengthy and difficult process of changing organizational routines and reallocating managerial

[7] For fear of misinterpretation, the points in the previous footnote must be emphasized. This analysis does not imply that the centrally planned economies became progressively more productive, nor does it mean that the centrally planned system will be an efficient one. All that is necessary for the present argument is that pressures to be socially productive were not totally absent in the old system.

[8] Consider, for example, the following statement about the Hungarian chemical industry (a convertible-currency export-oriented industry in the most reformed East European country): "Managers selected by officials of the ruling party in the past have conformed with communist traditions: loyalism, mediocrity, and inflexibility. The number of western-type entrepreneurial managers remains low..." Chemical and Engineering News, 12 November 1990.

personnel. This decline in performance is all the more certain when the change in environment produces adversity that removes the possibility of simply continuing past behavior. Organizational efficiency tends to diminish rapidly in the face of adversity when long-stable cooperative agreements are no longer viable and must be replaced with less attractive ones.[9] Thus, a precipitate change in the economic system could be equivalent to reducing, at a single blow, the productivity of each enterprise by a substantial amount.[10]

The decline in economic performance that is immediate on the implementation of reform would occur even if the new economic system would be exactly the one that would be best in the long-run, after things have had time to hammer logic into people.[11] Thus, whereas in the long run a market system might be the most productive economic environment, in the short run, when routines and expectations are still adapted to the bureaucratic environment of central planning, a swift changeover to the market could be very destructive of the capacity of the existing enterprises to produce output.[12]

It is important to emphasize here that the phenomena to which I point are general ones, widely observed in market societies, and not simply the product of socialist economic reform.[13] For example, in the United States "there's an important correlation between change and corporate crises. Most big companies have built in immobility.... Consequently, some changes in markets or competition demand a degree of flexibility they simply aren't capable of, and could not reasonably be expected to possess" (Austin-Smith 1966, p. 8) What is unique about the East European situation is of course the number of companies that will be simultaneously subject to the stress of change and therefore the likely feedback between declines in performance in one area and the pressures of adversity elsewhere. Moreover, it seems that there is a highly nonlinear relation between adversity and declines in performance. Whereas moderate amounts of adversity

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[9] See Nelson and Winter (1982, pp. 121-24).

[10] It should be emphasized that there are two effects of change that need to be taken into account. The first effect arises from the fact that the features of organization that are productive in one environment are not necessarily productive in another environment. The second effect arises because all organizations are less productive while undergoing the process of change.

[11] The last phrase is of course a slight rewording of Schumpeter's (1934, p. 80) dictum on when one can use theories that assume that "conduct is prompt and rational."

[12] Thus, here I provide an interpretation of the causes of the declines in output in Polish industry in early 1990 that is very different from those that rely on macroeconomic imbalances (Frydman and Wellisz 1990, and Coricelli and Calvo 1990).

[13] Abernathy and Clark (1985, p. 18) point out that deregulation of a capitalist industry can create conditions that are similar to those in a new industry. Hence, reform, i. e., deregulation, is essentially equivalent to the creation of a new selection environment.

might be salutary, inducing productive reactions, extreme adversity appears to produce highly dysfunctional response, enhancing crisis rather than diminishing it (P. Nelson 1981).[14]

The previous point leads directly to the question of whether the present observations are relevant to decisions on the speed of reform. Given a nonlinear relation between organizational performance and degree of adversity, and given that declines in performance in one sector due to adversity will produce adversity in others, then it could well be that a slow reform results in a larger sum of discounted national income over the relevant period than does a fast reform.

The notion that one might want to change only gradually to a better environment (i.e., the market) could at first seem paradoxical. But the element of paradox vanishes as soon as one realizes that there are inherent externalities in the creation, design, and destruction of large organizations. These externalities arise from the non-market elements of coordination intrinsic in organizations and from the public-goods nature of organizational performance that is a consequence of the impossibility of establishing an automatic link between individual performance and individual rewards. In such situations, cooperation unsupported by immediate short-term incentives is essential for organizational performance. If existing cooperative arrangements are rendered nonviable by a large change in the environment, then a long and costly search for new cooperative arrangements becomes necessary.[15] During this process, the productivity of each worker will be lower than before, because each worker's productivity is intimately connected to the behavior of other workers. In sum, in the transition to a market economy, there is an inherent market failure arising from the destruction of system-specific organizational capital, which is the solution to the externalities problem that is intrinsic in organization itself.

Given that reform calls for the replacement of a large portion of society's organizational capital, the speed of reform can be viewed through the lens of optimal capital replacement policy. Decisions on the speed of reform must depend upon the cost of borrowing for consumption smoothing during transition. If such borrowing is not possible to the degree necessary, which seems likely given the present situation of the reforming economies, then the optimal path of reform would be one that conserves some of the existing organizational capital in the early stages of transition. This would seem all the more likely if it is important to ensure that living standards are not radically depressed in the early stages of democracy.

ON THE BENEFITS OF PRIVATIZATION

[14] Large amounts of adversity destroy the existing cooperative agreements that are the basis of organizational performance. Conflicts that had been suppressed will surface and the members of the organization will turn to the struggle over distribution rather than focusing on production.

[15] It is important to understand that strikes and large amounts of manager-worker hostility are inherent in this process and not simply a symptom of social and political failure.

Quick privatization of existing state enterprises is often viewed as a necessary and sufficient condition for the success of reform. It is assumed that, given a new ownership structure and market competition, there will be large increases in the efficiency and output of the existing stock of enterprises, which will more than repay the rather large political, social, and organizational costs incurred in the privatization process itself. Here, I use the evolutionary paradigm to reflect upon the likely benefits from privatization.

The construction of new organizations is costly and difficult. However, it could be even more costly to restructure old organizations that must be transformed because of a change in economic environment.[16] An existing organizational structure entails the adaptation of behavior and language of communication to existing conditions, the alignment of organization with an existing structure of physical plant, and many commitments to existing members that are costly to negate. Because of the difficulties of changing such organizational features, the reconstruction of existing organizations involves costs that are not present in the construction of new organizations. Hence, there can be no *a priori* assumption that privatization is better than simply shutting down existing enterprises in coordination with the gradual rise of new private enterprise. In the process of privatization and restructuring of state enterprises, more capital might be used than would be required in the process of creating new enterprises. This is especially the case if "restructuring grants" (i.e., subsidies) were a part of the whole privatization process.

This argument gains force when one remembers that it is the experience of capitalist societies that large organizations are often quite unresponsive to new circumstances.[17] As Arrow (1974, pp. 56-59) emphasizes, new organizations are often essential for change because established ones are likely to have an irreversible commitment to existing arrangements. In capitalist societies, in new industries and in existing industries where the technology is new, new firms are of enormous importance for these very reasons (Mansfield et al. 1977, p. 16, and Nelson 1981, pp. 1051-52). It seems plausible that the situation of a newly privatized enterprise would be every bit as demanding as that of an existing capitalist firm confronted by a new technology.[18]

The difficulties of reorganizing existing enterprises would be especially large if restructuring would require fundamental changes in an enterprise's sectoral specialization, production technology, or market orientation. Yet, there is reason to believe that East European enterprises will have to make changes of all three types during the restructuring process. Judging

[16] Leszek Balcerowicz recently emphasized that the costs of transition were much higher than expected, resulting in unexpectedly poor economic performance in the early part of 1991. One of the reasons he cited was the slow pace of changes in management structure. See Foreign Broadcast Information Service-Eastern Europe, 14 May 1991.

[17] The reasons for this are clear given the arguments of the second section.

[18] Moreover, the factors that give large established firms an advantage in market economies--economies of scale in science-based R&D and the benefits of accumulated learning-by-doing--will not be as relevant to the situation of large established enterprises in reforming economies.

by comparisons with capitalist countries at an analogous level of development, there are large structural shifts to be made from industry to services and within industry from heavy to light.[19] Changes in production technology will be needed because of the imposition of more stringent environmental policies, the higher quality standards of new Western markets, and the downsizing of factories that are of inefficient scale for a market economy.[20] Large changes in market orientation follow from the demise of the CMEA and the desire to become more fully integrated in international markets.

The foregoing argument gains additional force when one acknowledges the strength of entry and exit processes in capitalism. In a normal market economy, there is substantial turnover of firms. If this process were imitated during the next few years in Eastern Europe, a substantial number of enterprises would be expected to close anyway. For example, only 60 percent of large, new, single-plant firms survive their first five years of operation in the United States (Dunne, Roberts, Samuelson 1989, p. 694). Given the status of East European enterprises--large organizations being cast into a new market environment--one could expect their failure rate after privatization to be of the same order.

The implication of the previous discussion is that perhaps too many hopes have been invested in privatization and rather too much intellectual, social, and political capital is being consumed in the process of privatization. This is especially the case when the efforts behind privatization are contrasted to the lack of attention being paid to creating and fostering the development of new private sector firms. In many East European countries, policy toward the private sector can be characterized, at best, as one of benign neglect. In particular, little attention has been paid to the question of how to generate the additional capital to realize investment in the private sector.[21]

In fact, in the early stages of reform, there is a trade-off between efforts to create a new private sector and the speed and scope of privatization. In the centrally planned period, the state extracted the surplus from its enterprises and used it to reallocate investment across sectors. During reform, the state could either surrender its claims on such revenues through

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[19] If one compares the size of industry in an average East European economy to that in the poorer European countries, then the over-production of industrial goods is probably between 25 and 33 percent.

[20] On the basis of very crude calculations, I estimate that the East European economies would have to shut down half of the manufacturing capacity of large plants (and create a similar amount of capacity in small plants) in order to obtain a distribution of plant sizes that was roughly comparable to that in Western Europe. In individual industries, such as textiles, the figure could be as large as 70 percent.

[21] Other authors (e.g., Svejnar 1990) have consistently emphasized the benefits that can come only from a new private sector, rather than from privatized firms. However, it is my perception of the literature that such emphases are not the major focus of the majority of discussions of the transition process. For example, it is common to see the terms "privatization" and "creating a private sector" used synonymously. Conversely, it is quite unusual to find authors who emphasize the costliness of the privatization process and the need to slow down this process in order to channel resources to the new private sector.

decentralization and privatization or continue to use state-sector surpluses as a means of financing the growth of the private sector. In that case, there is an inverse relationship between the amount of privatization and the rate of growth of a new private sector.[22] This inverse relationship also occurs because a significant part of the country's entrepreneurial talents and scarce financial infrastructure will be consumed in the process of privatization itself, rather than being freed to participate in the new private sector. Moreover, the desire to privatize ongoing operations, rather than to sell their assets by the piece, leads to a lack of facilities, particularly buildings and land, that are easily available to new entrepreneurs.

In conclusion, one might venture the thought that "privatization" has gained too much prominence as an objective of reform policy. The appropriate goal is "creation of a private sector." Privatization is only one route to that latter goal. Moreover, it might be a very costly route, one whose implementation impedes more effective means of creating a private sector, particularly the encouragement of the development of the nascent private sector.

ON MARKET-BASED MACROECONOMIC STABILIZATION MEASURES

The evolutionary paradigm emphasizes that there is a strong tendency for organizations to continue behavior that has been successful in the past. If this is correct, there is one particular aspect of pre-reform enterprise behavior that would prove to be very dysfunctional in a swift change to a market-regulated regime. Kornai (1980) has emphasized that excess demand pressures are almost intrinsic in the operations of economies with large state productive sectors, due to enterprise manipulation of soft-budget constraints. When reforms are being implemented, the organizational behavior that led to excess demand in the past is likely to be an important determinant of economic outcomes. Until a process of large-scale restructuring and entry and exit has taken place, it is likely that the East European economies will have a much stronger tendency to generate macroeconomic instability than economies that have had dominant private sectors in their recent past.

This prediction has been borne out in the recent reform experience of Hungary and Poland. Enterprises in those countries have used their previously learned channels of action against adversity in the new environment. Hence, there has been a very large growth of inter-enterprise credit in Poland and Hungary in the past year, after the reforming governments tightened banking system credit. The growth of inter-enterprise credit can be viewed as a simple continuation of the passive monetary system of central planning, where credits and debts were built largely to accommodate changes in the real side of the economy and where creditors were largely unconcerned about the risks of non-payment.

The essence of the problem of macroeconomic stability during reform lies in the incompatibility between the new market environment and the enterprise behavior and expectations

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[22] Exactly this trade-off is appearing in the most dramatic way in Poland. The Huta Katowice steel plant is under consideration for privatization and commercialization, but the government is reluctant to begin the process because of the drop in tax revenues that will result. Financial Times, 19 April 1991.

that are a heritage of the past.[23] The old systems accommodated themselves to certain features of enterprise behavior, among them the tendency to disregard financial constraints in the face of seemingly more urgent real priorities. Given the stability of the old system over a number of decades, one might conclude that, within the constraints of that system, such accommodation was successful in controlling or neutralizing those elements of enterprise behavior that had most immediate dysfunctional consequences.[24] Thus, policy and institutions under the old regime were matched to the behaviors and expectations of enterprises. But with a swift change to market-based stabilization policies and with the destruction of old institutions, deep problems arise when the old expectations are still held and when the old patterns of behavior continue.[25] Hence, market-based stabilization policies will be much more costly for reforming economies than they are in economies with a tradition of markets and private enterprise.

The main conclusion relevant to policy to be derived from the above observations is that during transition there might be a case for direct controls on state enterprises to promote macroeconomic stability, rather than relying upon solely market-based measures. At the very least, the economist's usual presumption of non-interference in markets can hardly be accepted without question. Certainly, for the state sector, price and wage controls, direct credit restrictions, and exchange controls must be considered as potential candidates for use by macroeconomic policy-makers.

The foregoing also contains lessons on the manner in which stabilization programs should be implemented. With the melange of old enterprises and new market institutions, there will be very little knowledge in society of how the new system functions. Hence, the early period of reform will provide valuable information about the characteristics of the new system. Where there is some element of irreversibility to the actions involved in stabilization,[26] there is some value to implementing a stabilization program with caution. The existence of learning implies that there is value to be had from preserving options through the implementation of appropriate policies (Arrow and Fisher 1974).

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[23] An interesting example of this phenomenon has been identified in capitalist economies in the period after deregulation of an industry. In such cases, it has been observed that firms continue cartelistic behavior, using the very instruments that were legal before the deregulation took place.

[24] The old centrally planned system was moderately successful in keeping macroeconomic imbalances in check, in the sense that these imbalances did not threaten the short-term stability of the system. In such a way the system accommodated to the most immediate consequence of state-sector financial indiscipline. Of course, all the negative effects of macroeconomic imbalance on productivity, work effort, and quality emphasized by Kornai (1980) were not ameliorated.

[25] One East European central banker explained the extending of inter-enterprise credit by saying: "If only our managers had just once seen a company not paying its debt, but this is not part of our corporate culture."

[26] Elements of irreversibility include, for example, decentralization of the enterprise sector and loss of the government's political capital if there is a failure to keep to commitments.

Moreover, while learning is taking place, it might be unwise to base stabilization too heavily upon schemes that depend upon "nominal anchors." The fixing of such anchors relies upon the necessarily scanty knowledge about the structure and behavior of the newly reformed economy. Hence, such anchors can only be set with large margins of error, thus causing the stabilization program itself to be wide of its target, putting the government under the severe pressure of weakening its very commitment to stabilization. Hence, observers of the Polish economy comment frequently about the overshooting that was the cause of the unexpectedly large macroeconomic adjustments that occurred in the first part of 1990. It is crucial, however, to emphasize that this overshooting must not be viewed as the result of mistakes or poor planning. Rather, it was a normal outcome for a stabilization relying upon the setting of nominal variables in an environment where policy-makers are only beginning to understand the structural features of the economy.[27]

The points emphasized in the preceding paragraphs gain extra force when stabilization is considered within the context of the reform process as a whole. In that process, the creation of a viable private sector is the *sine qua non* of success. The essence of market-based stabilization policies is to contain the expansionary impulses of enterprises and firms, usually by imposing very tight money policies and high real interest rates. These policies will, if the state and private sectors are treated symmetrically, greatly constrain the growth of new private-sector firms at a time when the economy most needs them.[28] Hence, one observes again the very important trade-off between the creation of a private sector and the short-run decentralization and marketization of the state sector. That initial decentralization, before privatization, will impede the development of the new private sector in a manner that will ultimately lengthen the transition itself. In deciding whether only market-type stabilization measures are to be used or whether more dirigiste policies might be countenanced, one should perhaps consider whether the growth of the private sector might be a more important goal than decentralization of the state sector.

DO EXISTING INSTITUTIONS HAVE ANY VALUE?

To some reformers, a market economy is synonymous with the decentralization of decision-making. In this view, the destruction of the existing control institutions of central planning is sufficient to lead to a viable market economy.[29] That notion, together with some

[27] The Polish stabilization policy depended rather crucially on estimates of the appropriate exchange rate and forecasts of the rate of inflation, which helped to establish monetary and credit targets and affected enterprise evaluations of the implications of the tax-based wage-control measures.

[28] In the Polish stabilization, the tight credit policy applied both to the private and state sectors, as did the draconian wage-control policies. Thus, despite all the exaggerated claims for the growth of the private sector in Poland in 1990, investment in the private sector went down from 1989 to 1990. See Rzeczpospolita (Warsaw), 2 February 1991.

[29] This view was shown to me most clearly by a top official of a reforming regime who proudly boasted of the "liquidation" of the central planning apparatus, at a time when no market economy institutions had been created.

justifiable resentment of the past impositions from the center, probably contributed in no small degree to the destruction of the old system of planning and control in many countries in the latter half of the 1980s, before any market institutions had been created. In turn, that destruction, together with the accompanying decentralization of decision-making, was the proximate cause of the loss of macroeconomic control that was evidenced in a majority of East European countries in the late 1980s.

But this market-as-decentralization view overlooks the role of the many important institutions of control present in modern capitalist systems, each contributing at a microeconomic level to macroeconomic stability. First and foremost, there is the institution of private property which places responsibility at the individual level, especially the immediate responsibility for obeying budget constraints. Second, there are large sets of institutions ensuring that allocation of responsibility is clear and can be enforced--for example, commercial codes, civil law procedures, collateral, and bankruptcy. Third, there are the institutions that monitor and control the behavior of those who hold the property of others in trust--accounting practices, banking regulators, stock markets, securities regulators, and so forth. Lastly, there is a whole set of expectations about the way other economic agents will behave, and these expectations apply most importantly to the actions of government itself.[30]

It is a given that these institutions will take many years to create.[31] Thus, there is a decision to be made at the beginning of the reform process concerning how society is to exert the necessary degree of control over the actions of economic agents in order to preserve budgetary, financial, and monetary stability during the early stages of reform. The central issue in this decision is whether it is optimal at the earliest stages of reform to rely exclusively upon the disciplining force of the free market. The alternative is, of course, to use some of the existing state institutions on a selective and temporary basis to exert control over the state enterprises in the period before privatization and creation of market institutions can take place.[32] Although this latter alternative is politically less attractive, there are some economic arguments implying that this option should be put on the agenda for consideration.

The suggestion of using some of the existing structures of the old regime rests upon the thesis that the creation of workable institutions and organizations is a lengthy process requiring much trial and error. The information and skills of existing personnel are attuned to the existing set of institutions and lose much of their value when those institutions are destroyed. In situations of increasing uncertainty, that is, reform, the value of information sources increases

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[30] In the foregoing, I have emphasized the control functions of the institutions of capitalism rather than their incentive properties. There is no implication here that those incentive properties are less important in the long run. Rather, it is the control functions that need to be emphasized in the present discussion of the treatment of state enterprises, before they are privatized.

[31] For example, Fischer and Gelb (1990) cite the very revealing fact that it takes five years to train a bank examiner in the United States. Furthermore, the privatization process is inherently a slow one.

[32] Here, I emphasize that the nascent private sector should not be subject to the same control.

(Hess 1982). Therefore, some economic value might lie in existing institutions, even though they are not the best from a long-run point of view and even though there are firm intentions to scrap these institutions during the transition process. This argument is, of course, the obverse of the argument that privatized firms might not be able to change to fit the requirements of the new capitalist market: the old institutions might still be useful for temporarily carrying out the tasks for which they were originally designed.

What possible job could the old institutions do in the early stages of reform? One property of traditional central planing--probably much envied by some reforming regimes--was the ability of the old system to produce some semblance of macroeconomic balance.[33] The traditional central planning systems had a passably good record of budgetary, financial, and monetary stability (of course at a cost in terms of economic efficiency). There is thus a *prima facie* case to suggest that some elements of the traditional central control system could be retained in the early stages of reform.[34] This case is strengthened once one realizes that there is virtually no example to which one can point of a decentralized socialist economy that has evidenced macroeconomic balance and stability. (Privatization takes long enough that reforming economies are still dominantly socialist ones in the first few years of reform.) Decentralization and liberalization can occur too early. Old inefficient institutions may be better than ones that are planned, but which do not yet exist.

Beyond these remarks, there are good reasons not to be more precise when talking about reforms in general. Given the differing histories of different countries during the period of central planning and given that each country is now at a different stage of reform, few general points can be made. Analogous institutions will have functioned with varying degrees of effectiveness in different countries. Reform and change might have already irreversibly destroyed many institutions of the old systems. Nevertheless, at the beginning of the reform process policy-makers should take stock of the effectiveness of the existing institutions and ask whether there are some that would be useful in the early stages of reform.

I will conclude this section with a theme that has run through the conclusions to previous sections. This theme is the trade-off between the reform of the old state-sector institutions and the creation of new private-sector ones. In the context of the present section, this trade-off appears in two ways. First, if old institutions are immediately scrapped, there is an immediate need to create market institutions that help to control state enterprises. Assuming that there is a scarcity of talented personnel, some precious talent will be used in the state sector that might be more advantageously employed in creating the institutions most needed by the new private

[33] In questioning the veracity of this statement, the reader should keep in mind the exact periods when traditional central planning was operating. For example, Poland had essentially given up economy-wide macroeconomic balancing in the mid-1970s. See Montias (1982).

[34] In particular, it would seem that there is an argument to keep some central control over the state enterprise use of credit, access to foreign exchange, and payment of wages.

sector.[35] Second, when the state is not willing to use the old state control mechanisms to constrain the activities of the state enterprises, the effects of their actions are much more likely to impinge on the nascent private sector. For example, monetary policy might need to be more stringent and foreign currency less available for the private sector, if the state eschews all non-market means of controlling its own enterprises. Hence, the growth of the new private sector would be slowed.

CONCLUSION: CONFLICT BETWEEN REFORMING THE OLD AND CREATING THE NEW

In this paper, I have explored the implications of using evolutionary economics to examine the central policy questions that arise during the early stages of the transition from socialism to market capitalism. One concern has consistently recurred in the discussions of the diverse elements of policy--the fact that there is a trade-off between promoting the growth of a new private sector and reforming the old state sector. The centrality of this concern arises from the basic insights of the evolutionary paradigm, especially the existence of rigidities in organizational behavior and the importance of entry and exit processes to the dynamism of capitalism. Hence, restructuring and privatizing the state enterprise system, which is the central hope of most transition plans, is bound to be a long and costly process, using resources that might be more profitably employed in facilitating the growth of the new private sector.

The case for a go-fast policy in the state enterprise sector weakens once one acknowledges the competition for scarce resources between the state enterprise sector and the nascent private sector. Rapid reforms in the state sector might actually impede the vitality of the entry and exit mechanism in the new private sector. Since this mechanism is vital in imparting dynamism to the transition, the overall speed of change in the economy might be inversely related to the effort spent on reforming the state sector.

Although inconsistent with the views of rapid marketizers who are in the majority in the Western academic community, the observations made in this paper do find reflection in the actual course of reforms. The economic reforms have proceeded at a much slower pace than the rapid marketizers first believed would be the case. Moreover, the need for non-market constraints on existing state enterprises is recognized even in the policies of the fastest reforming countries: wages are still subject to very severe controls, full convertibility has still not arrived, and domestic credit is still rationed. This paper shows why such constraints are consistent with the desire to create market capitalism as quickly as possible. However, it argues that such policies

[35] For example, the creation of a commercial code is probably more important to the new entrepreneurs who are building new commercial relationships and who do not have the backing of the state than to the state sector firms with their traditional ties. Hence, the creation of an authoritative commercial code at the outset of reform is essential if the emphasis is on the creation of a new private sector. However, this element of the legal infrastructure will perhaps receive lower priority when the new free markets are dominated by state-sector firms than when the government is concentrating on the needs of the new private sector.

of state-sector restraint should be set within a consistent program that promotes the growth of the private sector, rather than as epicycles patching up a free-market theory of reform.

Echoes of the conclusions reached in this paper can be found in other general analyses of reform that have appeared in the last year. Kornai (1990, p. 62) writes: "Precisely because I am a proponent of liberalization of the economy...I would like to see tight control over the ways in which taxpayers' money is spent. In this respect I classify the manager of a state-owned firm among the state officers." The identification of the possible conflict between liberalization of the economy and liberalization of the state sector, as well as Kornai's emphasis on organic development of the private sector, marks his theories as broadly consistent with an evolutionary approach. Similarly, the phenomena of "negative value added" and the "shoddy product syndrome," identified by McKinnon (1990), can be viewed as examples of the organizational legacies emphasized above. Moreover, the role of these legacies in justifying McKinnon's advocacy of a gradual reduction in tariffs is also consistent with an evolutionary approach to policy during the transition.

A significant omission in the argument of this paper is the political dimension of reform policy, which is obviously very important given the intertwining of democratic and economic transitions. The particulars of the politics of each country are important in defining the exact implications of the foregoing arguments, for at least two reasons. First, the efficacy of the old institutions during the transition will depend on the extent to which these institutions were dependent on the structures of the old political system. The lesser was this dependence, the more use will the old institutions have during reform. Second, it is possible that some reformers might see a non-economic, political need to destroy the old system. The structure and rhythm of the economic transition must certainly be attuned to the needs of the democratic transition from the old political structures. Indeed, this is one of the lessons of the evolutionary paradigm, which emphasizes the importance of the legacies of the past, both political and economic.

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NOTES ON CONSERVATISM AND ITS IMPLICATIONS FOR ECONOMIC POLICY IN EASTERN EUROPE[1]

Peter Murrell

INTRODUCTION

Social science, especially economics, does not center its efforts on the processes of socio-economic change. The concern within economics has traditionally been on end points: how to achieve the first-best Pareto efficient outcome, rather than deciding which problem to solve first; the implications of behavior under rational expectations, rather than the study of learning processes. This lack of emphasis on change has become increasingly apparent as scholars apply existing theories to the most momentous economic changes of our times-- the East European economic revolutions.

There are a few scholarly traditions that have placed the analysis of change at the center of concern.[2] Important among these is a set of works that might be grouped under the rubric "conservative political philosophy" or, perhaps more appropriately in the present context, "principles of democratic social reconstruction" (Popper 1971, p. 1). The leading works in this genre are Burke (1790), Popper (1971), and Oakeshott (1962).[3] This essay examines the lessons of conservative political philosophy for the process of economic change in Eastern Europe.

[1] The author would like to thank the Center for Institutional Reform and the Informal Sector (IRIS) at the University of Maryland for financial support in the writing of this paper. Norbert Hornstein is thanked for his key suggestions that led the author into the literature on conservative political philosophy.

[2] In economics, there are the sets of somewhat related theories called evolutionary economics, Schumpeterian economics, and Austrian economics. The accompanying paper examines the implications of evolutionary economics for the design of policies in the East European transition.

[3] In classifying these three authors together, there is no implication that there are not important differences between them. However, the similarities are obvious when one reads these works in the light of developments in Eastern Europe and particularly in contrast to the current works on the changes in that region.

The following two sections lay out the central assumptions of philosophical conservatism and explore the important distinction, made by Popper, between utopian and piecemeal social engineering. The fourth and fifth sections use this distinction to examine policies for the East European economic transition in two important areas: the place of workers' management in the transition and the relative properties of large-scale and small-scale privatization. The analyses of these two areas of policy are provided as examples of the application of the conservative philosophy of reform, which can in principle be brought to bear on all the major policy decisions in the economic transition from socialism.

ASSUMPTIONS

A central concern of conservative political philosophy is the way in which societies use the knowledge that is available to them. This concern arises most notably from two interrelated assumptions. First, there is the view that a large part of socially useful knowledge is acquired in the context of the prevailing set of socio-economic arrangements and is usable only in a narrow domain of that set. Second, there is the hardly controversial notion that politico-economic systems are vastly complicated constructs, especially when viewed in the light of limits on human intellectual capacities. These concerns run through the discussion that follows and are elaborated in the context of that discussion.

In almost all societies, the socio-economic framework has been built up in a gradual process of accumulating small changes.[4] As each new institution arises, it is fitted into a larger pre-existing structure. Therefore, the effectiveness of each piece of the socio-economic structure is deeply dependent on the existence of a network of institutions. The functioning of each institution cannot be understood as an isolated phenomenon, but only in the context of the particular set of working arrangements in which that institution sits. One might be able to understand and predict the effects of small changes or the marginal consequences of the presence or absence of a particular institution. One cannot hope, however, to break down the major elements of a society's socio-economic processes into separate components and then understand how the whole society works, at least at the present stage of the development of social science.

A society's institutional structure is an organic whole, the result, in successful societies, of a long historical process. The human capacity for understanding is small in relation to the complexity of such organisms. Therefore, in political matters, "we can never walk surely but by being sensible of our blindness" (Burke 1949, p. xiv). Or, according to Popper (1971, pp. 167-68), "It is not reasonable to assume that a complete reconstruction of our social system would lead at once to a workable system."

Thus, there is at the center of conservatism an extreme skepticism concerning the workability of any blueprint for a new society. Implicit in this view is the assumption that

[4] Moreover, it is assumed that this gradual process of change has been the case in <u>all</u> successful societies, as discussed later in the paper.

a vast number of rearrangements of society's institutions would produce worse outcomes than those that presently exist, while only a few would result in improvement. Moreover, since the present state of knowledge on socio-economic processes is so limited, policy-makers have not been able to discriminate between workable and disastrous theoretical blueprints for new social systems. This might be called the "bad bet" argument against radical change. (But not, as we will see, against all change.)

The preceding argument requires the assumption that the existing structure of society has been built by a process that selects those arrangements that, at least partially, take into account social welfare. If today's arrangements are randomly chosen--or worse, inimical to welfare--then a bad bet on a new blueprint might still be one that is worth taking. But this is a minimal requirement. This assumption does not imply that the present arrangements are anywhere near first best; the insistence is solely on some attention to human welfare in existing arrangements. For reasons discussed in the following paragraphs, this minimal amount of attention to the functional needs of society is unlikely to be present in a society that results from the implementation of a blueprint.

A distinct, but related, argument for conservative change begins with observations on the nature of a society's stock of knowledge and especially on the association between this knowledge and existing socio-economic arrangements. Following Oakeshott (1962, pp. 7-8), one might distinguish between two types of knowledge.[5] The first is technical knowledge, the set of explicit rules and articulable procedures that are used in undertaking an activity. This is the type of knowledge that can be conveyed by lecturers and systematized in textbooks. It is the type of knowledge that knows no borders and no boundaries.

In contrast, one has practical, or personal, knowledge, although this term should not be allowed to evoke the mundane. Practical knowledge is that inarticulate knowledge that is required in the effective performance of any activity and that can be acquired only by direct acquaintance with the activity. It is the knowledge of the scientist who has an instinct for the correct experiment to make; it is the knowledge of the experienced businessman who senses opportunities through a cloud of disparate facts. Because personal knowledge is acquired through activity, it is inherently specific to particular contexts. It can only be communicated between individuals by the joint sharing of experience and activity, as, for example, in apprenticeship.

All activities, whether science, art, politics, or economic policy-making, use of both types of knowledge. To the extent that one type of knowledge is missing or inappropriate, the resulting outcome will be that much poorer. This point is hardly worth stating for the first type of knowledge; we all know, for example, that it would be inadvisable to employ judges and lawyers who have not studied the legal code. But the value of the second type

[5] The distinction between the two types of knowledge has been offered by many authors, most notably Polanyi (1962). It is also the basis of much economic theorizing on the nature of organizations, see, e.g.,Nelson and Winter (1982) and Williamson (1975).

of knowledge is often overlooked. It is frequently suggested, for example, that legal codes can be transferred between countries, replacing existing codes and practices wholesale. What this suggestion fails to recognize is the practical knowledge that is essential to the interpretation and use of a legal code. Without this practical knowledge, which only exists in the working arrangements of a set of lawyers and judges, there is no reason to suppose that the transplanted legal code will have positive value.

Practical knowledge--of an economy, of legal arrangements, of a political system--is always acquired in a particular institutional context. Hence, the knowledge possessed by a society is most fully applicable within that society's present context. Practical knowledge loses much of its value when applied far from the framework of activity in which it was acquired. It is hardly likely to be productive in deliberating on the consequences of implementing some radical blueprint for a new society.[6]

Recognition of the existence of personal knowledge suggests that the productivity of small changes will be much greater than that of large changes. The ability of policy-makers to identify good policies decreases rapidly as those policies move society further from its existing position. Moreover, the nature of personal knowledge suggests that societies cannot quickly acquire the knowledge required to implement a blueprint. Many years of practice and, in the meantime, poor and very costly decisions are required to acquire the practical knowledge that is needed if the blueprint is to be implemented.[7] Thus, we have reached a second argument for conservative change--this might be called the "use of knowledge" argument.

UTOPIAN AND PIECEMEAL POLICIES

In order to draw out the implications of the forgoing, it is useful to employ a distinction drawn by Popper (1971) between Utopian and piecemeal social engineering.[8] Although the distinction is somewhat strained, it is apposite for expositional purposes in the

[6] For those preferring a somewhat mundane example of this principle, the variance of forecast error of regressions increases with the distance from the mean of present observations.

[7] The use of foreign advisers, who are experienced in the workings of a society similar to that envisaged in the blueprint, might seem to be one way to solve this problem of implementing the blueprint. There are reasons why this is not possible, however. First, the number of policy decisions is much too great compared to the number of foreign advisers that would be available. Second, many of the existing institutional arrangements will remain before the blueprint is implemented. The foreign advisers suffer from lack of the practical knowledge of these arrangements in much the same way that the domestics lack the knowledge of the blueprint society. Therefore, foreign technical assistance must be implemented through a meeting of the minds of foreign experts and domestic policy-makers.

[8] It is interesting to note here that Popper did not shrink from the use of the phrase "social engineering" when discussing the types of reforms that should be implemented in a democratic society. He does not argue against social engineering *per se*, but rather against specific types of social engineering. In particular, his arguments are addressed against reforms based on a utopian ideal.

present context. As with many artificial dichotomies that are useful for expository purposes, the contrast is really between the two extremes of a continuum, rather than between the only two possibilities.

Utopian social engineering begins most often with a radical critique of the existing arrangements of society, a denial that there is anything worth preserving in these arrangements, and a picture of what a better world would be like. The driving force of utopian policies is a blueprint of the end state of society, which usually has little in common with present arrangements. Policy measures en route are always framed in terms of this destination, rather than as departures from the initial situation, which contains nothing of worth. Since the existing institutions of society are so different from and so incompatible with those that are in the target blueprint, and since these existing institutions are presumed to have no value, the initial phases of utopian engineering always center more on destruction than creation.[9]

Of course, there will be some institutional construction that can be done at the beginning of reform. However, the sheer complexity of creating workable social arrangements argues that the whole blueprint cannot be created quickly. Moreover, implementation of the blueprint is in principle impossible due to the inevitable inaccuracy and imprecision of the blueprint that exist for the epistemic reasons outlined above. Hence, those positive measures that occur in the early phases of a utopian project will inevitably involve planting in place one of the pieces of the blueprint jigsaw, even though the remaining pieces are nowhere to be found quite yet.[10]

The emphasis on the final destination and the willingness to throw away existing arrangements both lead to policies that are inevitably irreversible. In the utopian approach, reversible policies are harmful. For those with faith in the blueprint and the ability of a society to implement it, the tenacity of the old, together with its intrinsic worthlessness, mean that irreversible policies have much benefit. Policy-makers must ensure that society can never go back because that isolated island in the storm is simply a temptation not to advance to more fertile shores.

Given the view of knowledge described in the previous section, it is easy to see why a conservative perceives grave dangers in the utopian approach to social change. The "use

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[9] There is one philosophy in which destruction is all that is needed. This is the philosophy that derives from primitive economics--perfect competition, with a dash of the Coase theorem--emphasizing that the market is simply the freedom to engage in the propensity to truck, barter, and trade. That is why a belief in a crude laissez-faire doctrine interacts most unfortunately with the utopian approach.

[10] A perfect example of this occurs when reforming countries implement currency convertibility under the assumption that a working private sector will follow quickly from privatization. This assumption shows all signs of being incorrect for two reasons. First, the privatization process is obviously a very slow one. Second, privatized firms will not necessarily behave in the fashion of classical private sectors, which have been created in an evolutionary process.

of knowledge" argument stresses that a radical move destroys much of the valuable knowledge in society. Practical knowledge, dependent as it is on a specific configuration of society's arrangements, is only useful for judging the effects of small changes. Hence, individual policy-makers will have little ability to construct new arrangements that will lead society reliably to the destination laid out in the blueprint.[11] In the process of trying to get to the destination quickly, one destroys the knowledge of how to get there certainly. Then the "bad bet" assumption becomes relevant: unanticipated consequences become a major determinant of the outcome and there is every probability of finishing up in a worse position than at present.

The foregoing critique of the utopian approach can be challenged, of course, by denying its central assumptions. The following seem the most important criticisms of these assumptions:

1. One might argue--and this is heard frequently in the East European context--that existing arrangements really have no utility (presumably compared to those that can be easily established at the beginning of a move to a final blueprint). This is also an argument that was made very strongly by socialist revolutionaries in the early parts of this century.

2. It might be claimed that we really do have a good understanding of how societies work and that this understanding is relevant outside the specific historical context in which it was acquired. In the present context, this means that economists really do know how capitalist societies work and that this knowledge is relevant outside developed capitalist countries. Keynesian economists--the majority in the 1960s--of course frequently used this argument against their conservative critics.

3. These understandings can be communicated quickly to the policy-makers who will be implementing the new policies. In the present context, East European banking officials, legislators, politicians, and others can be relied upon to acquire quickly the skills that are relevant to their new roles in the market economy.

Suppose, however, that one believes that these three claims are incorrect. Utopian social engineering will then be, at best, unproductive and, at worst, thoroughly dangerous. What alternatives are there? Popper (1971) advocates piecemeal social engineering. In this approach to "democratic social reconstruction," the emphasis is not on a blueprint for the end state, but rather upon identifying the worst problems of the existing set of arrangements. Intellectual efforts are primarily focused on solving these problems in the specific institutional context in which the solutions will be implemented.

Piecemeal social engineering places an emphasis on reversible changes, insofar as these are possible, since one cannot necessarily expect society's limited knowledge of socio-

[11] The use of knowledge argument also implies that the blueprint itself will inevitably be flawed.

economic processes to produce even small changes that are necessarily beneficial. Finally, there is a preference for replicating policies that have been used in a similar institutional context or for widening the scope of experiments that have worked on a smaller scale within the existing system.[12] The risks in the introduction of the new are then minimized.

The emphasis is on gradual change for a variety of reasons. First, the larger the number of institutional changes that are implemented simultaneously, the more difficult it is to design a workable set of arrangements. Second, reversibility is enhanced by making changes slowly. Bad policies can be stopped midstream. Third, with gradual change, society can accumulate practical knowledge of the new arrangements as this knowledge is needed. There is a chance to experiment on a smaller scale and to provide usable feedback on which policies work and which do not.

The arguments encapsulated above in the distinction between utopian and piecemeal engineering are summarized in Table 1. These arguments for gradual change are offered in the present context not with any sense that they are obviously correct, but rather with the suggestion that they are worth considering in the context of the massive changes in Eastern Europe. They do derive from an important tradition--one that has given insights into the problems caused by massive socio-economic changes in the past.

Perhaps the best capsule summary of the arguments offered above is provided by Oakeshott (1962, p. 172). He lists the implications of the conservative temperament for matters of innovation and change:

> First, innovation entails certain loss and possible gain, therefore, the onus of proof, to show that the proposed change may be expected to be on the whole beneficial, rests with the would-be innovator. Secondly, [the man of conservative temperament] believes that the more closely an innovation resembles growth (that is, the more clearly it is intimated in and not merely imposed upon the situation) the less likely it is to result in a preponderance of loss. Thirdly, he thinks that an innovation which is a response to some specific defect, one designed to redress some specific disequilibrium, is more desirable than one which springs from a notion of a generally improved condition of human circumstances, and is far more desirable than one generated by a vision of perfection. Consequently, he prefers small and limited innovations to large and indefinite. Fourthly, he favours a slow rather than a rapid pace, and pauses to observe current consequences and make appropriate adjustments. And lastly, he believes the occasion to be important; and, other things being equal, he considers the most favourable occasion for

[12] Interestingly, this is a characterization of what is arguably the most successful reform that has yet been implemented in countries moving from central planning. The Chinese reforms began not with a grand plan on the part of the leadership, but rather with the leaders validating and spreading an experiment that had been conducted under the initiative of the leadership of some localities.

innovation to be when the projected change is most likely to be limited to what is intended and least likely to be corrupted by undesired and unmanageable consequences.

This summary leads us to one final observation, that the term "conservative" is much misused in many parts of the reforming socialist world. This term does not denote those who are against change *per se*, as seems to be assumed in the Soviet Union. For conservatism is about types of changes, not their existence. Nor does the term denote those who advocate radical measures to implement capitalism overnight, as is the case in Czechoslovakia. For conservatism eschews ideological blueprints. Nor is there any necessary association between conservatism and the various positions that one might take on such matters as the appropriate size of government, the role for income redistribution, and so on. One can be a "liberal" in the American sense or a "liberal" in the European sense and still be a conservative. For conservatism is about how societies should change, not about where they should finish up.

The importance of the above discussion in the context of deliberations on East European economic policy should be obvious. In the remainder of the paper, I give examples of the application of the conservative outlook for present policy debates in Eastern Europe. The two examples focus on the role of workers' management in the transition and the types of privatization schemes that are being implemented.

ON PIECEMEAL PRIVATIZATION VERSUS MASS PRIVATIZATION

There seem to exist two basic models for the privatization of large state enterprises in Eastern Europe.[13] The first model is one of a variety of piecemeal actions. This involves waiting for groups of interested parties to arise with sufficient funds, seeking out foreign buyers, constructing ad hoc lease-purchase arrangements, and perhaps giving away some enterprises when there is only one potential "buyer" at a zero price. Above all, this approach to privatization is signified by patience, a heavy emphasis on traditional forms of the market mechanism to exchange ownership rights, and the search for traditional types of owners. These three features are of course interrelated. The need to wait arises from the search for a variety of arrangements for privatization, each identifying a buyer willing to risk his or her own resources in undertaking ownership.

The alternative model stresses the need for speed. Speed implies that a large number of privatizations be carried out simultaneously using a single method. Because privatization on such a mass scale has not been accomplished before, this method requires the creation of wholly new procedures and institutions (voucher trading schemes, new mutual funds, etc.). It must be stressed not only that these institutions and procedures are new to the country in question, but also that there are no close models from other countries on which to base

[13] Of course, this is a gross simplification, again for expositional purposes. See Stark (1990) for an excellent discussion of the various dimensions of privatization.

their design. Hence, the foundation of the mass privatization method is pure theory. The builders of the huge institutional structure are primarily technocrats, whose stake in this process is necessarily trivial compared to the amount of resources that their schemes affect. In contrast to the usual mechanisms of markets or pluralistic democracies, the mass of the population and important economic interests have limited influence on this process.

The critique of the two methods of privatization is transparent once one combines the few details given in the last two paragraphs with the analysis provided in the second and third sections of this paper. There is no need here to give that critique in detail. Rather, it is given as a summary by using the structure of Table 1 to contrast the two schemes. The resultant comparison is provided in Table 2.

ON WORKERS' MANAGEMENT IN THE TRANSITION

It is common to find the argument that there cannot be a third way--between capitalism and socialism--in the transition. Most notably this argument is targeted at those who advocate some form of worker's ownership of enterprises during the transition to a market economy. This argument is ultimately end point based. When emanating from Western economists, it is usually driven by two familiar pieces of logic. The first is the theoretical analysis that implies that several perversities result from workers' ownership in a competitive economy. The second element in the argument is the observation that there are few successful economies in which workers' management has been prominent. Given that this ownership form was perfectly legal in most developed economies, its lack of use shows its inefficiency.

I do not take issue with either the theory in the first line of argument or the empirical interpretation in the second. Moreover, I would agree that these arguments, especially the second, imply that it is unlikely that there will be workers' management at the end of a very long transition. But, as one should guess from the previous discussion, this does not mean that these two pieces of logic sustain the conclusion that workers' management cannot begin the transition. This conclusion relies too much on the notion that initial policies should be guided by the target blueprint, the utopian view.

The piecemeal approach would first ask a series of questions about the importance of workers' management in the economy undergoing reform. It would ascertain whether the principle of workers' management, and its organizational embodiment, is a deep part of the country's tradition. If the answer to that question is in the affirmative, then the short-term productivity of society's practical knowledge will be intimately tied to the continuation of workers' management. In such a situation, the knowledge of how to organize enterprises is contingent on the existence of workers' management, as is the intuitive knowledge that policy-makers possess about the economy's responses to exogenous events and to policy changes. A quick move away from workers' management would destroy this practical knowledge, which cannot be replaced by even the instantaneous and complete acquisition of formal knowledge of the new system. Consequently, the productivity of enterprises and the effectiveness of policy-makers would be reduced to some large degree by the destruction of an existing system of workers' management.

In those societies in which workers' management is important, the piecemeal approach would then seek to determine whether workers' management is the principal cause of the society's problems. Such a determination could not rely on theoretical strictures concerning the behavior of a worker-managed economy compared to an idealized system, since that idealized system is exactly the one that reforming economies will not have in the near future. Obviously, then, ascertaining whether workers' management is really one of the crucial problems of the economy is not an easy matter. But that becomes a crucial point, since a conservative approach would require burden of proof to be on the side of the zealous reformer, when scrapping large elements of both society's institutional capital and its stock of knowledge.

The preceding discussion implies that the decision on the role of workers' management in the transition must begin with a series of questions about the nature of the existing system in a specific country. I have some guesses concerning the answers to these questions and know that these answers vary between countries. In most cases, however, the answers would depend upon deep contextual knowledge about the country in question. This is perhaps the most important point to be made. That point makes it obvious that the blanket dismissal of workers' management as an element of transition policy is totally unsustainable, except in an approach that assumes that the institutions of a new economic system can be designed and reliably implemented instantaneously.

In countries such as Yugoslavia, and perhaps Poland, it is plausible that workers' management is deeply embedded in the existing economic fabric. In that case, there seems to be little justification to eradicate it at the beginning of the process of transition. This does not mean that workers' management is expected to survive the transition nor, especially, that it should be helped to survive the transition. There will surely be rapid growth of the capitalist sector over the next few years. It is clear that fair competition between this sector and the workers'-management sector must be a vital element in the transition process. Competition for survival--the most important missing element under socialism--should determine the end state of the reform, not ideas about the ultimate nature of good societies that are applied at the beginning.[14]

CONCLUSIONS

The above analysis ultimately rests on a distinct vision of the way in which successful socio-economic systems are created and the way in which some of the mostly costly socio-economic experiments of history were generated. Those living in Central and Eastern Europe, above all, should need no reminding of the huge costs that can befall societies when

[14] Murrell (1990) argues that the absence of competition for survival among economic units was the most important problem of East European economies.

utopian blueprints are implemented. It is surely no coincidence that Popper's distinction between utopian and piecemeal socio-engineering should have been developed in the 1930s and 1940s. (And indeed no coincidence that Burke's most famous work was written in 1790.)

The vision of socio-economic progress presented above emphasizes that successful socio-economic systems have seen their institutions build up slowly in a succession of relatively small changes. Revolutions against an existing system, intending to destroy it, invariably result in excess in another direction and failure in some other way.[15] Of course, in the present context, it is perhaps fruitless to hope that either East European policy-makers or their Western advisers would take the lessons of Burke, Popper, and Oakeshott seriously. Therefore, I do not hope to offer the above analysis as a normative exercise relevant to the development of East European policy. Rather, it is a predictive exercise for the events of the 1990s. In that case, the successes and the failures of Eastern Europe in the economic transition <u>from</u> socialism will provide a test of the applicability of a political philosophy that last had a burst of energy in reaction to the transition <u>to</u> socialism.

[15] Those tending to disagree with this statement would, I presume, most readily cite the English revolution of 1688 and the American revolution of 1776 as counter-examples. This is not the place to discuss interpretation of history. But it must be noted that Burke, for example, interpreted both events as situations where a monarch was overstepping the bounds that had been created in a long period of historical development. Therefore, the majority of "revolutionaries" were in fact quite conservative in intent, as later events indeed showed.

Table 1: Characteristics of Utopian and Piecemeal Approaches to Policy

Utopian	Piecemeal
1. End Point Driven. Choice of initial policy determined by the goal for the final outcome of the process.	1. Focus on Immediate Problem. Identifies worst problems, trying to solve them largely ignoring the effects of today's decisions on some long-run equilibrium.
2. Clean the Slate. Emphasizes the interrelatedness of society's problems and therefore the need to make a decisive break with the past, with the necessity of institutional destruction in the first stages.	2. Use Existing Institutions. Recognizes that new structures can be created only slowly and accepts that existing institutions are usually better than either none or hastily constructed alternatives.
3. Large Leaps. To make a decisive break from the constraints of the past, advocates bold policy steps that involve packages of many new institutions.	3. Small Steps. Emphasizes the risks from going too fast and the impossibility of successfully creating a network of interrelated institutions anew.
4. Faith in the New. Willingness to trust in theoretical reasoning as the primary input for the design of society's new arrangements.	4. Skepticism. Search for existing models and methods to help in the formulation of institutional changes.
5. Irreversibility. In the weak form, willingness to accept large irreversible changes. In the strong form, emphasizes the need for them.	5. Reversibility. Advocates policies that facilitate feedback on their effects and that can be stopped or even reversed.
6. Design and Theory. The most important intellectual resource for policy-makers is the knowledge held by theoreticians and technocrats.	6. Judgment and Practice. The most important intellectual resource is the practical experience accumulated in the context of a particular set of institutional arrangements.

Table 2: Characteristics of Two Privatization Approaches

Large-Scale	Gradual, ad hoc
1. End Point Driven. Attempt at immediate implementation of ultimate goal of reform--capitalist economy.	1. Focus on Immediate Problem. Unclear property rights can be solved without immediate privatization; solution to lack of competition necessarily lies outside the existing enterprise structure (in the creation of an environment where entry of new firms is easy).
2. Clean the Slate. As soon as possible, erase all non-capitalist ownership forms.	2. Use Existing Institutions. Validate and strengthen some existing property rights; rely on state control during the lengthy period before all enterprises can be privatized.
3. Large Leaps. Many privatizations handled simultaneously.	3. Small Steps. Each privatization is an individual decision involving different actors.
4. Faith in the New. Theoretical reasoning establishes the nature of the voucher schemes, the new forms of mutual funds, and new managerial incentive schemes.	4. Skepticism. Rely on the tried and tested features of market processes.
5. Irreversibility. Once the scheme is launched new property rights are issued, the revocation of which would destroy the whole reform.	5. Reversibility. Each separate privatization is, of course, not reversible. However, the general policy can be amended and changed easily.
6. Design and Theory. Relies on the skills of technocrats and standard intellectual approaches for the design of new institutions.	6. Judgment and Practice. Uses decentralized judgments of many participants on the forms and scale of privatization and the post privatization structure of ownership and corporate control.

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